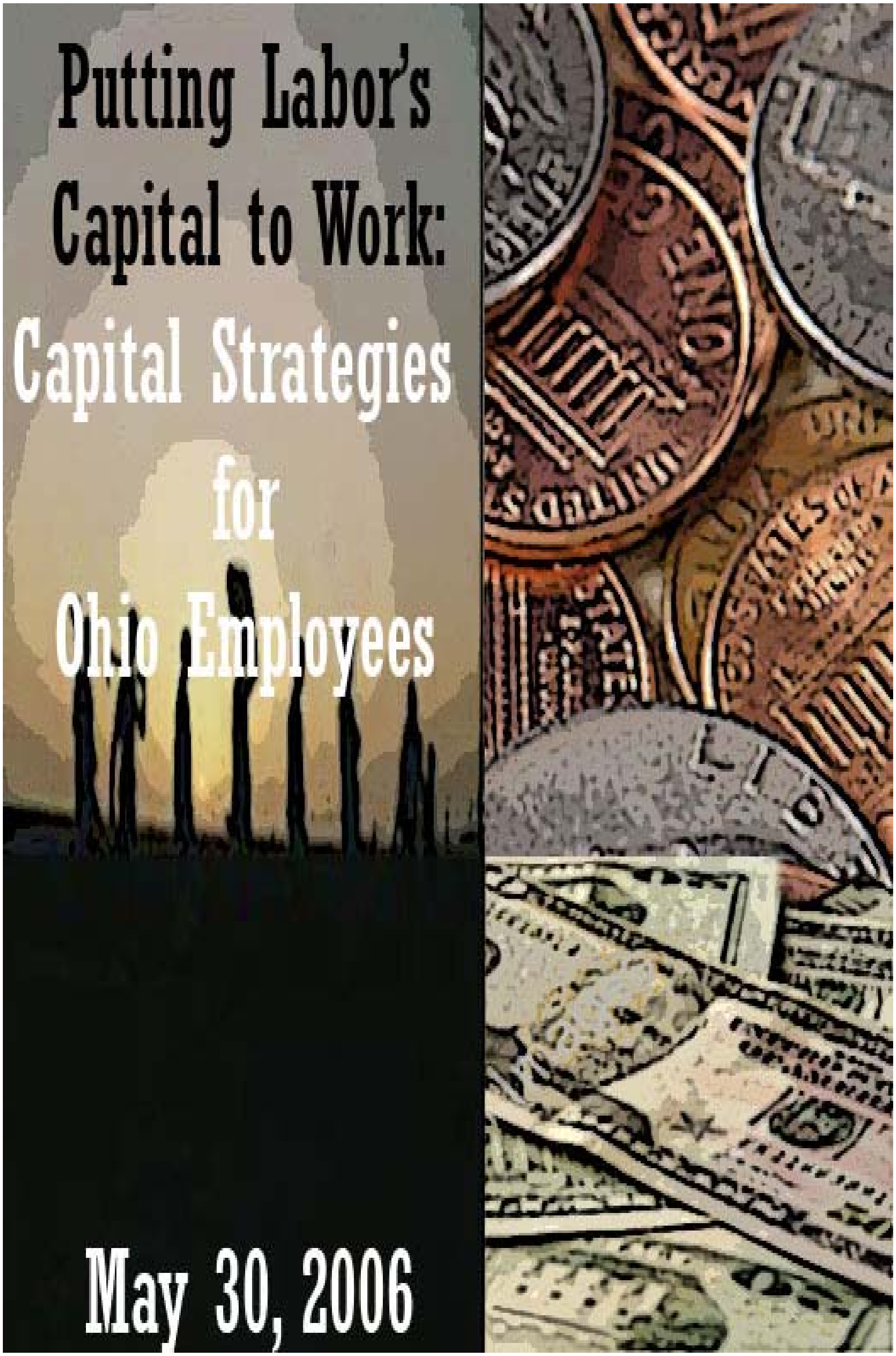
Putting Labor's
Capital to Work:
Capital Strategies
for
Ohio Employees
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Executive summary

Pension plans have become the primary source of savings in the United States. Although they are nominally the property of pension plan participants, they are invested in ways that often do more harm than good to sustain employment and wages of plan participants while they are in the labor market. Can we develop strategies for pension investment that not only provide good retirement incomes but also help sustain employment at good wages and benefits and good community economies in Ohio?

Economically targeted investment (ETI) policies ("double bottom line investing") offer an alternative to conventional pension investment strategies which focus only on financial return. This paper explores the experience with such investments sponsored by labor at home and abroad in the building trades, in public employee funds, and in the Canadian labor-sponsored investment funds. Returns have generally matched or exceeded those of their investment benchmarks.

The paper goes on to look at the legal regime concerning ETIs governing different categories of pension funds in the US. Ironically, ETIs have developed primarily in the categories with most restrictive legal investment regimes: ERISA governed multi-employer pension plans and state and local public employee pension plans. This appears to reflect both the presence of labor representatives in the governance structure of both categories of plans and the commonality of interests between labor and employer representatives in strengthening the industry or the community. In no American case, however, do ETIs comprise anyway close to a majority of any fund's placements. The California Public Employee Retirement System (CalPERS) represents the top with 11% of assets placed in California.

By contrast, in the more permissively regulated "self-directed" sector of IRAs, 401(k)s and 403(b)s, ETI funds have not been created. Yet the legal regime in these sectors would permit as aggressive a use of ETIs as has been the case in Canada.

We make a particular argument for ETI fund investment that encourages employee ownership. This is double-bottom line investing at the max: higher wages and benefits, higher local multipliers, greater local reinvestment, greater economic growth, fewer layoffs in recessions, and creation of locally anchored wealth which stabilizes property values and the tax base.

The paper concludes by discussing what could be done to make ETI investments and investment opportunities more generally available to working Ohioans, and some of the roles that labor can play in achieving that end. It looks particularly at targeting pension fund investments to strengthen community economics while increasing well paid employment through targeting investments in small and medium-sized manufacturing firms and in employee-owned companies.

Introduction: Ohio's economic stagnation

Ohio is undergoing major economic change. Once a manufacturing state with family incomes above the national average, Ohio has been undergoing a long-term relative economic decline that seems to have accelerated in recent years. Between September 2000 and March 2006, Ohio has lost 261,000 manufacturing jobs, 24% of our manufacturing base (Table 1). The manufacturing jobs lost typically paid higher wages and had better benefits than the service sector jobs which have replaced them. Moreover, the manufacturing jobs lost had a higher multiplier effect: Not only do their higher wages and benefits support greater ability to consume, but manufacturing processes typically create more jobs among suppliers than service employers do. The consequence is that the number of people employed in the state has also fallen by 200,000 over the last six years. You'd think we were at the bottom of a recession, but we're not. We are in the sixth year of an economic expansion, albeit a jobless one. What's wrong?

Table 1. Change in US and Ohio employment and manufacturing employment, 2000-2006

	September 2000	March 2004	March 2006
U.S. Non-Farm Employment	131.8 million	130.5 million	134.9 million
Proportion of population 16-65 employed	64.2%	62.2%	63.0 %
U.S. Manufacturing Employment	18.4 million	14.3 million	14.2 million
Ohio Non-Farm Employment	5.6 million	5.4 million	5.4 million
Ohio Manufacturing Employment	1.07 million	828.3 thousand	808.6 thousand

Source: US Bureau of Labor Statistics. Numbers are seasonally adjusted.

Part of the answer is how we invest (and how we don't invest) our largest single source of new capital available: pension funds.

