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Emerging Market Investment:
Is Corporate Governance and CSR the problem or the solution?

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Thank you Mr Chairman and ladies and gentlemen for asking Universities Superannuation Scheme to share with you some ideas on this important question. USS is the third largest pension fund in the UK with over 170,00 members from the UK University system and assets of about £20 billion and we have made a commitment to adopting a Socially Responsible and Sustainable Investment policy within our overall investment process.

I think most of us would agree that it would be "good thing" to have a more significant investment in emerging markets and for this investment to incentivise "sustainable development", assuming that this rationale also meets our fiduciary targets. Who could argue against the "win-win" outcome? Sustainable companies, sustainable economies, sustainable environments, sustainable societies – and in our case, sustainable investment returns! So the question is this. **Are investors who are interested in corporate governance (i.e. whether a company is run for the benefit of its ultimate shareholders) and corporate social responsibility (i.e. whether a company deals responsibly with its social and environmental impact) part of the problem or part of the solution when it comes to investing in emerging markets?**

My presentation today covers four points:

- How different investors have very different agendas. Governments who want to mobilise resources need to understand that different investors respond to different drivers, and then choose who you want to work with most.

- How, by responding to the developing interest in corporate governance and corporate social responsibility by investors, you can encourage some major investors who are wary of emerging markets.

- Who needs to do what, and given this audience, I will focus on what OECD and non-OECD governments can do.

- And finally, I will explain why institutional investors are not the cure.

So let's start with the fact that different investors have very different agendas and I am grateful to Bob Monks, the leading shareholder activist and former head of the US Department of Labour's pension division, for the next two slides.

There is a range of investors – something that is often forgotten when we speak of "the City" – each with differing interests:

- Arbitrageurs who own the stock for a very short period.
- Mutual funds who have annual tax considerations.
- Active managers with a two or three year holding pattern.
- Insurance companies who generally hold for a bit longer than active managers and a bit shorter than pension funds.
- Pension funds who typically might hold a stock for several years.
- And Index funds that are permanently held by definition (whilst the stock remains in the relevant index).

Given that we all have very different interests, who should governments and inter-governmental bodies like the OECD, listen to most carefully? Let me suggest – of course with *no* self-interest at heart – that pension funds and other institutional investors – should get this recognition. Why?

- We are also the most patient sources of capital. Pension funds typically hold shares for several years. To the extent that is possible in world of quarterly and yearly benchmarks, we also have a 20 to 30 year timeframe in considering our liabilities and investment strategy.

- With the growth of pension funds in the OECD world, institutional investors are significant players. Here are just the ten largest pension funds in the world – I am sad to say USS doesn't make the list – who together account for a lot of money. The global pension fund market is $15.5 trillion. Just focusing on the UK, institutional investors own over half of the UK stock exchange.

- And finally, the beneficiaries of *funded* pension funds make up a significant percentage of society, especially in some OECD countries.

So in some ways, what is good for us is a good proxy for what is good for society as a whole. I hope you agree that the case is strong for viewing institutional investors as your partner of choice!

Let me move on to my second point. Many of us have been concerned about corporate governance issues for some time and increasing numbers of us are now becoming concerned about CSR issues as well. Suffice to say that even the trade associations are moving! Just this month, the UK Association of British Insurers, launched a set of guidelines on social, ethical and environmental issues, dealing with this difficult debate from a risk management perspective. At the launch event a senior ABI spokesperson said: "Two years ago, it would have been unthinkable [for the ABI] to be having this gathering. Our members weren't very concerned with corporate social responsibility. [It] was seen as extraneous and a distraction." Currently these guidelines refer to UK companies but inevitably the process will go international. And the US Council of Institutional Investors – which represents 110 US pension funds and nearly 100 money managers – declared for the first time in its 16-year life that investors can promote “responsible business practices and good corporate citizenship” as part of their “fiduciary responsibility of protecting long-term investment interests.”

Why are mainstream investors taking these issues seriously? At one level, important stakeholders – like our members, pressure groups and our governments – are asking us to. Some funds and some countries have more active, better organised and better informed sources of pressure than others, but this is a global trend. But fundamentally, investors are organisations that respond best to fiduciary duty. And we are now getting evidence that this *is* the right thing to do from a *bottom-line* perspective as well, provided we take a pragmatic approach. By pragmatic I mean a "best of class" (i.e. companies who are leaders in their sectors) or "constructive engagement" approach (i.e. where we don’t screen but do engage with companies to encourage them to adopt good practice standards). I am contrasting these options with a wholesale negative screening (i.e. ethical investment) model. Let me quote just four studies which document this correlation.

- In a very interesting study – and I am grateful to them for providing their slides - McKinsey’s interviewed 200 institutional investors who control together $3 trillion in assets. Three quarters said board practices are at least as important to them as financial performance. Over 80% said they would pay more for the shares a well-governed company than for the same company if it were poorly governed. The actual premium they were willing to pay varied country by country – an extra 18% for a UK company and 27% for a company on Indonesia or Venezuela.

