STRATEGIC PENSION FUND INVESTING

by

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ABSTRACT

This thesis examines pension fund investments which are targetted to benefit fund members or the general public. The paper first discusses the obstacles to strategic investing, second, asks why certain pension funds, especially the building trades union pension funds, have been able to implement non-traditional investment policies, and third, identifies the essential elements in a successful strategic investment policy.

The first chapter presents the problems with traditional pension fund investment policies. Institutional barriers which prevent changing traditional investment practices are described. Chapter Two explores alternatives to traditional investing and offers examples of strategic pension fund investments. The third chapter discusses pension funds within the AFL-CIO Building and Construction Trades Union, which have been the most successful at strategic investing. After looking at these successful cases, two elements are identified as supportive of strategic investing: 1) worker representation in investment decisions and 2) access to responsive financial institutions. Having identified these two elements, the final chapter describes ways workers can attain more control in investment decsions and use or develop institutions which are responsive to strategic investment goals.

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INTRODUCTION

Pension funds of American workers are the largest single source of new investment capital in the United States today. In 1980, pension funds provided over twenty five percent (25%) of all new capital available for investment in the United States economy. By the end of this decade, it is estimated that pension funds will finance half of all new investments in the United States. By 1995, total pension fund assets are expected to be four trillion dollars! It is no wonder that Senator Howard Metzenbaum noted that "without question those who manage pension funds are in a position to play a crucial role in determining the method and direction of the nation's economic growth and devlopment." 1

The current eight hundred billion dollars in pension funds is managed by a few bankers and investors in the largest bank trust departments and insurance companies in the country. The billions of dollars in pension funds are the "deferred wages" of workers, but workers have very little say over how and where their money is invested. In the United States, we have democratic processes to decide how public revenues should be invested. But, with pension funds, which are also social capital, owned by workers, democratic proceses hardly exist. There are no public hearings or debates on how pension fund money should be invested in the economy. By investing pension fund money, a few bankers, literally, have the power to shape economic growth in this country.

Unions, state and local governments and corporations are starting to acknowledge the economic power of retirement funds and have begun to focus attention on the investment of pension fund assets. A variety of government and private organizations have set up task forces to review pension fund investment policies. This attention on pension fund investments has been triggered by the poor financial performance of pension funds, while in the hands of bankers, over the last fifteen years. Past poor financial performance of pension funds, inflation, calls for divestments from certain companies and the concentrated control of the funds have all contributed to the questioning of traditional investment practices.

This discontent with traditional investment policies, has led to the development of an alternative theory about how pension funds should be invested, called "strategic investing". This term, "strategic investing", generally means that investments are targetted in ways that "directly benefit fund beneficiaries and the general public while still maintaining competitive rates of return and keeping risks at acceptable levels."[2] Social returns which accrue directly to the beneficiaries as well as the financial rate of return and risks are considered in a "strategic investment" policy. Currently, there is discussion among unions, state and local governments about strategic investing, however, thus far, there has been little change investment practices. It is evident there are obstacles to changing traditional pension fund investment policies.

But a few pension funds have successfully implemented strategic investments. This thesis asks the question, why is strategic investment easier to implement for some pension funds than for others? In other words, what characteristics about certain pension funds encourage them to pursue a strategic investment policy?

In order to find an answer to this question, we must understand what strategic investing is, what the obstacles are to its implementation, and then examine cases of successful strategic pension fund investment. From the existing cases, we can identify the common elements which support strategic investing.

The first chapter of this thesis looks at the problems with traditional pension fund investment policies. The chapter focuses on how and where pension funds are currently invested. The majority of investments are in the top one hundred corporate stocks and bonds. A very small percent of pension fund assets are invested in mortgages, even though mortgages have had higher financial returns than corporate bonds. This mortgage investment issue reveals an anomaly in the traditional theory that pension fund portfolio managers use objective financial criteria in choosing their investments. As we will see, there are many other problems with the way pension funds are presently managed.

The largest problem is that workers long-term financial, social and economic interest are often not considered when investing their money. The second chapter discusses pension funds which have proposed different strategies to create investments which have added social and economic benefits for workers, (i.e. housing, jobs). The obstacles to strategic investing are discussed in the final section of the second chapter.

The third chapter closely examines a group of pension funds within the AFL-CIO Building Trades and Construction Union, which have been the most successful at implementing strategic investing. The building trades union pension funds have invested in mortgages to increase jobs in the unionized sector of the construction industry. Mortgage investments serve the long-term employment interests of pension fund members, along with providing a secure, financial rate of return. I chose the building trades pension funds because I wanted to know why they, in particular, have been successful at implementing strategic investing. After looking at the building trades cases, three reasons are identified for their success: 1) mutual incentives for employer and employees to participate in mortgage investing, 2) joint control, meaning both employers and employees control investment decisions and, 3) innovative institutions are used to facilitate their mortgage investing.

The first reason, mutual incentives for employer and employee to participate in strategic investing, is specific to the building trades and not generalizable for other pension funds. However, the other two elements, joint control and innovative institutions, are common to all the other examples of strategic investing. Thus, employee participation in investment decisions and the use of alternative financial institutions are identified as key elements in supporting strategic pension fund investing.