1. The rise of pension savings in our economy

The largest single source of new capital in the United States every year isn't family savings -- not even the family savings of those families who got the benefits of the tax cuts on dividends and capital gains that Congress passed in 2003. Rather it is pension funds – workers' deferred wages. Today total workers' pension funds in employer-sponsored defined benefit and defined contribution plans amount to about $8.4 trillion dollars; in Individual Retirement Accounts, to $3.5 trillion; and in reserves at life insurance companies for annuitized pensions for current retirees, $2.1 trillion – a total of $14 trillion (Federal Reserve, 2006: Tables L.118-120, L.225, and L.225.i).

The assets of employer-sponsored plans have grown extraordinarily rapidly: from about $500 billion in 1977 (Rifkin and Barber 1978: 10) to $1.1 trillion in 1981 to $3.4 trillion in 1996 to $6.8 trillion in 2001 (Solomon 2002) to $8.4 trillion today. By comparison, the total value of all publicly traded companies in the US is around $11 trillion. Employee pension funds own about 45% of all publicly traded equities (Hebb 2001: 2).[1[1]]

Additionally American workers held $3.5 trillion in Individual Retirement Accounts at the end of 2004 (Federal Reserve 2006). Including IRAs, total pension assets amount to $11.9 trillion.

The pension fund landscape

The landscape of our pension system is a bit complicated. Besides Social Security, which remains the foundation of the retirement system for most Americans, there are six significant categories of pension plans:

> 1. "Taft-Hartley" multi-employer funds that are jointly administered by labor and companies of about $400 billion. These may be either defined benefit or defined contribution but are typically defined benefit.
>
> 2. Defined benefit single company pension plans -- about 29,650 plans in 2004, down from about 112,000 in 1985 according to the Pension Benefit Guarantee Corporation. These funds belong to workers as their deferred compensation but are generally administered by the companies with almost no employee voice, and they contain more that $1.4 trillion (Federal Reserve, 2006: 113).
>
> 3. Defined benefit state and local public employee funds that more often than not are jointly administered by labor and management of about $2.7 trillion
>
> More than $145 billion of that -- or about 7% -- is in the 5 Ohio public employee funds.

[1[1]] The rest is invested in bonds, real estate, "hedge funds" – which don't actually hedge risks but are vehicles for speculation, and private equity.

Ohio's public pension funds are among the largest in the country. At the end of 2005, the Ohio Public Employee Retirement System (OPERS) ranked #16 with over $69 billion in assets and the State Teachers' Retirement System (STRS) ranked in the top 25 with $59.6 billion in assets (June 30, 2005) among all American pension funds in size of assets.[2[2]]

4. Defined benefit Federal employee pension funds with $1.1 trillion in assets (12/2005). Like the Social Security reserve fund, these are invested largely in Federal securities to finance the Federal government's deficits.

5. Defined contribution plans sponsored by employers hold about $2.8 trillion (2005) and are the most common in terms of numbers covered. Employer-sponsored DCPs cover almost 50% more workers today than all the first three defined benefit plans (58 million in the DCPs to 42 million in DBPs). They use individual accounts – 401(k)s with $1.8 trillion (2003) or 403(b)s with $560 billion (2003) are the largest components of this category – primarily which are self-directed within a limited series of choices made by employers but largely administered through mutual funds. These plans have the highest total administrative cost of any part of the pension system which can approach 3% of the assets under management annually. Workers select individual investment choices among the very limited universe of choices presented by employers.

6. Defined contribution Individual Retirement Accounts (IRAs) held $3.5 trillion at the end of 2004 (Federal Reserve, 2006: 113) and are the largest single category for deposit of pension fund dollars. Employees have a wide range of individual choices as to how these self-directed accounts are invested.

Additionally, life insurance companies hold $2.1 trillion in assets for annuitized pensions for current retirees. This is a product of the standard practice of many pension plans buying annuities for their plan participants at retirement.

Issues in pension fund investment

Ironically, much of American employees' pension money today is invested in ways that make it unlikely that workers will keep their jobs until they qualify for their pensions.

Let us make four key points about our pension system and the way it administers our money.

[2[2]] The others are SERS which had $9.9 billion in assets (2/28/06), Police and Fire $9.8 billion (12/31/05), and Highway Patrol $680 million (12/31/04)

First, the private sector pension system outside Social Security is doing a worse job of providing adequate pensions for working Americans than it used to. While about half of private sector employees are covered by pension plans (and this number has been stable for the past 20 years), the shift from traditional defined benefit plans to defined contribution plans has diminished pension security while it has increased the costs of the pension system. A recent study by Ed Wolff at New York University found that between 1983 and 1998 – as this change took place **and** as the stock market kept going up[3[3]] – projected retirement income **fell** for all Americans except those **who already had other assets in excess of $1 million outside their pension plans** (Wolff 2002).

Second, our pension money is not invested in making our lives better now. The investment policies of those who manage our pension funds – which are our property and which represent our deferred wages – do little to provide good housing, inexpensive mortgages, job security, reinvestment in small and medium-sized companies locally or other things we need in our communities. Instead they are heavily invested in corporate America – stocks and bonds of public companies.

Instead, there is a good bit of evidence that pension fund investments are funding job flight overseas. Ohio public employee pension funds, for example, have placed more than $31 billion in stock in foreign companies (Table 2). Curiously, and symptomatically, there is no category in their annual reports yet for investments in Ohio.[4[4]]

Among Ohio public employee funds, OPERS has taken the lead in beginning to address the issue of local reinvestment. It has begun a broader program of economically targeted investment through modest placements including the new Ohio-Midwest Fund, managed by Credit Suisse/First Boston. That will place $50 million in OPERS funds with existing private equity funds, which invest in closely held companies in the region. These private equity investments are categorized in "alternative investments" in Table 2.

The state's new Ohio Venture Capital Fund, set up in 2003, creates a new vehicle for pension fund investment in Ohio. Currently raising money, the OVCF has targeted raising $200 million for early stage investment in Ohio high tech companies. It is underpinned with $20 million annually in deferred tax credits to guarantee against losses to investors (including those who have no tax liability). It will make its placements through existing venture funds. Its board is made up of five members from the private financial services industry, three public sector representatives, and one business owner. The board has no labor representation.

There are capital gaps that we need to fill and investments we need to make: for equity and long term debt capital to grow small and medium-sized companies, for low and moderate income housing, for what we deal with every day: employee ownership.

[3[3]] The DJIA rose from 1,075 in January 1983 to 9,181 at the end of December 1998.

[4[4]]By contrast, CalPERS reports in portion of its funds invested in California prominently in its report.

Third, our pension system disenfranchises working people. It's our money. But it's the money managers who vote our shares. They don't vote in our interest. For example, they don't seem to be outraged about CEO compensation exploding from 45 times the average non-supervisory worker's wages in 1980 to 430 times the average non-supervisory worker's wages in 2005.[5[5]]

Most American employees would vote against those excessive CEO compensation packages that are based on stock options that go to regular shareholder votes, if they had a vote. But the folks who manage our money almost never do. That's why CEO compensation has grown obscenely large.

If the average American's wage had gone up at the rate the CEOs' have, the average worker would have made more than $160,000 last year. Similarly, if the minimum wage, which was $3.10 in 1980, had been indexed to CEO compensation, it would be more than $29 an hour today -- and way above the poverty line -- rather than $5.15.

Table 2. Placement of investments by Ohio public employee pension funds

	OPERS	**STRS**	**SERS**	**Police/Fire**	**Highway Patrol**
	12/31/04	**6/30/05**	**2/28/06**	**12/31/04**	**12/31/04**
Bonds (%)	22	19½	20	22	21
Domestic stock (%)	47	45½	45	49	55
Foreign stock (%)	22	21½	20	22	15
Real Estate (%)	5	8½	11	5	8
Alternative investments (%)	*	2½	2	2	
Cash & short term (%)	2	2½	2	1	2
Total Portfolio Value on Date ($)	65.4 billion	59.6 billion	9.9 billion	9.8 billion	680 million

Alternative investments include private equity and hedge funds.
*less than 1%

[5[5]] The increases are even more dramatic at the very top: Between 1970 and 1998, "according to Fortune magazine, the average real annual compensation of the top 100 C.E.O.'s went from $1.3 million – 39 times the pay of an average worker – to $37.5 million, more than 1,000 times the pay of ordinary workers" (Krugman 2002).