- CLSA, the stockbrokers, have done an extensive study of corporate governance in emerging market corporations. They looked at over fifty indicators divided into seven key criteria of good corporate governance: (1) management discipline, (2) transparency, (3) independence, (4) accountability, (5) responsibility, (6) fairness and (7) social responsibility. They found that there is a striking degree of correlation between share-price outperformance and corporate governance. Their key finding was this. Of the largest companies across the emerging markets, the average US$ return for the past three years has been 127%. The average return for companies in the top corporate governance quartile was more than double this at 267%.

- The US Environmental Protection Agency undertook a major study into the relationship between environmental and financial performance of a company and the investment returns to be had. It concluded: “A significant body of research shows a moderate positive correlation between a form’s environmental performance and its financial performance. However, capital markets have been slow to incorporate environmental information into mainstream investment decision-making.”

- A major study of 1,500 listed US companies by academics from Harvard and Wharton has discovered a “striking” correlation between governance and stock prices. An investment strategy that bought the firms in the lowest decile of the index (strongest shareholder rights) and sold the firms in the highest decile of the index (weakest shareholder rights) would have earned abnormal returns of 8.5 percent per year during the sample period. This paper, *Corporate Governance and Equity Prices*, is likely to emerge as the single most persuasive academic case to date that good governance can boost investor returns and lower the cost of capital for companies.

I am not saying that corporate governance and CSR analysis is a sure fire way to pick stocks! That would be silly because there are many issues which can be more important. What I am saying is that there is no evidence that better CSR or corporate governance standards result in reduced financial performance of the company and there is a lot of evidence of a positive correlation. What is the basis for this linkage to the bottom line? Is it because better corporate governance & better CSR reduce risks? Is it because it helps us identify outperformance potential? Or is it simply a proxy indicator for good management? I guess the answer will turn out to be mix of all three but actually it doesn’t matter why the link works – the key thing is that that it does! **So if governments help ensure companies meet benchmark standards on corporate governance and CSR, that will encourage a more positive approach from potential investing institutions.** And this is important given that currently, according to UK government estimates, only 2-4% of money invested by pension funds have gone to developing countries.

How is this interest translating itself on the ground? Let me give you just two examples of what is happening.

In Thailand, CalPERS – the largest pension fund in the world and a pioneer in corporate governance issues – has set up what its *Thailand Equity Fund*. The fund has a target of $250 million and will only make investments in companies that agree to comply with Government of Thailand and IFC environmental and social policies, including high standards of corporate governance and transparency. According to William Crist, CalPERS President, the other side of the coin to the economic crisis is that it has, "created an unprecedented investment opportunity" resulting in CalPERS wanting "to participate in the renewed growth of Thailand's leading enterprises while securing a good long-term investment for our members."

And Brazil is going to be an important test case of whether corporate governance reform can spur economic growth. Bovespa, São Paulo's stock exchange, is about to see its first IPO for the Novo Mercado, the new market shaped only for those corporations meeting high governance standards. Many other companies are busy restructuring to meet fresh governance guidelines for Bovespa's main board. Foreign investors, led by the large US fund, TIAA-CREF, are pressing top companies to meet best practices. At the same time, the International Finance Corporation, an arm of the World Bank, has become the anchor shareholder for an activist corporate governance fund managed by Bradesco Templeton. Another fund manager, Rio de Janeiro-based Dynamo, is showing index-beating results from activism. ABN Amro Asset Management last week launched a fund aimed only at companies with superior records in social, environmental and corporate governance practices. The consultancy LCV is marketing a new corporate governance rating service to Brazilian companies, as is Unibanco on the CSR agenda. And, last month, ex-Bradesco-Templeton fund manager Paulo Conte Vasconcellos founded ProxyCon to advise investors and companies around Latin America on governance. All this comes on top of a new law expanding shareholder rights.

Interest is so significant that I expect we will soon begin to see emerging market activist funds of the kind that are doing very well in the US and EU. In these situations, investors buy into a company that has the potential to be a success but is held back by remediable corporate governance factors, shake it up in a positive way and liberate shareholder value. This development will be much more effective if governments can develop a shared understanding about corporate governance, a point to which I will return later.

What I am trying to say is that there are things that can be done which improve the access of emerging market companies and countries to this, a specific but very significant, slice of global capital. Clearly investors may be more concerned about other issues (e.g. political and economic instability and, of course, business fundamentals) but provided these things are not ignored, action on corporate governance and CSR issues can only help.

And so to my third point, what can governments do? In a nutshell, OECD governments need to send clearer signals to the public (ie the ordinary members of pension funds) and the trustees of these funds that they want investors to be responsible and active long-term owners. I think the UK Government is getting many things right in this regard. Amongst other things, it has:

- Commissioned Paul Myners, a well respected City professional who could not be dismissed as a campaigner or outsider, to look at how fund management works and he said he was "particularly concerned by the value lost to institutional investors through the reluctance of fund managers to actively engage with companies in which they have holdings even when they have strong reservations about strategy, personnel or other potential causes of corporate underperformance".