Having identified these two elements, the final chapter describes, ways workers can attain more control in investment decisions and use or develop institutions which are responsive to strategic investment goals. The underlying argument in this thesis is that workers must participate in the control of pension fund assets to assure that investments serve their immediate and long-term interest. Before, this argument can be laid out, we need to understand how pension funds have evolved and what their institutional and legal apparatus look like.

Introduction

NOTES

1. Senator Howard M. Metzenbaum: Speech before the Retirement Income Conference, September 29, 1978. See AFL-CIO, Building and Construction Trades Department, Pension Investment Education Program, Maximum Benefit, Making Investments Do the Job, AFL-CIO, Washington, D.C., 1980.

2. Thomas Triplett, Investing in Minnesota: A Proposal to Use State Moneys For Maximum Benefit, Conference on Alternative State and Local Policies, Washington, D.C., February, 1980, pg. 4.

CHAPTER 1

PENSION FUND INVESTMENT BACKGROUND

HISTORY OF PENSION FUNDS

Pension funds have existed in some form for over a century. The first private pension plans were offered by large companies in the railroad industry in the late 1800's. American Express Company, which at that time, was involved in the railroad business started the first pension plan in 1875. By the 1920's, most major railroads, utility companies, banks and oil companies initiated pension plans. A few public employee pension funds were also established around the turn of the century; Massachusetts was the first state to establish a statewide pension plan for its public employees. All together about ten percent (10%) of the non-agricultural workforce were technically covered by an informal pension plan by 1925. [1]

Although four million people may have been covered by a pension plan, few people ever received a pension. There were no eligibility rules nor were benefits legally guaranteed. The pension fund was a gratuity from the employer. Infact, most of the plans before 1929 had a clause that read:

> (The employer has) "The right to change from time to time any of the foregoing provisions and substitute others in their stead and the right to revise or alter from time to time the plan under which this pension system has been established or to abandon said system is hereby reserved. . . . . . The allowances are voluntary gifts from the company and constitute no contract and confer no legal rights upon any employees." [2]

The early retirement plans were set up and paid for entirely by the employer. Employers set up these funds, first, to stop employees from shifting from job to job and thought a retirement fund would create a loyalty incentive. Second, employers could encourage older workers to leave with the promise of a pension fund.[3] By paying for the whole pension fund, the employer maintained control over paying out benefits. Murray Latimer, author of a two-volume book on early industrial pension funds wrote:

"If the dominating influence were the desire for a humane method of retirement, there would seem to be no reason against the employees contributing to a fund and having a voice in the administration. That they do not do so leads to the conclusion that the railroads have preferred to bear the entire cost in order to retain full control of the schemes. This policy has the advantages at least in the opinion of the managements of not complicating relations with trade unions, retaining full control of retirements and final judgement on the fulfillment of qualifications, discouraging strikes and permitting retirement for the good of the service and the public safety." [4]

Today, most pension funds, as we will see later on, are totally paid for and controlled by employers, for many of the same reasons mentioned above.

Organized labor was understandably suspicious about the management pension fund schemes and tried to set up their own union pension funds. However, it was difficult for unions to increase dues on their members and as there were more older workers in unions, the burden of a pension fund was too expensive for unions. By the depression, practically all union plans had collapsed.

The Great Depression did change the view about retirement plans. Pension funds were given more legitimacy because of public acceptance that individuals could not save enough money by themselves to provide for retirement. The adoption of Social Security in 1935 further legitimized the need for retirement funds. World War II also provided another impetus for companies to institute pension plans. The wage and price controls gave labor a reason to push for retirement plans because the funds were exempt from controls. High corporate taxes during the war encouraged companies to make use of the tax exempt status that pension funds had already received in 1921. These pension plans were more formal, bound in legal contracts and required to adhere to certain eligibility rules to keep their tax-exempt status.

A company, however, did not have to negotiate with the union over a pension fund until 1949 when the Supreme Court ruled that employers must bargain on pensions in accordance with the Taft-Hartley Act.[5] (Pensions were defined as part of the structure of wages.) The Court decision gave impetus to unions to negotiate on pension funds. Collective bagaining and revisions in the tax code led to continued growth of all types of pension funds, private and public.

Although the number of workers covered by pension funds increased during the 1950's and 1960's, few laws existed which protected the retirement benefits of those workers. Numerous horror stories were told about people working twenty-four years for a company only to have the company leave town, without ever paying the worker his or her pension benefits.[6] The most famous of these real-life stories involved the Studebaker plant closing in 1964 which left most of the eight thousand employees without a pension.

After ten years of hearing testimony from workers who never received their promised benefits and reports on corporation and union manipulation of pension fund assets, Congress enacted the Employment Retirement Income Security Act of 1974 (ERISA). ERISA is the most comprehensive pension fund legislation to date, touching on all aspects of pension fund administration.