There has been a lot of work done in the last decade to improve our stewardship of pension funds. The labor movement has done a lot of the heavy lifting but has had some excellent allies in some of the multi-employer pension funds; several of the public employee pension funds, most notably CalPERS; a handful of foundations, such as Nathan Cummings; and a number of religious groups.[6[6]] However, the single-company funds and the 401(k) or 403(b) mutual fund managers have gone merrily ahead voting to continue the exponential rise in top management salaries and to continue the tenure of boards that grant huge CEO salaries while stock prices fall.[7[7]] They have also voted systematically against shareholder resolutions for establishing international labor standards for the corporations in which they invest.[8[8]] Fund managers "ownership" rights were so complete that, until 2003, they were not required to make public their guidelines on how they determined their votes on resolutions on corporate proxy statements and how they actually voted (Lydenberg 2005: 128).

Fourth, there are better alternatives. (1) We can invest in ways that have lower administrative overhead costs. When pension fund administrators take 2% to 3% of assets to administer our funds -- as is often the case in defined contribution plans investing in mutual funds, they take a quarter to a third of the average 7-10% of return on assets. That's why it's better to invest in the stock of mutual fund managers than in the mutual funds that they market.

(2) We can invest in ways that have a better return for employees today as well as for pensions in the future. These investment choices are what we call "economically targeted investing" or "double bottom line investing." That double bottom line is a market rate of return plus some additional good – like more local investment, good jobs, better housing, and improved health and safety at work.

[6[6]] Ohio public employee pension funds are becoming more active on this issue. PERS and STRS filed suit in May 2006 against United Health, alleging that the company permitted CEO William McGuire to "dictate his own compensation through the manipulation of the company's stock option plans" for the better part of a decade.

[7[7]] To cite one current example: Home Depot CEO Bob Nardelli has drawn $123.7 million in compensation since he joined the company in December 2000 while the stock price has declined from $50/share to $40/share in that period. Institutions own 65% of the stock, significantly on behalf of pension funds; insiders, including Nardelli, own only 1.6% of the company. Yet the institutional shareholders – all of which have fiduciary responsibility to act on behalf of the beneficial owners of Home Depot stock through them – voted against restrictions on top management compensation at the 2006 shareholder meeting. Nardelli, who also serves as Chairman of the Board, cut off the 2006 annual shareholder meeting after 30 minutes to stop criticism of the company's pay practices. None of the other twelve directors of Home Depot, including those standing for reelection, saw fit to attend the annual shareholder meeting at all (Weber 2006). And the economics textbooks say we have "shareholder democracy."

[8[8]] Interestingly, a July 2005 Moody's Investors Service report found a high correlation between credit risk and "high unexplained options grants" and "high unexplained bonuses" for CEOs which weren't explained by factors of size, past performance or other objective economic variables . Moody's is one of the major credit rating agencies ("Special Comment – CEO Compensation and Credit Risk," *Moody's Investor Service*, July 2005, as cited in Eisenhofer and Levin, 2005).

2. Capital gaps and market failures

One of the ironies in the new American economy is that we are awash with capital: credit cards, home refinancing, mergers and acquisitions, IPOs of companies which had never made a profit, stock market bubbles and the like. Heck, we must get a dozen credit card applications every week. And the folks who want to refinance our mortgages house send as much email spam as folks selling viagra.

On the other hand, too many small and medium-sized Ohio businesses are finding that there's no capital for everyday business initiatives today. See, for example, the depressing results of Mark Cassell's study of the availability of credit for Northeast Ohio manufacturing companies employing 25 to 250 that's being presented today. He found that a third had trouble obtaining adequate financing currently – 24% were using personal credit cards for business purposes – and fully half of them considered issues of credit availability to be one of the top three challenges to growth and expansion in the future (Cassell 2006).

It's small and medium sized companies that create jobs in America. Between September 1992 and September 2005, companies with fewer than 500 employees accounted for 65.5% of net employment growth in the country. Companies with fewer than 100 employees accounted for 46.4% of net employment growth in the period (Bureau of Labor Statistics 2006: Table E). By contrast, the big companies – the Fortune 500 – are often net liquidators of jobs, as they were in 2001, 2002, and 2003; they increased employment by 1.4% in 2004 (Loten 2005). If you want to grow employment in America, you have to pay attention to the capital needs of the small and medium-sized companies.

Or try to finance affordable housing development or minority business development on market premises. That's become the province of non-profit Community Development Corporations, Community Development Finance Institutions, and Community Development Venture Capital Funds that rely on foundation support and sale of Federal tax credits to wealthy individuals and corporations looking to cut their taxes.[9[9]]

For many years, as director of the Ohio Employee Ownership Center, we have had to struggle with the issues of how to obtain adequate loans and equity for employee-owned companies.

[9[9]] Historically we have dealt with capital gaps through Federal programs put in place during the New Deal or Fair Deal: the Federal agricultural credit facilities for family farms, for farm cooperatives, for rural electric co-ops, the various Federal home mortgage programs, and the special Federal credit facilities for veterans set up after World War II for home ownership, buying farms, and setting up businesses. Of course today there is no political will in Washington for new Federal programs to deal with credit gaps.

In practice, however, employee-owned companies have trouble getting financing. The ones we work with are all small and medium-sized companies. The median size is about 100 employees, doing about $10 million in sales. Of the 75 Ohio Employee-owned Network members, only 6 employ more than 500. In short, these are classic small and mid-market companies. And they are strapped to get capital for growth.

The capital gap that we see in our work is pretty simple.

Every year, in our technical assistance at the OEOC, we have lost at least one otherwise viable employee buyout in Ohio because of the lack of timely, friendly equity capital. Yet we can never find it when we need it. To put it very bluntly, almost every year for the last 19, we have seen at least one viable employee buyout effort fail with the loss of 100 to 200 jobs because no one could round up $ ½ million to $2 million in equity in a timely fashion.

Probably the worst case was the Amana Plant in Delaware OH, a good facility that built stoves and which would have made money under employee ownership. In 1999 we lost it – and with it, 350 well paid Teamster jobs -- because of a last minute shortfall of $1 million in equity. Employees lost control of flood-struck Republic Storage in 2006 when it was forced into bankruptcy when GE Capital pulled its working capital line. A friendly equity investment of $2 million certainly would have enabled it to recapitalize as a largely employee-owned company.

And every year our 75 network companies – which have about 16,500 employees –tell us that they could grow faster and do better if they had long term debt, like the big boys get on Wall Street by issuing bonds. They can't, of course, because they're too small.

3. Causes of capital gaps

Why isn't adequate capital available for small and medium-sized companies? After all, we are supposed to have the best banking and finance system in the world.

There are basically four reasons:

1) The first reason is the concentration in banking. Interstate banking and banking deregulation are making your hometown bank an endangered species.

I'm reminded of the comment by one CEO to me in the early 1990s. "For the better part of a century, our banking relationship has been with the same bank. My grandfather, my father and I all worked with the old Cleveland Trust. They knew our business as well as we did ourselves. You had the same loan officer for a decade or two. Then they got bought. Then the bank that bought them got bought in its turn. I'm not sure where their headquarters is now – but it's sure not in Cleveland. Now you may have the same loan officer for a year or two. They are all highly qualified MBAs, and they are probably great at financial analysis, but I doubt that they know what we make."

The big out-of-state banks are much quicker to pull their loans than hometown banks. The worst in our experience was Fleet which in one six month period pulled the plug on two companies we were working with and threatened a third. Other asset-based lenders are equally fast on the trigger: GE Credit slaughtered employee-owned Republic Storage earlier this year as it was beginning to recover from the flood that shut it down for months.

