WHY PROXY VOTING POLICIES SHOULD ENABLE VOTING DECISIONS THAT INCORPORATE BETA

Voting Beta Is Appropriate

Pension funds and other asset owners must preserve their capital and earn sufficient return to satisfy obligations to retirees and other liabilities. Asset managers must help investors optimize their returns based on an acceptable level of risk. For owners and managers alike, returns are the result of three variables:

1. The return of the market overall to the classes of securities within a portfolio ("beta");
2. The performance of the portfolio above or below beta based on the securities selected to be in the portfolio (alpha); and
3. Costs and fees expended to manage the assets.

Historically, asset owners and managers ("institutional investors") have focused on the second and third components and accepted beta as a factor over which they did not have control and for which they had no responsibility. The increasing recognition that the social and environmental systems upon which the global economy depends are at risk from corporate behavior demonstrates the deep flaw in that thinking—corporate behavior with respect to social and environmental systems affects the economy as a whole, and overall economic performance is a critical determinant of beta.

Moreover, shareholder activism in other areas demonstrates that shareholders can indeed affect corporate behavior. Thus, if shareholders can analyze the potential effects of their votes on corporate behaviors that effect the economy, they can—for the price of exercising a vote—make reasonable attempts to improve a critical facet of return. At a minimum, institutional investors should be open to the possibility that beta considerations can enter into proxy voting decisions.

A number of specific factors underlie this conclusion:

- Institutional shareholders are broadly diversified, and the variability of beta has the potential to have a much greater effect on a portfolio long-term return than variability of alpha, which accounts for less than 10% of the variability of portfolio returns.

- Corporate practices that contribute to social and environmental conditions that externalize costs (such as climate risk, antimicrobial resistance, and racial disparity) can lower GDP nationally and globally.

- Over long time periods, a lower GDP is likely to lower a diversified shareholder's long-term portfolio performance by a similar proportion.

- Institutional shareholders can vote collectively with other shareholders to effectively limit corporate practices that lower GDP without creating significant out-of-pocket costs or reducing alpha.

- When presented with a choice on a vote implying beta, a choice must be made—failing to support a measure that promotes beta may contribute to the measure failing and beta falling.

- There is nothing in current law that suggests beta activism violates the duties of trustees.

Based on these factors, every institutional owner should make sure that its voting policies properly incorporate considerations relating to beta. Appendix A to this document includes proposed language that can be added to a voting policy to add these concepts.

Set forth below are data and resources supporting this idea.

<u>The Established Relationship between Beta and Portfolio Performance</u>

1. *Mathematical demonstration of linear relationship between GDP and a diversified portfolio*

- "[T]he long-term price of a universally-owning institutional investor's portfolio represents the Universal Owner's part of the appropriately discounted sum of all future GDP proportions of corporations."

- "[T]he relationship between GDP and the price of the portfolio of a Universal Owner is linear in the long term."

- "Measurement and market imperfections can lead to a non-linear relationship between the price of a universally owning institutional investor's portfolio and GDP in short observation intervals, but in long observation intervals economic theory and mathematical logic strongly expect this relationship to converge towards linearity."

Universal Ownership: Why Environmental Externalities Matter to Institutional Investors, Appendix IV available at https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf;

2. *Common sense expression of concept from the world's most successful investor:*

   Total market capitalization to GDP "is probably the best single measure of where valuations stand at any given moment."

https://www.advisorperspectives.com/dshort/updates/2020/11/05/market-cap-to-gdp-an-updated-look-at-the-buffett-valuation-indicator (quoting Warren Buffet).

3. *Alpha makes up only a small part of the variability of portfolios*

   "Beta drives some 91 percent of the average portfolio's return." Stephen Davis, Jan Lukomnik & David Pitt-Watson, WHAT THEY DO WITH YOUR MONEY: HOW THE FINANCIAL SYSTEM FAILS US AND HOW TO FIX IT, 50 (2016).