The major provisions of ERISA involve the following issues: 1.) minimum standards for eligibility, 2.) vesting rights (the right to receive a pension once certain age and service requirements are met, even if the worker is not with the company at retirement) 3.) a government insurance fund called the Pension Benefit Guarantee Corporation which the employer pays into to insure pension benefits in case the company goes out of business, 4.) standards for disclosure and reporting assets to the Department of Labor and, 5.) sets out requirements for fiduciary responsibility.

This last requirement, "fiduciary responsibility" is the legal phrase dictating pension fund investment decisions. In ERISA a fiduciary is defined as follows:

> "A person is a fiduciary with respect to a plan to the extent (i) he/she exercises any discretionary authority or discretionary control respecting management or disposition of its assets (ii) he/she renders investment advice for a fee or other compensation direct or indirect with respect to any moneys or other property of such plan or has any authority or responsibility in the administration of such plan" [7]

This defined fiduciary has certain responsibilities to the pension fund as set forth in Section 404 of ERISA:

> "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participated beneficiaries and
> A) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan.
> B) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in conduct of an enterprise of a like character and with like aims.
> C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and
> D) in accordance with the documents and instruments governing the plan in so far as such documents and instruments are consistent with the provisions of this title."[8]

Thus, the fiduciary must invest the pension fund assets in the interest of the beneficiaries and administer it with prudence by diversifying investments. A fiduciary can be held liable if his or her investments are proven to be imprudent. There is also a section in ERISA which describes prohibited investment transactions to prevent self-dealing among trustees. For example, it it illegal to invest more than ten percent (10%) of pension plan assets in the employers securities.

ERISA's funding standards, vesting rights, termination insurance and investment requirements have all been interpreted and reinterpreted in hundreds of legal cases since 1975. One entire journal, the Journal of Pension Law and Compliance, is devoted to legal interpretations of ERISA, a highly complex peice of legislation. ERISA, however, only applies to private pension funds which represent about sixty five percent (65%) of total pension fund assets in the United States.

TYPES OF PLANS

The nine hundred billion dollars in public and private pension fund assets is held in over five hundred thousand different pension plans. These plans can be divided into two categories: public sector and private sector funds. Within public sector funds, there are state and local government pension funds (which includes teacher, police, fire, public univeristy funds) and federal retirement funds (i.e. military pensions). Private sector funds are divided into single employer funds and multi-employer funds. Public and private sectors are different in their funding mechanisms, their investments and the laws governing them. The approximate amount of assets in the different types of funds is shown in Table #1; together, public and private pension funds represent an enormous source of investments capital.

PUBLIC FUNDS

As the entire state and local government sector has grown, so has their pension funds. Currently, there are about six thousand six hundred state and local government retirement plans. The total assets in these funds have grown from five billion dollars in 1950 to over two hundred billion in 1981. State and local pension funds are financed by contributions from the employer (the government) and the employees. The government usually contributes about eighty percent (80%) and the employee twenty percent (20%) to the fund.

Private sector funds, in contrast, generally do not have any employee contributions to the fund.

The vast majority of state and local pension funds are financed through a defined-benefit plan as opposed to a defined-contribution plan. A defined benefit plan means the employer guarantees a certain amount of money to the employee upon retirement. It is a fixed benefit based on a formula which takes into account years of service and average annual salary. In a defined contribution plan, the employer contributes a set amount to the fund, such as fifty cents an hour per employee, which is estimated to be sufficient to meet certain pension goals. Investment risk falls on the employer in a defined benefit plan, because no matter how well investments do, the employer still must pay out a specified amount to retirees. Conversely, in a defined contribution plan, investment risk falls on employees because benefits are tied to the investment performance of the fund. The chart below illustrates who bears investment risk according to the type of financing of the pension plan.

Financing of the Plan	Investment Risk
Defined-Benefit	Employer
Defined-Contribution	Employee

State or municipal pension fund investment policy is made by retirement boards whose members are elected or appointed officials and plan participants. A recent survey or public pension funds concluded: "In most cases the boards carried ample representation of plan members who were either appointed or elected by plan participants".[9] Usually, retirement boards manage some of the investments in-house and also contract out investment responsibility to bank trust departments or insurance companies. Each state has its own statutes governing public pension fund investments, however, most states set limits on the amount of equity and real estate their public funds can hold. Recently, many state legislatures have revised their outdated pension fund restrictions.

TABLE #1

Approximate Pension Fund Size in 1982

		size
Public Sector:	State and Local Funds	$250 bil.
	Federal Funds	$100 bil.
Private Sector:	Not Collectively Bargained	$250 bil.
	Single Employer - Collectively Bargained	$250 bil.
	Mulitemployer Funds	$ 50 bil.
TOTAL PENSION FUND ASSETS		$900 bil.

Source: Peoples Business Commission, Washington, D.C.