Note also that banks as a source of financing of the economy have fallen from about 45% in 1960 to 23% in the 2nd quarter of 2001 (Federal Reserve, flow of funds accounts, as per Karczmar 2001).

2) The second reason is the change in the private placement market -- that is, longer term debt provided to private companies. There has been a decline in traditional private placements – because the major intermediaries (the insurance companies) providing them have cut back

Moreover, since 1990, there has been an effort to securitize and create a secondary market for private placements. This is supposed to create a more efficient market, and possibly it does. But it has also transformed the market, by encouraging the private placement market to move from smaller companies to much larger corporations. Further, the SEC's Rule 144A has encouraged foreign investors to make private placements in the US and US investors to make private debt placement in foreign companies. The trouble is that it was much more successful in getting US private placements made abroad than foreign private placements made here. US private debt placements in foreign companies went from almost nothing in 1989 to 39% of all US investor private placements in 1994 while foreign private placements in the US filled only 20% of the market. About twice as much flowed out as flowed in (Hebb 1996).

3) The third reason is the diversion of financial resources that could otherwise finance productive investment into highly speculative activities.

You may remember the M&A craze of the mid 1980s that diverted $1 trillion in investment capital between 1984 and 1988 into buying up companies, breaking them up, stripping them down, selling them again. You could make a lot of money if you kept churning the companies. Al Dunlop was the master of that. You buy a company. You lop off the bottom fifth or quarter of the facilities in terms of return which automatically raises the rate of return on the remainder. Then you sell. That's how Dunlop earned his nickname Chainsaw Al.

The 1990s brought us the "new economy"– the world of high tech initial public offerings of companies that all were touted as the next Microsoft or Cisco in spite of the fact that they had never made a profit. Of course they never made a profit for guys who bought and held their stock, but they sure made a profit for the insiders who sold stock and brokerage houses that touted it. Of course part of the "new economy" were the energy traders, like Enron, and the telecom shooting stars – the World Coms, Aldelphias, etc. That was a pretty costly bubble. Again huge amounts of capital were diverted into the modern equivalent of Dutch tulip bulbs by the promise of unbelievable returns.

Incidentally, this is encouraged by Federal tax policy. We want businesses to invest and grow, so we make business interest costs tax free – whether it is for investment in new plant and machinery to make better products or to engage in mergers, acquisitions, and pure speculation. I'd be remiss if we didn't mention a couple current situations that may prove to be comparable.

The first is international currency trading has gone from the $10-20 billion-a-day range in 1973 to $1.2 trillion-a-day in 2002 + $580 billion daily in currency and interest rate derivatives (Peter Martin, *Financial Times*, 2-12-02). It is generally estimated that somewhere between 1 and 2% of that actually finances world trade and perhaps another percent or two helps to hedge currency values for the exchange of real goods and services. The rest – 95, 96, 97% – is speculation.

Of course it was the hot currency flows that brought down the Asian economies in 1997 and drove them to devalue against the dollar, making their jobs cheaper here and our balance of trade worse.

The second is the case of what are called "derivatives" – contracts on change in value of assets. Derivatives aren't the assets themselves. Rather they are simple bets on whether their value is going to go up or down. Derivatives have a valid, and limited, role in hedging against risk, but their vast growth is because of rampant speculation. Derivative contracts outstanding have grown from $3 trillion in 1990 to $127 trillion in 2003.

Let me put that in perspective. They've grown from roughly half the size of our annual production of goods and services a dozen years ago to roughly 10 x the real American economy today. It's no wonder derivatives have triggered Warren Buffett's warnings that they are "financial weapons of mass destruction" (Crutsinger 2003).

You may remember that it was speculation in derivatives that bankrupted Orange County some years ago.

4) The fourth reason has to do with the rise of pension funds themselves. So the rise of pension funds has tended to channel savings from local financial institutions (bank and credit union CD s, and the like) into the stock market at home and abroad. Managers of DBPs have turned to public company equity investments to chase higher returns. 401(k)s and 403(b)s are invested primarily in mutual funds which, in turn, are almost exclusively invested in public markets.

Employer-sponsored plans put close to 3/4s of their assets into stocks and bonds of public companies and into mutual funds which invest in them. (Not surprisingly it's the private sector DCPs which are committed primarily to high-fee mutual funds – 37% of assets – versus 11% in private sector DBPs.) (Calculated from Federal Reserve 2006: Tables L118.b, L118.c, and L.119.)

That's one of the reasons why we have gradually bid up the value of public companies relative to small and medium sized businesses. So the "price to earnings" (PE) ratio for small and medium-sized closely held companies in Ohio is 4 or 5 while the PE ratio for the publicly traded S&P 500 has averaged 20 in the last 25 year period, up from an average of roughly 11 in the 1950s (http://www.comstockfunds.com/files/NLPP00000%5C026.pdf).

It’s often noted that European and other mature economies’ stock markets carry lower PE ratios. It’s not because their companies are riskier than ours; rather it’s because they aren’t channeling as much of their savings into various pension funds that invest primarily or exclusively in publicly traded companies.

The result of these four factors has been the capital shortfall we described for small and medium sized companies. It restricts their expansion and growth. It’s particularly an issue in smaller communities that no longer have an independent local bank. It contributes to our loss of jobs – especially in manufacturing.

Can pension plans help solve the capital gap problem? The answer is yes, they can. In fact, in a few areas, they already are.

It’s called economically targeted investment.

4. Experience with labor-sponsored, economically targeted investments

Unlike conventional Wall Street investment practices that focus on financial return to the exclusion of all other values, “economically targeted investment” or “double bottom line investment” is the practice of securing both a competitive rate of return and a “collateral benefit,” such as affordable housing, good jobs at good wages, a cleaner environment, or more sustainable communities. It aligns pension fund investment with the values of the owners of the pension funds – American blue and white collar workers – without sacrificing return on their pension dollars.[10[10]]

The building trades have been the pioneers of economically targeted investment in the US. Since 1964 when the AFL-CIO’s Housing Investment Trust (HIT) was initiated, building trades multiemployer pension funds have been invested systematically both to provide low and middle income housing and to increase the jobs available for building trade union members while maintaining rates of financial return that matched or beat similar conventional investments that didn’t have the additional goals.

[10[10]] Much of the push for ETI has come from the Steelworker-sponsored Industrial Heartland Labor-Capital forum. For a good summary of the thinking that has come out of the Industrial Heartland project, see Fung, Hebb and Rogers 2001 and visit http://heartlandnetwork.org/index2.htm

The HIT has been supplemented at the national level since with the Multi-Employer Property Trust (1982), which builds and retains commercial and office properties build with union labor, and the Building Investment Trust (1988) which finances unionized commercial and office construction. Local building trades funds followed, like the ERECT funds (1987) in Western Pennsylvania and Eastern Ohio and the Northern Ohio Building Trades Real Estate Investment Trust (2001) in the Cleveland area as well as direct investment like that of the Ohio Brotherhood of Carpenters, to provide direct investment in local projects where the members jobs are.

Please note that the these building trades pension fund investments successfully align the interest of pension fund members -- who own the pension fund capital -- as future retirees (good financial return) and as workers today (more good jobs and good wages). They also increase the financial stability of the pension funds themselves by creating more hours of pension fund contributions.

More recently, some state employee pension funds have been doing economically targeted investment as well. Here the values of the state employees -- the owners of the pension funds – are broader, and hence the collateral benefits sought are also broader: reinvesting in development in the state and community, encouraging local home building or mortgages or filling capital gaps.

A 1995 General Accounting Office (GAO) study analyzed a 1992 survey of the 139 largest state and local pension plans in which 119 (86%) responded; respondents held 85% of total non-federal public sector pension plan assets. Of the 119, 50 had made ETI investments, amounting to 2.4% of assets, in housing, real estate and business development. The overwhelming bulk was in housing and real estate. Business development represented 4/10 of 1% of assets placed (GAO 1995).