- Asked pension funds to disclose their approach to social, environmental and ethical issues. Similar disclosure acts have now been passed in Australia and Germany and action is under consideration by the European Commission.

What else can governments do? They can be supportive of their companies adopting good practice standards in corporate governance and CSR. This is *as* important for OECD governments – since companies based in their countries are often the client for companies in non-OECD countries and able to use influence to transmit standards down the supply chain – as it is for non-OECD governments.

Here again, I will use the example of the country I know best. The UK government has:

- Commissioned the Company Law Review which seeks to bring company law into the 21st century through a focus on board leadership, proactive management of strategic risk (including social and environmental issues) and disclosure to owners and other stakeholders.

- Made clear, some would argue in a overly cautious way, that it wants major companies to monitor and report on environmental performance, and that it supports emerging international standards such as the OECD treaty on bribery and corruption.

- Appointed a Minister for Corporate Social Responsibility to co-ordinate the overall approach.

The important point is not the particular methods a government uses to send these signals. I know some non-OECD countries are very actively engaging with the UN Global Compact for example. The key issue is: are the words and policies being translated into actions?

And are there things that government shouldn't do? The most important thing is don't make it any harder for institutional investors to be responsible shareholders! There are some who would say that many investors don't need any encouragement in this regard! A litmus test is the issue of voting at AGMs. If we want to vote our equities with regard to a company based in Belgium, we need to make a decision in less than 16 days, our shares will be blocked for 3 days before the meeting, and we have to attend in person. The situation is pretty much the same in Finland, Netherlands, Thailand, Turkey…..I could go on!

What else could you do? Talk to us! The best companies now spend a lot of effort, through their investor relations departments, building relationships with us. Could not countries do the same? I see the Institute of International Finance issued a paper earlier this year, *The Principles for Private Sector Involvement in Crisis Prevention and Resolution*, highlighting the need for active and regular two-way contact to help market participants manage risks and to help authorities identify early signs of market concerns.

So let's come back to the question of whether investors who are interested in corporate governance and CSR are the problem or the opportunity. We are both! Which we turn out to be will depend heavily on what governments do. What is clear is that companies and countries that are able to compete on this front will have better access to more capital. And competing on this basis is surely a good thing. After all, don't we really all want a "win-win world"? Sustainable companies, sustainable economies, sociable environments, sustainable societies and sustainable investments?

So let me conclude with the words of someone who is well known in OECD circles, Ira Millstein. Mr Millstein is a leading corporate governance specialist and the chairman of the Global Corporate Governance Forum, which as you know is sponsored by the OECD and the World Bank. Writing in the FT a week after September 11th, he said: "Eliminating poverty and misery is crucial to the 'just war'; ideologues and fanatics breed on poverty and oppression. Diminishing the great economic divide between 'haves' and 'have nots' will require as much energy, effort and dedication as rooting out those who perpetrated the events of September 11."

What Mr. Millstein was saying was that an expanded definition of corporate governance that includes the corporate social responsibility agenda, is part of the solution in a world of growing inequality and tension. It's not the *only* solution and it may not even be the *most* important thing in some situations. We all know that FDI is very concentrated with five economies, led by China, Mexico and Brazil, receiving 56 percent of it. We know this marked a contrast with the 1994-1997 period, when concentration was diluted as economic prospects improved in many developing countries and access to the capital markets was obtained by a wider range of countries. We all know the massive creation of wealth in the past decade - with global savings and investment estimated at $7.5 trillion last year – has "bypassed" dozens of least developed countries (LDCs) – as a forthcoming UN report will conclude. We know that there needs to be an increase in overseas development aid – a challenge which most OECD governments are not meeting. We have all heard Mr. Wolfensohn comment frequently in the last month on the disparity between international aid and domestic subsidies. We all know that liberalisation of those sectors where OECD countries have protected markets, and where non-OECD countries can compete, is a priority as is the need to do this in a way which is socially responsible.

What I am trying to get across, and this is the fourth point, is that institutional investors are not the "cure". Governments cannot expect us to do their work for them. But if governments can set the right context, then investors can play an important supportive role. Investors may now, like governments, be ready to hear that what happens in far off places is no longer something that has no strategic relevance to our work. If you want to use this opportunity, may I suggest that what we do not need are appeals to be more moral or more long-term. For sure these are good things. But given the way institutional investors are held accountable by our clients, we don't have a lot of scope for acting very differently. What we do need is for governments to put in place strategic frameworks that genuinely change the risk/reward calculation of investing in emerging markets.

To recap, what we need OECD governments to do is to encourage your investors to be responsible and active shareholders. And what we need, from both OECD and non-OECD governments, is to encourage your companies to adopt benchmark standards of good practice on corporate governance and CSR issues. As part of this, it will be essential to develop a meaningful consensus between OECD and non-OECD governments on the relationship between, on one hand, the rights of the shareholders, and on the other, the responsibilities that corporations have to other stakeholders – something which will be particularly important as corporate governance activism develops. As these things happen, "pension power" could really become a major part of the solution!