TABLE #2

The 25 Largest Corporate Pension Systems
(assets in billions)

1.	AT&T Bell System	$31.1	14.	Rockwell	$2.7
2.	General Motors	$14.1	15.	Boeing	$2.7
3.	General Electric	$ 7.2	16.	Eastman Kodak	$2.7
4.	Ford Motor	$ 6.4	17.	Mobil Oil	$2.6
5.	U.S. Steel & Carnegie	$ 5.5	18.	Standard Oil, CA	$2.3
6.	IBM	$ 5.2	19.	Lockheed	$2.2
7.	Dupont	$ 4.9	20.	Westinghouse	$2.2
8.	Exxon	$ 4.3	21.	McDonnell Douglas	$2.1
9.	GT&E	$ 3.0	22.	Bethlehem Steel	$1.9
10.	Sears	$ 3.0	23.	United Air Lines	$1.9
11.	Shell Oil	$ 2.8	24.	ARCO	$1.8
12.	Standard Oil (Ind.)	$ 2.8	25.	Union Carbide	$1.7
13.	United Technologies	$ 2.7			

Source: Labor & Investments, Vol. 1, No. 5, June, 1981.

Public pension funds usually refers to state and local plans, but there are also federal retirement funds which cover all federal employees, including those in the military and Members of Congress. Employees as well as employing agencies contribute to federal pension funds. All federal pension funds are defined benefit plans and assets are invested in government securities. Investments and benefits are controlled by the Federal Civil Service Retirement System.

PRIVATE SECTOR FUNDS

SINGLE EMPLOYER FUNDS

Single employer funds is the largest category of pension funds and includes the plans of the majority of large U.S. corporations. Although there are over five hundred thousand private pension plans, the seventeen largest cover more than twenty percent (20%) of all private sector workers.[10] Table #2 lists the largest single employer pension plans and their current assets.

Two types of private pension plans can be distinguished by their type of management. The first is the insured plan in which an employer deposits money with an insurance company, which in turn administers the fund and creates an annuity contract for each retiree. The second type is a trusteed fund in which the employer contributions are paid into a bank trust fund which manages the investments of the pension fund assets. Sixty seven percent (67%) of private pension plans are trusteed and thirty three percent (30%) are insured plans.

The majority of single employer plans are entirely paid for and controlled by employers. Employers often prefer a plan to which employees do not contribute, because they are simpler to administer, cheaper because employee contributions are not tax deductible and "there is less apparent ground for union participation in the management of the plan."[11] However, unions often do participate through collective bargaining on issues concerning employer contributions or benefits to the pension fund. Approximately sixty five percent (65%) of all workers in private plans are covered by collective bargaining agreements. The few single employer funds with defined contribution plans have union representatives on the trustee board. A trustee board makes decisions on investment policy, the contributions to the pension fund and chooses an actuary, but daily investment is administered by in-house staff, an insurance company, or a bank trust department and more recently private investment houses.

MULTI-EMPLOYER PLANS

A multi-employer pension plan covers two or more enterprises which pool pension fund assets into one fund. There are about 7.5 million participants in multi-employer pension plans.[12] Firms in competitive industries are typically involved in multi-employer funds, such as companies in the food industry apparel, printing and publishing, mining, motor transportation, construction and certain wholesale trades. These industries have small businesses, seasonal and irregular employment and employees are typically represented by one large union. A multi-employer plan benefits employers who would find it too expensive to fund their own pension plans and benefits workers who can change employers and transfer their pension credits amoung those employers participating in the multi-employer plan.

Multi-employer funds are defined contribution plans, whereby the employer's obligation is limited to a contribution, usually as a percentage of payroll or cents-per-hour-per employee. The administration of multi-employer funds is governed by Section 302 of the Taft-Hartley Act of 1947, which among other things states that a joint board of trustees on which management and labor are equally represented must administer the fund. Previous to the Taft-Hartley Act, unions managed their own pension fund with no employer representation. The business community and the Republicans in Congress in 1946 - 1947 were very worried about losing control of pension fund capital to large unions and over President Truman's veto pushed through the Taft-Hartley Act.[13]Unlike single employer funds which usually are corporate adminsitered, multi-employer plans are jointly administered by unions and employers.

However, these jointly-administered funds follow the same practice as single employer funds and turn over the management of the assets to insurance companies and bank trust departments.

INVESTMENT MANAGEMENT

Pension fund assets are managed by bank trust departments, insurance companies, independent investment firms or in-house management. Although there are thousands of these financial institutions in the United States, just fifteen bank trust departments, twelve insurance companies and twenty four private investment firms control and manage ninety percent (90%) of the approximate eight hundred billion dollars in pension fund assets. From Table #3 we can see that the top ten pension fund managers invest twenty five percent (25%) of all pension fund assets. The dominance of large banks and insurance companies in pension fund management is not new. In the 1950's Paul Harbrecht, commented in Pension Funds and Economic Power: "In the end, the anatomy of control of the pension trusts may be described quite simply. In general, financial control has been delegated by employers to the banker trustees, which exercise considerable power in the capital markets as a result." [14]

Pension funds are not only controlled by relatively few financial institutions, but day-to-day investment decisions are made by very few people in these institutions. One portfolio manager often invests several pension funds. The average individual portfolio manager controls two hundred million dollars.[15] Jeremy Rifkin and Randy Barber , authors of the book The North Will Rise Again, Pension Politics and Power in the 1980's, described the power of an individual portfolio manager:

> "What is even more disturbing is the number of people who are ultimately responsible for making all-important decisions on how and where to invest these funds. The general public has never heard of Harrison Smith, Willard Wheeler or Al Thompson, but, as investment managers of Morgan, Manufacturers Hanover Trust and Citicorp, they each control as much investment money as Dupont, Rockefeller, Morgan and Ford families."[16]

TABLE #3

The 25 Largest Pension Managers
(assets in billions)

Managers	$
1. Equitable Life Assurance	26.3
2. Prudential Insurance	22.8
3. Aetna Life & Casualty	18.5
4. Metropolitan Life	17.7
5. Morgan Guaranty Trust	14.3
6. Bankers Trust	13.6
7. Connecticut Beneral Insurance	10.6
8. Mellon Bank	9.9
9. Travelers Corp.	9.9
10. John Hancock Mutual Life	9.3
11. Harris Trust & Savings Bank	8.7
12. Citibank	8.0
13. Scudder, Stevens & Clark	8.0
14. Chase Manhattan Bank	7.1
15. State Street Research & Management	7.1
16. Fayez Sarofim	6.8
17. Manufacturers Hanover Trust	6.8
18. Chemical Bank	6.6
19. First National Bank of Chicago	6.6
20. Wells Fargo Bank	6.4
21. Capital Group	5.8
22. First National Bank of Boston	5.5
23. Bankers Life	5.3
24. Batterymarch Financial	5.3
25. Loomis, Sayles & Co.	5.3

Source: Institutional Investor, 1982
Pensions Directory, January, 1982.

Sometimes, the trustees of a pension fund will give investment guidelines to their portfolio manager. Usually these guidelines specify the asset mix between stocks and bonds that the trustes want. More often, though, portfolio managers are given free reign to invest the funds as he or she sees "prudent". Greenwich Research Associates, a firm which annually releases a survey of one thousand pension fund investment managers reported: "corporate executives are less and less interested in giving explicit instructions to outside pension investment managers."[17] The majority of trustees give full discretion over investments to their portfolio managers.

Trustees usually do not give their portfolio managers investment guidelines, but, they do monitor the performance of the fund. Large pension funds divide their assets among different bank trust departments or investment firms to create competition for higher rates of return. Trustees can reward or punish their managers depending upon the return of the pension fund portfolio. This practice of pitting investment managers against each other has increased because the rate of return on all pension funds has been notoriously low over the last fifteen years. The poor performance of pension fund investments, which will be discussed in a later section of this paper, has also led to a trend toward in-house management of pension funds. Some companies have decided that they can manage at least some of their assets better than banks have in the past. In-house management is a controversial trend because of the potential abuses which can arise from mixing company investments with pension fund investments. The concern is that pension funds tax-exempt status encourages manipulation of company and pension investments to have the least annual tax liability. Charles Epstein of Pension's Investment Age, discussing he mixing of company and pension fund investments, expressed the fear that: "the pension fund because of its sheer dollar size will no longer be looked upon as an isolated fund to provide an employee benefit, but as a potential pool to fuel corporate profits."[18] Manipulation of pension fund assets to further the company's self interest can occur with in-house management as well as outside investment management.

A recent case in which the pension fund was illegally manipulated involved the Grumman Corporation fight against an unfriendly takeover by LTV Corporation. Grumman Corporation trustees purchased 1,275,000 shares of Grumman stock to prevent the LTV takeover. Newspaper accounts stated that the trustees only spent a half hour discussing whether to buy their own securities and never consulted their own in-house invesment staff. A few Grumman pension fund beneficiaries sued Grumman and a Judge recently ruled in the beneficiaries favor concluding that the pension assets were manipulated "with the knowledge that if the trustees objectives were realized, the pension plan would have to absorb substantial short-term losses.....trustees have manifested an inability to separate their corporate loyalty and their loyalty to the pension plan". [19]

The potential for "confusing loyalties" is just as great when investments of pension fund assets are controlled by a few large banks. There are several ways that pension fund management by large financial institutions is susceptible to conflict of interest; these include banks using pension funds to invest in companies in which the bank has made outstanding loans, a company using a bank as its manager because the bank is also its primary lender or a major stockholder and interlocking directorates between companies and banks.

The Industrial Union Department of AFL-CIO did a survey of large corporatioins and their investment managers, and found that many of the major financial institutions, such as Morgan Guaranty, Citicorp, Prudential, Rowe Price own considerable amounts of stock or are debtholders in companies in which they manage a pension fund.[20] For example, Morgan Guaranty Trust is a top stockholder and major debtholder in General Electic as well as one of General Electric's pension fund investment managers. In addition, Morgan Guaranty and General Electric have interlocking directorates, where at least one bank official is on the Board of Directors of General Electric.

Another startling example of bank-corporate interlocks involves Chase Manhattan Bank.