The national leader has been CalPERS, the California Public Employee Retirement System, the public sector retirement fund with the most systematic policy of ETI -- of making prudent investments "designed to produce a competitive rate of return commensurate with the risk as well as to create collateral economic benefits for a targeted geographic area, group of people, or sector of the economy." CalPERS is the largest public employee retirement fund in the US and the third largest in the world. As of June 30, 2005, it had almost $190 billion in its trust fund.

As Sean Harrigan, the former president of CalPERS' Board of Administration,[11[11]] put it, CalPERS made ETIs because "the present and future financial health of our trust fund is inextricably linked to the economic health of California" and as prudent fiduciaries it is "necessary to consider the macroeconomic *implications* of our investments."

"In other words," he says, "it is not just acceptable to consider what are referred to as the collateral economic benefits of any investment, it would be *imprudent* not to include such considerations in the investment decision making process."

[11[11]] Harrigan is International Vice President and Executive Director of the United Food and Commercial Workers Region 8 States Council. He lost his job with CalPERS after a new governor came in.

CalPERS has come to lead US public pension funds in investing in the local economy. It has invested about 11% of its assets in California, including a fair portion in economically targeted investments. It has focused on capital gaps in what it calls “underserved areas” – geographic areas and economic sectors that are underserved in terms of capital. “Investments in underserved areas hold potential to deliver superior returns for our Fund and its members while fueling the growth of jobs, businesses and stronger communities in our state,” CalPERS said when providing an additional $475 million into the initiative in May 2001 (California Public Employees’ Retirement System 2001).

According to its 2002 annual report, these investments included

- members’ home loan program addressing the shortage of mortgage opportunities in California’s expensive housing market for public employees – CALPERS has financed members’ purchase of 71,000 housing units and provided $9.6 billion in mortgages.

- housing – put $1 billion into building housing – built more than 32,000 homes for Californians – part of it through the AFL-CIO’s Housing Investment Trust

- in 2001 committed another $1 billion to urban real estate initiatives including industrial, office, commercial, multifamily and single family homes in urban areas

- invested $500 million through 11 private equity firms to serve “underserved markets” in developing businesses and business expansion in declining rural and urban areas

- made a number of direct equity investments in business expansion

The latter two programs had helped more than 500 firms expand (California Public Employees’ Retirement System 2002).

It is estimated that CalPERS’ investments have created 54,000 jobs in California (Harrigan 2002).

And to our immediate north, our Canadian brothers and sisters have pioneered a system of labor-sponsored investment funds (LSIFs) which offer Canadian employees the opportunity to pool their savings in the Canadian equivalents of our IRAs, 401(k)s, and 403(b)s to create jobs in their own provinces (the Canadian equivalent of our states) and communities. (For a good summary of the Canadian LSIFs, see Hebb and Mackenzie 2001.)

These 19 funds now account for **half of private equity funds** in Canada. They are being invested primarily in growing small and medium sized, closely held businesses. These individual investments, capped at $3500 to $5000 annually, are subsidized with a 15% provincial and 15% Federal income tax credit. Econometric studies have concluded that the provincial and federal governments recover their tax credit in 1.2 - 2.1 years (Quebec) and 6 years (British Columbia including start up costs; annual additional tax credits are recovered in about a year) in increased revenue from economic growth (Hebb and Mackenzie 2001: 155).

The *Fonds de solidarité FTQ* -- the Quebec Solidarity Fund, sponsored by the Quebec Federation of Labour -- is the oldest (1983) and largest LSIF, with assets of more than $Can 6.5 billion and more than 550,000 shareholders. It has made equity and subordinate debt investments in more than 2100 Quebec companies; of these, 99% are minority positions and the average stake is 30%. Its investments have created, maintained, or preserved 106,000 jobs in the province.

It is worthy of our attention not just because of its size but because it departs so much from our normal assumptions about how to invest private equity. It offers a model that wouldn't be suitable for defined benefit plans but could be very suitable indeed for self-directed plans.

The Solidarity Fund has four main objectives: (1) to assist enterprises having an economic impact in Quebec to create, maintain, or protect jobs; (2) to promote workers' economic literacy "so they can increase their influence on the economic development of Quebec"; (3) to make strategic investments in Quebec's economy for the benefit of workers and businesses; and (4) to encourage retirement savings (Fonds de solidarité 2003: 3).

Its asset allocation is split between companies operating in Quebec (60%), of which half is in listed companies and half in private equity, and fixed income, largely public sector bonds (40%). Shareholders cash out at early retirement (55 or older), regular retirement (65), disability or death; to buy a home; to return to school; or for "unforeseen event," like unemployment.

Limited investments outside Quebec are permitted provided they have a direct positive impact on job creation in Quebec.

The Solidarity Fund has reached the size that it has created a decentralized structure of 86 municipal funds and 17 regional funds that cover the province, 19 specialty funds, and the central provincial fund. The municipal funds (SOLIDEs - Local Investment Corporations for Job Creation) make placements of $5,000 to $50,000 for start ups, expansion and turnarounds. They have volunteer boards and share a handful of paid full-time staff. The regional funds make placements of $50,000 to $750,000, again with volunteer boards, but they average 5 paid staff per regional fund. The specialty funds focus on investment in specific industries, particularly in developing technological fields; they are professionally staffed. Some are wholly owned by Solidarity; others are partnerships with outside investment capital. The central provincial fund does investments of $500,000 and up. The dream, of course, is the start-up or local firm that grows with municipal fund support to the point that it turns to the regional fund and finally to provincial fund as it becomes a significant economic actor. The municipal and regional funds guarantee reinvestment throughout Quebec, including rural areas and Quebec's northern tier.

As of its 2003 annual report, the Fund had invested $440 million in local and regional funds to support their local investments. Direct investments by the provincial fund were $235 million in real estate, $778 million in consumer and service sector firms, $512 million in industrial, and $686 million in new technology firms in life sciences, information technology, telecommunications, and bio-food industries.

The Solidarity Fund is governed by a board of 17. Ten are from the Quebec Federation of Labor, 2 elected by shareholders, 4 come from the business community, and the last is the CEO of the fund. Despite the union dominance on the board and among shareholders -- 60% of the shareholders are union members, the Fund invests in both union and non-union companies. In fact, 90% of its investee companies are non-union, although these are generally smaller companies.

The fund conducts a “social audit” with 4 screens in addition to financial due diligence before making investments. It examines the potential investee company’s occupational health and safety record, its commitment to communications with employees, its willingness to do open book management, and its labor relations practice. Fund social auditors meet with employees as well as managers, and compare management self-appraisal and employee views. Discrepancies or problems uncovered lead to efforts to work out the social issues, but if they can’t be fixed, the investment doesn’t happen.

The Fund also requires that its investee companies have to create functioning boards if they don’t have them, and the Fund takes a number of board seats commensurate with its investment. (Fund employee board members are not compensated by the investee company, but the Fund receives the director fees.) Similarly, investee companies are required to fund economic and financial education for their employees with an annual $40 contribution per worker; the fund does the training. Investee companies are also required to provide a $250 minimum match into the Canadian IRA equivalent if the employee contributes.

The Fund provides a range of services to investee companies including a regular employee survey -- results go to both employees and management, communications committee and problem solving training, and management troubleshooting and consulting as needed. Total operating expenses in 2003 were 1.8% of assets.

The Fund bills itself a patient investor although it generally expects to exit in about seven years through sale of the company, a public offering, a management buyout, or the sale of the Fund’s stake back to the company. Its employment and social goals supersede efforts to maximize return. Its bench mark is the interest rate on Canadian government bonds. This is not a model for investment by ERISA funds with their specific legal requirements, but it could be used with IRA, 401(k), and 403(b) deposits.