<u>How Corporate Practices Can Affect GDP: Case Studies</u>

1. *Generally*. In a recent study, Schroders determined that publicly listed companies imposed social and environmental costs on the economy with a value of $2.2 trillion annually—more than 2.5% of global GDP.
   https://www.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf

2. *Obesity*. The World Health Organization assesses the unpriced social burdens of obesity as equaling almost 3% of global GDP annually. *Id*. Sugary drinks sold by companies like Coca-Cola and PepsiCo bear some responsibility for this cost.
   https://www.hsph.harvard.edu/nutritionsource/healthy-drinks/sugary-drinks/

3. *Inequality*. It has been estimated that inequality has reduced demand by 2-4% of GDP. https://www.epi.org/publication/secular-stagnation/. In the United States, corporate depression of wages for low income workers and exploding executive pay are expanding inequality. https://inequality.org/great-divide/putting-the-brakes-on-corporate-americas-inequality-engine/#:~:text=Corporations%20are%20contributing%20to%20inequality%20on%20two%20fronts.&text=The%20legislation%20%E2%80%94%20the%20Tax%20Excessive,the%20higher%20the%20tax%20rate

4. *Racial Injustice*. A recent report from Citigroup calculated that closing racial disparity would add $5 trillion to the U.S. economy over the next five years. *Closing the Racial Inequality Gaps: The Economic Cost of Black Inequality in the U.S.*, available at http://citi.us/3olxWH0. The same study explains steps that corporations could take to reduce the gap.

5. *Antimicrobial Resistance.* Antimicrobial resistance may decrease global GDP 3% by 2030, and almost 4% by 2050. At an intermediate discount rate, this will amount to economic losses by 2050 with a current value of $54 trillion. http://documents1.worldbank.org/curated/en/323311493396993758/pdf/final-report.pdf Scholarship links this increasing resistance in part to commercial pressures in agriculture and consumer packaged goods. https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4165128/

6. *Climate Change*. The world economy will be 3% smaller in 2050 due to lack of climate resilience. https://www.eiu.com/n/global-economy-will-be-3-percent-smaller-by-2050-due-to-lack-of-climate-resilience. Just 100 companies are responsible for 71% of industrial global carbon emissions. https://www.publicbooks.org/corporate-responsibility-in-the-climate-crisis/#:~:text=Although%20states%20are%20largely%20responsible,global%20industrial%20greenhouse%20gas%20emissions

<u>Fiduciary Law Does Not Appear to Preclude Voting to Support Beta Simply Because It Might Involve "ESG"</u>

1. *New DOL Rules clears up confusion.* After years of shifting guidance, the DOL proposed two rules essentially creating a presumption that ESG considerations were in violation of trustees' duties. After receiving comments including overwhelming evidence that ESG strategies are largely designed to increase return and/or decrease risk, the DOL finalized the rules, but eliminated the presumption. The following language from the DOL releases of the new rules shows that investment strategies—including beta activism—are not under any ERISA cloud.

- "Thus, the final rule removes all ESG terminology from the proposed regulatory text… the regulatory requirement will be clearer and more consistent if it demands that fiduciaries focus on providing participants with the financial benefits promised under the plan and focus on whether a factor is pecuniary, rather than being required to navigate imprecise and ambiguous ESG terminology."

- "[Both new rules] make clear that, from a fiduciary perspective, the relevant question is not whether a factor under consideration is 'ESG,' but whether it is a pecuniary factor relevant to the exercise of a shareholder right or to an evaluation of the investment or investment course of action."

- "The ERISA fiduciary duty of prudence requires portfolio-level attention to risk and return objectives… The proposal was not intended to suggest that these principles apply other than neutrally to all investment decisions by a trustee or other fiduciary…"

- "Commenters . . . expressed the view that the roles that proxy voting and shareholder voices play in current portfolio risk management practices should be evaluated in the context of the long-term and portfolio-wide strategy, with consideration of the aggregate effects of shareholder votes and voices. After considering these comments, the Department has modified paragraph (e)(2)(ii)(A) and (B).

  ". . . In the Department's view, the final rule provides sufficient flexibility for fiduciaries to consider longer-term consequences and potential economic impacts…"

2. Legal scholarship has long focused on ESG from the point of view of directors of individual companies, but there is now a growing focus on the need for trustees to use ESG strategies that increase systemic health and thus portfolio-wide performance—even where such strategies may decrease the value of individual holdings within a portfolio.