> "Chase Manhattan jointly manages a $423 million dollar pension fund for Firestone. Former Chase President, Willard Butcher, sits on the Firestome Board. Firestone is a commercial customer of Chase and the bank trust department holds 950,000 shares in Firestone. [21]

Barber and Rifkin ask: "Can Mr. Butcher really look the American public squarely in the eyes and claim, without qualification, that there is no possibility of a conflict of interest occuring here?"[22]

There have been two books put out by the 20th Century Fund, Conflicts of Interest: Corporate Pension Fund Management and Conflicts of Interest: Commercial Bank Trust Department, which discuss the way banks use pension funds to further the banks interests, sometimes at the expense of the pension fund. A common situation is one in which a bank invests in securities of a company which is a commercial borrowing client, even if the company is in a declining market. Last year, there was a court settlement between Continental Illinois Bank and the AirlinePilots Association (ALPA) pension fund, which represents a clear example of bank manipulation of pension fund assets.[23] Continental had to pay $1.75 million to the ALPA pension fund in restitution for lost pension fund money caused by conflict of interest investments. Continental had invested ALPA's pension fund in stocks of companies they were commercial lenders to, such as TWA, Penn Cental Company, Management Assistance, Inc. and U.S. Freight. The suit charged that Continental held onto the stocks even when the security prices were declining and it was evident that one of the comanies was facing bankruptcy. The bank served as a creditor for the declining companies, so they also posessed "inside information" about the financial status of the company.[24]Pensions & Investment Age remarked on the Continental case: "This suit and others like it have brought up the broader issues of whether a trustee bank may invest in securities of companies to which the bank has made outstanding loans. The questions have not been legally decided." 25

Of course, banks are not the only ones that have mismanaged pension funds. There have been notorious cases of union trustees "ripping off" their members pension fund. Teamsters fund is noted for its corrupt management which invested in the underworld businesses of Las Vegas. Although the Teamsters and the United Mine Workers are the unions most associated with corrupt pension fund management, there have been other cases of conflicts of interest with unions and pension fund investment. It is the union abuse of pension funds, infact, that has received the most coverage and few people realize the conflicts of interest involved in having a few banks control the billions of dollars in pension funds.

In summary, trustees of pension funds usually turn over the management of investments to financial institutions to protect themselves from fiduciary liability and because the investment bankers are the "experts". Trustees often try to create competition between investment managers in order to receive higher rates of return on their portfolio. Since the last fifteen years, the rates of return on pension funds have been quite low, this has led to a trend toward more in-house managment of funds. Nevertheless, the vast majority of pension fund assets are invested by a few bank trust departments, insurance companies and private investment firms. This concentration of pension fund management within the elite of the financial community creates conflicts of interest in investments. These conflicts stem from the close ties banks have with corporations as either a lender, stockholder, or director on a Board, or all three. The pension fund assets can too easily be manipulated to serve the interests of large banks. Rifkin and Barber discuss the dependence banks have on pension funds for their business:

> "Major banks are controlling tens of billions of dollars of pension funds. These moneys are increasingly providing these institutions with the primary instrument through which they carry on their overall business dealings. The pension fund has become indispensible to their operations and success.

> Therefore, it is absurd to continue to harbor the myth that their sole and exclusive interest is the welfare and benefit of the fund itself. The fact is that the banks are not the instrument serving the fund. Rather the fund is the instrument serving the banks."[26]

It is evident that a significant portion of America's new investment capital is managed by a few people in banks or insurance companies with very little oversight. These financial institutions invest pension funds because they are presumed to be the experts. In the next section, we will look at where the funds have actually been invested and what the performance of pension funds have been while in the hands of the experts.

INVESTMENT POLICY

Banks and insurance companies, the two financial institutions which control pension funds, have different investment policies regarding pension fund assets. State and local funds also emphasize different types of investments from private insured or trusteed funds. Table #4 compares the mix of assets that trusteed and insured pension funds have had in the past and currently hold. Insurance companies and trusteed pension funds are compared, not only because insurance companies invest over thirty percent (30%) of private pension funds, but also because the two institutions have similar financial needs. Both make their investments with a long-term horizon, are risk averse and pay benefits in the same manner. Thus, one would think that the investment portfolios of banks who invest pension funds and insurance companies would resemble each other. However, as Table #4 shows, banks emphasize equity investments while insurance companies and public funds invest more in bonds. A glaring difference between the types of funds is that insurance companies have invested approximately thirty percent (30%) of their assets in mortgages while banks hold a meager one percent to three percent in mortgage investments. These differences originate from historical, institutional and legal restraints on investments.

The first part of this section discusses the historical investment trends of trusteed, insured and public pension funds. The remainder of this section focuses on the small amount of mortgage investments by pension funds. The mortgage investment issue is interesting because it reveals an anomaly in the theory that portfolio managers use objective, neutral criteria in choosing investments from the menu of possibilities. In the previous section, we saw how bank trust departments can have biases toward certain investments because of ties to companies they invest in and interlocking directorships. In this section, we again see institutional management biases which favor certain assets, such as stocks and ignore mortgage investments, for no apparent market reason.

The institutional management bias explanation for lack of mortgage investments is backed up by three facts which will be discussed in this section and have been already articulated in Ken Rosen's paper, The Role of Pension Funds in Housing Finance.[27] First, as mentioned, insurance companies with comparable financial needs to pension funds have invested a much larger proportion of their assets in mortgages. Second, the economic characteristics of mortgages make them desirable investments. Third, public pension funds and jointly trusteed funds have a higher proportion of assets in mortgages than private trusteed funds. Before discussing the mortgage investment issue further, it is important to review the historical trends of pension fund investments.