The Fund achieved a 4.9% return for shareholders from 1983-2003, ending on two bad years when returns were a negative: losses of 11% (2002) and 7% (2003). These returns do not include the 30% tax credits for its depositors.

The population of Quebec is about 2/3s of that of Ohio. Imagine what could be achieved if we had a fund of this size earmarked for reinvestment in Ohio!

Of course the Solidarity Fund is the equivalent of only 4% of the total assets of the five Ohio public employee retirement funds....

Returns on "double bottom line" investing

What do we know about the returns on "double-bottom-line" investing?

We have two different styles: "negative screen" and "positive screen" investments.

Negative screen investments select out companies that produce "bad products" such as alcohol – an early socially responsible investment program was that of the Women's Christian Temperance Union – bombs, guns, tobacco, gambling, etc., or companies have bad environmental or health and safety records, and the like. Practically all "socially responsible investment" (SRI) funds – and there are now hundreds of these mutual funds that you can invest your IRA or 401(k) or 403(b) in – use negative screens.

Curiously, despite not investing in products that produce addiction or companies that trash their workers or the environment, socially responsible funds have, on the average, matched or beaten the broader market. The Domini Social Index of 400 public companies, which is the benchmark for SRI funds, has beaten the S&P with regularity. From 1990 to 1998, it returned 18.54% vs. 16.95% for the S&P 500, and socially responsible investment firms tracked by Morningstar were more likely to be ranked in the top two categories than the universe of funds tracked (Harrington 2003).[12[12]]

Positive screen investments select for positive attributes, such as good labor relations, good wages and benefits, excellent environmental records, or the like. The basics of "positive screen" investment is to select "high road" companies, rather than just avoid "low road" ones.

The positive screens may be highly specific. Consider the various Building Trades funds. Their positive screen is that they invest in construction or in real estate development that use only unionized labor. Thus the AFL-CIO's Housing Investment Trust (HIT), which was set up in 1964, and its Building Investment Trust (BIT), set up in 1988, finance unionized construction projects. The HIT has built 80,000 affordable housing units and, in the last 10 years alone, has created 35 million hours of union construction work – which, incidentally, had the collateral benefit of increasing contributions to the pension funds investing in the HIT. The Multi-employer Property Trust, set up in 1982, invests in building and owning union-built commercial properties, and has created 33 million job-hours of union construction work.

[12[12]] Steven Lydenberg, a long-time socially responsible investment practitioner, argues more broadly for screening out companies that (1) externalize their costs onto society, (2) deplete natural resources irretrievably, and (3) impoverish stakeholders. The firms that don't do such things create long-term wealth for society (Lydenberg 2005: 20-21).

Locally the Employee Real Estate Construction Trust Funds (the ERECT Funds) and the Northern Ohio Building Trades Real Estate Investment Trust do similar things with their investments. The ERECT Funds, set up in 1987, pool pension fund dollars from area multi-employer building trades funds as well as modest investment from public sector funds to invest in union construction projects and in union-built commercial and retail projects in the region. They have created more than 2 million hours of union work at union wages and benefits through their investments, providing employment for their members and, incidentally, additional pension contributions to the local building trades funds. The ERECT Funds are managed by PenTrust Real Estate Advisory Services and trusteed by AmeriServ Trust and Financial Services Company of Johnstown, Pennsylvania (ERECT Funds 2006).

The Northern Ohio Building Trades Real Estate Investment Trust, set up in 2001 by the Cleveland Building and Construction Trades Council and five Cleveland construction unions, similarly pools pension fund dollars from multi-employer building trades funds but from a more limited area. It invests specifically in unionized Cleveland-area construction, including the Legacy Village retail development and office development. It is managed by Courtland Partners and has "done well" according to Michael Humphrey, a principal at Courtland (interview with Steve Clem, 5/23/06).

The various Building Trades Funds have generally matched or exceeded their conventional Wall Street benchmarks. The HIT, for example, has outperformed its benchmark, the Lehman Aggregate Bond Index, over the last 1, 3, 5 and 10 year period (AFL-CIO Housing Investment Trust 2006), The BIT has provided a better return than its benchmark NCREIF Real Estate Property Index since its inception in 1988. [13[13]]

[13[13]]Why do SRI and ETI funds appear to outperform financially funds invested only for financial return?

This is a troublesome question. Logically one would think that investing in companies that don't produce addictive products like tobacco, don't make weapons of death and destruction on Federal cost-plus contracts like defense contractors, and don't trash the environment would produce lower rates of return, but the SRI funds match their benchmarks. Similarly one would think that selecting high wage, high benefit union construction over low wage, no benefit non-union projects would cut your returns, but the Building Trades funds again have matched their benchmarks. How can that be?

There are several possible answers: (1) ETI funds which don't match their benchmarks get attacked for political reasons much faster than conventional financial service industry funds that bought Enron and other scuzzy companies' stock. Hence the ETI funds make more careful, better informed investment choices because they are subjected to more scrutiny. (2) ETI funds attract more talented managers because they offer additional motivations for work beyond greed. As long as they are relatively rare, they will be more successful, but as they become more common, their performance will decline as the pool of high quality, socially conscious managers gets exhausted. (3) Conventional fund management under-invests in socially responsible and high road companies, offering ample opportunity for ETI funds. (4) The double-bottom-line criteria serve as a surrogate for good management. "High-road" companies are simply better managed than low-road companies. (5) Union workers in the building trades are more productive and do higher quality work and union contractors are better capitalized than non-union workers and contractors. (6) The local building trades funds know the contractors better than standard real estate investment funds. (7) The ETI/SRI funds, despite their relatively small size, may have lower administrative costs because of their sponsorship or more altruistic staff. (8) It's just dumb luck. (9) The studies which indicate superior performance are flawed. Here's a good research project!

Or the positive screens may be more general. The 1995 General Accounting Office (GAO) study cited above also looked at the experience of seven state and local public employee pension plans believed to have had most experience with business development ETIs. It found that they matched or exceeded benchmark returns in bond, loan and CD purchases and private placements in their business development efforts but fell short of the benchmark in venture capital placements. The GAO study also noted that most of the pension ETI programs examined did not systematically collect data on the non-financial returns of ETI investments (GAO 1995).[14[14]] A 2004 study for the Vermont State Treasurer reviews a number of other cases of public employee pension fund investment and reaches generally positive conclusions but is skeptical about Vermont's own venture capital forays (Hoffer 2004).

The Quebec Solidarity Funds, operating under a legal regime that pays more attention to social and economic development goals, invests to create or maintain jobs in Quebec in companies with good occupational health and safety, good labor relations, and good internal communications. It has created, maintained, or preserved 106,000 jobs, largely created through the 30% of the Fund's assets invested in private equity. It has a low benchmark – the Canadian Federal bond rate – based on the reasoning that working people should seek a secure rate of return for their retirement savings. However, the Canadian tax credit system provides an up-front 30% tax credit on contributions to the Fund and, with contributions out of pre-tax dollars and the Fund itself tax-sheltered, total return has been the equivalent of a 7% return in an IRA or 401(k).

Legal issues

The legal issues in economically targeted investing vary with the legal regime governing the category of pension funds.

ERISA defined benefit plans. The most heavily regulated of the funds are the private sector defined benefit plans which fall under ERISA, the Employee Retirement Income Security Act of 1974, which was a response to scandals that had plagued private sector pensions which included investment scandals, firing immediately before retirement to avoid payment of pensions, and systematic failure to fund pension promises – much like today's systematic failure to fund retiree medical care. These are the multiemployer DBPs and the single employer DBPs.

The pursuit of economically targeted investments is legal for both within clear limits. The legal standard is simple: economically targeted investments (ETIs) are expected to meet the benchmark return rate of comparable investments with comparable risks, and cannot sacrifice expected return for other benefits. If the investment cannot be expected to meet the risk-adjusted rate of return for the asset class, the investment is improper, regardless of the collateral benefits.