- "A rational owner would use his power to internalize externalities so long as its share of the cost to the externality-causing firms are lower than the benefits that accrue to the entire portfolio from the elimination of the externality." Condon, Madison, *Externalities and the Common Owner* (April 26, 2019). 95 Washington Law Review 1 (2020).

- "[I]t becomes rational and predictable that these institutional investors will make both investment and voting decisions on a portfolio-wide basis (rather than simply trying to maximize the value of individual stocks). This, in turn, permits the netting of gains and losses across the portfolio, and the implications of this transition are sweeping." Coffee, John C., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk* (September 21, 2020). European Corporate Governance Institute - Law Working Paper 541/2020.

Conclusions

- Even without certainty of the effect of any single vote on beta, the directional effect of externalizing costs should provide a sufficient basis for supporting beta measures if there is no showing of a corresponding cost at a specific investment of similar magnitude. Given the small fraction of overall return that any one company in a portfolio represents, it is unlikely that the risk of loss of alpha at a single company would equal the potential for gain in beta.

- A well-diversified investor's return is largely dependent on GDP, so that absent evidence that a collective voting action intended to raise GDP has unique characteristics that would change the calculus, there should be no question that the strategy would be considered "pecuniary" and in the best interests of fund beneficiaries.

Appendix A

PROXY VOTING POLICIES THAT PROPERLY ACCOUNT FOR BETA

Proposed text for Investment Beliefs or similar preamble material:

Portfolio-wide threats. Economy-wide costs imposed on the environment and society create systemic costs and risks that are undiversifiable and unavoidable in our portfolio. Therefore, the actions of companies that directly or indirectly increase these risks and costs threaten our entire portfolio.

Systems first approach. Our fiduciary responsibility to our beneficiaries includes taking advantage, when practicable, of opportunities to prevent companies from pursuing financial value through behavior that externalizes systemic costs and risks that harm our beneficiaries more than the isolated financial gains at a single company might benefit them.

Level playing field. In a market environment, competition can drive companies to externalize costs unless there is a level playing field for companies. Therefore, where there are reasonable opportunities to do so, we use our power as shareholders to create such a level playing field if it will redound to the benefit of our beneficiaries.

Proposed text to be inserted in director elections voting policy:

Our systems first approach means that, where practicable, we hold boards accountable at portfolio companies when they fail to adequately balance the imposition of system-wide costs and risks by failing to adhere to investor-mediated limits on activities that externalize social and environmental costs. Among other matters, we may vote against directors at companies that have failed to implement such guardrails in the areas of:

- disclosure
- compensation
- lobbying and political spending
- performance

Proposed text to be inserted in shareholder proposal voting policy:

In order to implement our systems first approach, we will, where practicable, vote in favor of shareholder proposals at portfolio companies that will promote the proper balance of those system-wide costs and risks by promoting consensus-based limits on activities that externalize social and environmental costs. Among other matters, such proposals may address:

- disclosure of the external costs of company activity
- compensation that fails to address such risks and costs
- the systemic effects of political spending
- adoption of a corporate form, such as the benefit corporation, that accounts for interests beyond company financial return that can affect diversified shareholders

Proposed text to create voting policy on certificate amendment to become a benefit corporation:

Conversion to a benefit corporation form gives companies a clear pathway to protect the systemic interests that may come into conflict with company-specific financial returns. However, the increased discretion may create a risk that directors fail to protect shareholder interests, so should be adopted only at companies that have strong corporate governance, including annually elected boards, a single class of stock and effective majority voting.

To protect the value of our portfolio as a whole, we will, where practicable, vote in favor of certificate amendments to convert to benefit corporations at portfolio companies with strong corporate governance if we determine that the conversion will promote the proper balance of system-wide costs and risks.

Proposed text for Mergers

In order to implement our systems first approach, we will, where practicable, consider available information indicating whether mergers and similar transactions impose significant costs on critical systems that impose undue burdens on diversified portfolios, and take such information into account in determining whether to support such transactions.