INVESTMENT TRENDS

Before 1930, most private pension plan investments were managed by the sponsoring company; there were few insured or trusteed funds. Most of the investments were in bonds of the sponsoring company with about ten percent (10%) of assets invested in government securities. By 1940, insured plans were used more and both types of plans invested a large percent of their funds in government securities. The World War II effort stimulated this increased investment in federal securities.

After World War II, the number of insured and trusteed plans and their assets grew substantially. Trusteed funds began switching their investments from government securities and bonds to common stock in large, established companies where there were higher rates of return. As stocks remained a solid investment through the 1950's and the 1960's, there was a large shift in trusteed funds away from corporate bonds toward corporate equity. In 1946, forty one percent (41%) of trusteed funds were in U.S. securities, twenty five percent (25%) in bonds and only eight percent (8%) in stocks. By 1965, only four percent (4%) of assets were invested in government securities, thirty percent (30%) in bonds and fifty six percent (56%) in stocks. Today, pension funds are top stockholders in the largest companies in the U.S.

TABLE #4

Distribution of Pension Trusts, 1946-1980, Selected Years

Type of Asset	1946 Bil.	1946 Percent	1955 Bil.	1955 Percent	1960 Bil.	1960 Percent	1965 Bil.	1965 Percent	1970 Bil.	1970 Percent	1975 Bil.	1975 Percent	1980 Bil.	1980 Percent
							Market Value							
Cash and Deposits	$.1	2.8%	$.4	2.2%	$.5	1.3%	$.9	1.2%	$1.8	1.7%	$3.0	2.1%	$9.3	3.1%
U.S. Gov't Securities	1.5	41.7	2.9	16.1	2.7	7.3	2.9	4.0	3.0	2.9	11.1	7.6	26.3	8.5
Corporate & Other Bonds	.9	25.0	7.7	42.8	14.6	39.4	21.9	30.0	29.9	23.8	34.5	23.7	60.0	20.0
Stock	.3	8.3	6.1	33.9	16.5	44.5	40.8	56.0	67.1	64.1	88.6	60.8	175.8	59.2
Mortgages	a	a	.3	1.7	1.3	3.5	3.4	4.7	3.5	3.3	2.1	1.4	3.8	1.3
Other Assets	.8	22.2	.6	3.3	1.4	3.8	3.0	4.1	4.4	4.2	6.3	4.3	22.0	7.4
Total Reserves	$3.6	100.0%	$18.1	100.0%	$37.1	100.0%	$72.9	100.0%	$104.7	100.0%	$145.6	99.9%	$297.2	100.0%
							Book Value							
Cash and Deposits			$.4	2.5%	$.5	1.5%	$.9	1.5%	$1.8	1.9%	$3.0	2.1%	$9.3	3.6%
U.S. Gov't Securities			3.0	18.5	2.7	8.2	3.0	5.1	3.0	3.1	10.8	7.4	28.3	11.0
Corporate & Other Bonds			7.9	48.8	15.7	47.4	23.1	39.0	29.7	30.6	37.8	26.0	63.9	24.8
Stock			4.0	24.7	11.5	34.7	25.9	43.8	53.5	55.1	84.8	58.4	129.8	50.5
Mortgages			.3	1.8	1.3	3.9	3.4	5.7	4.2	4.3	2.4	1.7	4.1	1.6
Other Assets			.6	3.7	1.4	4.2	2.9	4.9	4.9	5.0	6.4	4.4	21.5	8.4
Total Reserves			$16.1	100.0%	$33.1	100.0%	$59.2	100.0%	$97.0	100.0%	$145.2	100.0%	$256.9	100.0%

Distribution of Assets of Pensio Plans Funded Through Life Insurers, 1946-1980, Selected Years

Type of Asset	1946 Bil.	1946 Percent	1955 Bil.	1955 Percent	1960 Bil.	1960 Percent	1965 Bil.	1965 Percent	1970 Bil.	1970 Percent	1975 Bil.	1975 Percent	1980 Bil.	1980 Percent
Cash and Deposits	a	1.6%	$0.2	1.4%	$0.2	1.1%	$0.3	1.0	$0.4	0.9%	$0.5	0.7%	$1.0	0.6%
U.S. Gov't Securities	$1.4	45.6	1.1	9.8	1.1	5.6	0.9	3.4	0.9	2.3	1.6	2.2	5.9	3.6
Corporate & Other Bonds	.9	28.9	5.0	44.6	8.4	44.6	11.4	41.9	15.9	38.5	28.4	39.3	65.3	39.7
Stock	.1	2.6	0.5	4.1	.8	4.3	1.6	5.9[b]	3.2	7.7[b]	7.2	10.0[b]	18.3	11.1[b]
Mortgages	.5	15.1	3.8	33.5	6.8	36.1	10.6	38.9	15.2	37.0	3.0	31.9	46.1	28.0
Other Assets	.2	6.2	0.7	6.6	1.5	8.2	2.4	8.9	5.6	13.6	11.4	15.8	28.0	17.0
Total Assets	$3.1	100.0%	$11.3	100.0%	18.8%	100.0%	$27.3	100.0%	$41.2	100.0%	$72.2	100.0%	$164.6	100.0%

Source: Alicia Munnell, The Economics of Private Pensions, Brookings Institute, Washington, D.C., 1982.