[14[14]] The GAO study also notes prominent public sector pension fund ETI flops: Kansas PERS's private placements which legislative investigation found to involve violations of the fund's prudence rules and oversight failure and the Connecticut Retirement Fund's 1990 investment of $25 million in Colt which led to a $20.7 million loss when the company declared bankruptcy in 1992.

The legal standards were codified in 1994, when the Department of Labor issued an interpretive bulletin on the subject stating that "the selection of an ETI, or the engaging in an investment course of action intended to result in the selection of ETIs, will not violate" the fiduciary and "exclusive benefit of plan participants" standards of ERISA (Department of Labor, 29 CFR 2509.94-1 Interpretive Bulletin, June 1994). Robert Reich, then Secretary of Labor, testified before Congress at the time the interpretive bulletin was released, differentiating between "social investing" which subordinated financial returns to other social objectives and was not permissible under ERISA and "economically targeted investments" which generate competitive, risk-adjusted rates of financial return while also achieving other, collateral benefits. "We will encourage funds to reach for such collateral benefits, because—far from conflicting with their fiduciary duties—doing so complements their responsibilities to plan participants," Reich said. In his testimony, Reich went on to call pension funds "the stewards of economic future" and to argue that the very size of pension funds gives them the ability "to improve the long-term prospects of the entire economy" which, in turn, influences job growth, wage growth, and future pension benefits (testimony of Secretary of Labor Robert B. Reich Before the Joint Economic Committee, United States Congress, June 22, 1994).

The Department of Labor made clear in its interpretive bulletin that ETIs are legitimate only if pension funds do not sacrifice return for collateral benefits. For example, if the expected risk-adjusted rate of return is the same on several possible real estate investments, but one of the investments also offers the collateral benefit of including only union-built properties, the fund would be acting legitimately in opting for the union-built properties. But if the union-built option was expected to perform worse than the other comparable real estate investments under consideration, the fund would be acting improperly to invest in it.

These standards were reaffirmed in an ERISA advisory letter of May 28, 1998, which spoke specifically to ERISA plan investments in "socially responsible funds (PWBA Office of Regulations and Interpretations, 1998), and by its interpretive bulletin of July 1, 2002.

Despite this green light for ETIs, only multi-employer funds which are governed by boards representing **both** employers and employees have undertaken serious ETI investment. Single employer plans, which are run exclusively by the employer and which hold the bulk of the private sector DBP dollars, have been notably absent from ETI investing.

State and local public employee funds. State and local public employee pension funds are governed by laws of the states in which they are located. Many, like multi-employer private sector funds, are governed by boards representing both employers and employees. States may, and some have, mandated various forms of socially responsible investment, including divestment of holdings in the apartheid regime in South Africa. States may mandate reinvestment in the state as an appropriate investment category. Many have adopted at least part of the ERISA rules as their general operating procedure.

Employer-sponsored defined contribution plans -- 401(k)s and 403(b)s. These DCP plans are invested as participants choose, but the range of choices is determined by the employer. Employers often include socially responsible funds. Employers may choose to include funds which have an ETI component or could offer employees the option of a fund that reinvests in the geographic area when the employee lives, if such funds existed.

They could, for example, offer a labor-sponsored fund that reinvested in Ohio, just like those in Canada as one choice among the investment vehicles offered.

Individual retirement accounts. IRAs give total discretion to the individual IRA participant who can invest in any security, including private equity that the institution holding the IRA account is willing to accept.

Similarly, a labor-sponsored fund that reinvested in Ohio just like those in Canada, could be held in IRAs.

Canadian labor-sponsored investment funds. Funds are established under provincial legislation, so there is considerable variance across the country. The Quebec Solidarity Fund, which has more of an orientation to economic and community development than the other Canadian funds, operates in a legal regime that puts its social and economic goals above its goals for return. This is facilitated by the Canadian tax credit system that provides an up-front 30% tax credit on contributions to the Fund. In effect, what the Canadians have done is to create a trade-off in which the tax credit was traded for higher rates of economic and community development to achieve a rough market-rate return for LSIF investors.

Political factors

To date practically all economically targeted investment by pension funds in the United States has been done either by multi-employer funds which are governed by joint union-management boards and by public employee funds which often also have labor representatives on their governing boards. The Canadian labor-sponsored investment funds have similarly had strong or, in Quebec, controlling labor influence on their investment policies.

Employer-run DBP plans and employer-selected investment choices for 401(k)s and 403(b)s appear appear to have done little to put any portion of their capital to work for working people. There is no reason to expect better performance in the future unless we get some strong countervailing pressure from the labor movement to encourage better investment practices here.

Choices for IRA participants are essentially limited to socially responsible funds using negative screens, since there are essentially no economically targeted funds with positive screens available. The mutual fund industry simply doesn't produce them. Again, here is an important role for labor: to link with one of the union-related insurance companies to sponsor low cost funds for investment in local private equity, at least in major industrial states. These funds' boards should have substantial union representation. Once established, such funds could be opened to 40l(k) and 403(b) contributions.

6. Employee ownership in economically targeted investment

I want to make a strong plea for an employee-ownership component in any Ohio fund.

The basic reason is simple. Employee ownership is the best way yet found to anchor capital and jobs in our communities. Employee-owned companies pay competitive wages and better benefits than their competitors, grow faster, are slower to lay off in economic downturns, and apparently have a higher rate of reinvestment in capital improvements – which is the guarantee of jobs in the future. And we have yet to hit a case where an employee owned company has transferred the employee-owners' jobs to Mexico.

If we look at total employee compensation, the best study done to date was a Washington state study in 1998. It compared a group employee-owned companies with a matched sample of non-ESOP companies (Table 3). The findings: employee-owned companies paid somewhat higher average and median wages and had significantly larger retirement accounts than the non-employee-owned sample. Average total retirement assets in employee-owned companies were 2½ times those of non-employee-owned companies.

Table 3. Impact of employee ownership on total employee compensation: Comparison of wages and benefits in matched ESOP and non-ESOP companies

	ESOP companies	Non-ESOP companies
Current wages		
Average wage	$19.09	$17.00
Median wage	$14.72	$13.58
Average retirement assets		
In ESOP	$24,260	0
In other plans	7,953	$12,735
Total retirement assets	$32,213	$12,735

Source: Peter Kardas, Adria Scharf, and Jim Keogh, 1998

A great deal of evidence has accumulated over the years that employee ownership improves company growth relative to pre-employee ownership performance, especially when coupled with employee participation. A recent study by Douglas Kruse and Joe Blasi at Rutgers University, found that annual sales growth increased 2.4% and annual employment growth increased 2.3% when post-ESOP and pre-ESOP performance were compared (Douglas Kruse and Joseph Blasi, 2000)

Finally, there is no question that employee ownership reduces the propensity to lay off workers (and owners) during economic downturns. An Ohio study, covering the 1989 to 1991 period, found that employee-owned companies in the state beat their industries by a factor of 50 to 1 in job creation and retention during that economic downturn (Table 4). In fact, if the rest of the Ohio economy had performed as well as the employee-owned sector during that period, Ohio would have been spared the recession that cost the first President Bush his job.

Table 4. What happens during recessions: How Ohio ESOP companies compared with their industries in job creation and retention, 1989-1991

Worse than industry	1%
Same as industry	48%
Better than industry	51%

N=167

Source: Logue and Yates, 2001, Figure 1.2 (p. 36).

In addition to anchoring capital and investment locally, to paying better wages and benefits, to increasing company sales and employment growth, and to maintaining employment in economic downturns, employee-owned companies create significant wealth for their employee owners. As shown by the IRS Form 5500 filings for the 2002-04 period, Ohio-headquartered ESOP companies had created $36,678,000,000 in wealth for their 482,000 employee owners or $76,000 each. They paid out $2.8 billion to retirees in the filing year.[15[15]] The creation of significant, locally anchored wealth tends to stabilize property values and the tax base.

This is double-bottom line investing at the max: higher wages and benefits, higher local multipliers, greater local reinvestment, greater economic growth, fewer layoffs in recessions, and locally anchored wealth creation stabilizing property values and the tax base.

We'd hope that any Ohio private equity fund would have a special interest in co-investing with employees and, when it exits from investments, offering those equity stakes to the employees first.

[15[15]] Companies file subsequent to the end of their fiscal year, and some file late. Source: Larkspur data Fall 2005 Form 5500 filings CD. Statistics computed by Jackie Yates.

7. Courses of action for Ohio labor

There are better alternatives for investing pension savings than our current approach.

We've clearly built an investment regime for employer-sponsored plans that over-emphasizes investment in public companies, relatively to private companies, and which over-emphasizes high-cost investment vehicles for self-directed retirement accounts. Ironically it simultaneously produces suboptimal outcomes for employees as future retirees tomorrow and for employees as employees today. It does seem to provide pleasant returns for the financial services industry, however. But a general reform of pension fund investment – much less taking on the financial services industry – is beyond the scope of this workshop.

What can we do at the state level? Let's review possible choices first by objectives and then by category of pension plan.

Objectives

Economically targeted or double bottom line investing adds additional investment objectives to the goal of obtaining an adequate rate of financial return. Historically this was avoiding placing money in investments which were contrary to the beliefs of the savers, such as the Women's Christian Temperance Union's aversion to investment in liquor companies. Today we can add:

1) investing in high wage, high benefit union construction jobs, thereby also increasing contributions to pension plans (the national building trades' strategy);

2) reinvesting local pension funds in job creation and retention in the local area (local building trades' funds, CalPERS, Solidarity Fund);

3) affordable housing (HIT, CalPERS);

4) mortgages for members in high housing cost areas (CalPERS);

5) urban revitalization (CalPERS and others);

6) positive occupational health and safety, environmental, and labor relations records (Solidarity Fund);

7) regional development in outlying, declining, and rural areas (Solidarity Fund);

8) developing new industries such as tourism (Solidarity Fund), high tech (Solidarity Fund), or alternative energy;

9) demonstrated high economic multiplier effects, such as investment in manufacturing with higher wages and benefits, rather than in retail; in locally owned businesses, rather than in absentee-owned or, worse, in firms abroad; in family businesses and employee-owned firms that anchor capital locally; and in firms that pursue strategies of buying locally rather than those

which do global sourcing.

ETI choices by category of plans

ERISA plans. ERISA as interpreted by the Department of Labor permits economically targeted investments provided they can be expected to return the benchmark return for this category of assets. The sensible approach for ERISA funds is to establish an asset allocation model with appropriate benchmarks, commit to ETIs in one or more of those asset allocation categories, and then contract with or create specialized intermediaries to make and manage the ETI investments. ERISA (and public sector) funds get in trouble when they make decisions for political reasons.

Single company defined benefit plans appear to have done little or no ETI. Unions could seek to bargain investment policy for these funds to add an ETI component to their investments.

Public employee funds. We need our public pension fund trustees to follow CALPERS' lead to invest where their members live and work – and where stabilizing or growing the tax base is crucial to providing good public services (and paying public employees) in the future. The on-going discussion in OPERS is an important one in this regard.

Legislatures can lay down guidelines for fund investment that encourage local reinvestment and other ETI practices.

Again the funds are well advised to factor ETI into one, two or all of their asset allocation categories.

401(k), 403(b) and IRA investment vehicles. Since these are self-directed plans in which individuals choose where to place their pension savings on the basis of fund prospectuses, it would be possible to develop ETI funds for several purposes, including: (1) affordable housing through unionized construction using the existing building trades funds, (2) private equity in growing small and medium-sized firms in the state, (3) placements in alternative energy technology that could create national leadership for Ohio in this area, (4) placements in ownership transition to maintain small and medium-sized businesses whose owners are reaching retirement without heirs to step in as owner-managers, in partnership with the employees.

It may take some bargaining to get employers to add ETI funds to their 401(k) and 403(b) choices.

Combined investment vehicles. We can create investment vehicles suitable for use by multiple types of pension fund investors. These have the advantage of cost-effectiveness.

For example, Ohio public employee pension funds could invest a portion of their real estate investment dollars in the local building trades funds that invest in union construction in Ohio alongside the building trades multi-employer pension funds. That stimulates high value added, high quality, and high multiplier construction in Ohio that strengthens the local tax base – another bottom line for public employees.

The building trade funds could also open a window for local 401(k), 403(b) and IRA investments.

Ohio public employee pension funds could create or contract with existing pension fund managers to create general or special purpose ETI funds to reinvest in Ohio. OPERS has already embarked on that route in modest fashion with its $50 million Ohio-Midwest investment plan. As part of this process, OPERS could encourage these funds to open a window for local 401(k), 403(b) and IRA investments.

Public employee funds could also invest directly in developing employee ownership as a tiny part of their portfolio through the one of the handful of national employee-ownership equity funds located in Ohio -- South Franklin Street Partners – which no doubt could create an Ohio ESOP equity portfolio with an exit strategy of selling to the employees.

The Ohio AFL-CIO and Ohio Manufacturers Association could take the initiative to establish a fund to accept 401(k), 403(b) and IRA investments specifically for private equity investments in growing small and medium sized manufacturing businesses in the state. We would hope that the exit strategy for this fund would include sale of the fund's stake to company employees.

We need funds like the Canadian ones to give us a real choice of where we invest our IRA, 401(k) and 403(b) money. There are more than 8,000 mutual funds in this country that we can put our IRAs in – and not one of them will reinvest our dollars in creating and retaining jobs in Northeast Ohio. Talk about market failures!

Such funds could be incentivized by state tax credits, like the Canadian provincial tax credit for investing in labor-sponsored investment funds.

Other things being equal, of course, the administrative structure for the funds should be inexpensive. One possibility is to set up the fund management company as a cooperative, with any profits rebated to the investors.

Labor could establish model standards for single-employer DBPs and for employer-sponsored 40l(k)s and 403(b)s. Such standards could include investments in national and local building trades funds as well as offering funds investing locally to 401(k) and 403(b) participants.

It's a new role for labor, but it's beginning to happen with the Steelworker-sponsored Industrial Heartland Labor-Capital forum, the new Landmark investment fund, and several other labor-friendly funds. If the Building Trades, the Quebec Federation of Labor, and CalPERS can do it, so can the rest of us.

* * * * * * * * * *

Back in 1978 -- just a quarter of a century ago -- Randy Barber and Jeremy Rifkin wrote a little book called **The North Will Rise Again: Pensions, Politics and Power in the 1980s.** It was an eye opening volume for many of us. Consider what they had to say:

“Pension funds are a new form of wealth that has emerged over the past thirty years to become the largest single source of private capital in the world. They are now worth $500 billion and represent the deferred savings of millions and millions of American workers” (Barber and Rifkin 1978: 10).

Today they are worth 17 times as much.

“Pension funds at present own 20 to 25 percent of the equity in American corporations.” (Barber and Rifkin 1978: 10)

Today they hold 45%

“Pension funds are now the largest source of investment capital for the American capitalist system.” (Barber and Rifkin 1978: 10)

That’s even truer today than it was then.

They concluded the book saying “with the emergence of pension-fund capital, millions of American workers now have the power, through their unions and state and local governments, to claim control over their own economic destiny.” (Barber and Rifkin 1978: 232)

If that was true when pension funds held $500 billion and owned 20% of the stock in American companies, how much more true it is today when pension funds hold $8 trillion and own 45% of all publicly traded American companies!

Rifkin and Barber were visionaries. Today, we can make that vision a reality.

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