While trusteed funds accumulated equity investments, insured pension funds maintained a fixed income or bond oriented portfolio. State regulations governed the investments of life insurance companies and limited the amount of equity they could hold. In New York, for example, where most life insurance companies were domiciled, there was a three percent (3%) limit on the amount of equity an insurance company could invest in. Pension plans increasingly were managed by bank trusts in which there was more freedom over investments. Insurance company investments are still regulated by states.

There are not only state laws limiting the amount of equity investment by life insurance companies, but also regulations within the industry. There are standards set by the National Association of Insurance Commissioners which dictate the way life insurance companies make contributions to a Mandatory Securities Valuation Reserve (MSVR) and the amount of contribution is determined by the investment class (rating) of their assets.[28] An insurance company contributes less to the MSVR if it has investments in high-grade long-term bonds. This system discourages low grade bonds or common stock investments. For at least these two reasons, state regulations and industry standards, life insurance companies have emphasized bonds in their portfolios while trusteed pension funds have invested in common stocks.

In 1963, a law was passed allowing life insurance companies to set up separate accounts to manage pension funds. These separate accounts can invest in common stock without any restrictions. Approximately seventeen percent (17%) of insured pension assets are held in separate accounts.[29] The rest of insured pension assets are combined with life insurance assets. Even counting these separate accounts, life insurance companies invest only about ten percent (10%) in corporate equity, in contrast to trusteed pension funds which have sixty percent (60%) in stocks. Like insurance company investments, state and local pension funds have most of their assets in corporate bonds. Many states also have legal restrictions limiting the amount of equity their public pension fund holds, although some of these limits have been changed recently. During the last fifteen years public pension funds have increased their investments in corporate stock. In 1965, public pension funds only invested about four percent (4%) in stocks. Today they have around twenty percent (20%) in stocks. The combined stockholdings of public funds make them among the top five stockholers in over forty percent (40%) of the Fortune 500 companies.[30] California's state pension funds alone have thirty billion dollars in assets and are the fourth largest stockholder in Bank of America, fifth largest stockholder in Chase Manhattan Bank, seventh in ARCO and overall the nation's sixth largest institutional investor.[31]

In brief, there are differences between insured, trusteed and public pension funds and their allocation of their assets between equity and fixed income investments. While, commercial banks have leaned toward equity investments, insurance companies and public funds have traditionally steered a more conservative course and emphasized fixed income investments. Clearly, though, insurance companies and more recently public pension funds differ most from trusteed funds in the amount of their mortgage investments.

MORTGAGE INVESTMENTS

Given the similarities in financial needs of insurance companies and pension funds, it is curious that insurance companies have thirty percent (30%) of their assets in mortgages and non-insured private funds only have two percent (2%) in mortgages.* Along with comparable financial needs, life insurance companies and banks trust departments which invest pension funds, have similar industry structures. Like commerical banks, the life insurance industry is characterized by a high degree of concentration with a few firms

*Insured pension assets in separate accounts have only one percent in mortgages.

dominating the industry. Among 1,762 life insurance companies in the United States, the top five firms have forty four percent (44%) of the assets and forty two percent (42%) of the industry's mortgage investments.[32] It is not the differences in the competitive structure of the banking and insurance industries which makes insurance companies invest more in mortgages. There are, however, other institutional as well as legal and historical reasons for this curious difference in mortgage investments.

State legal restrictions on the amount of equity insurance companies could hold encouraged the companies to diversify their debt portolios. These legal barriers helped to promote insurance company investments in mortgages.

Since the early 1900's life insurance companies have invested about thirty percent (30%) of their assets in real estate mortgages. During the Depression and World War II, their mortgages investments dropped: in the early 1930's people had no money to pay their mortgages, so life insurance companies were forced to take title of property and during the war, there was little domestic construction. After the war, though, there was a need for housing which increased the demand for mortgage credit.[33] Life insurance companies filled this demand because home mortgages offered competitive rates of return. Annually, life insurance companies increased the percent of their assets they invested in mortgages.

In the 1960's, life insurance companies switched from residential mortgage investments to commercial mortgages. Alicia Munnell, a Federal Reserve Bank economist, writes: "This increased interest in commercial mortgage lending can be attributed, among other factors, to the attractive yield and the relatively short effective maturities of commercial mortgages (three to five years)."[34] Commercial mortgages tend to be on large income producing properties which have higher expected yields than residential mortgages.

Life insurance companies also developed relationships with mortgage bankers which facilitated their commerical and residential mortgage investments. A recent article in Mortgage Banker states:

> "Recognizing the local nature of real estate, insurance companies set up regional offices or established correspondent relationships with local mortgage bankers to analyze investments and monitor important developments in the community and in conjunction with servicing the loan or identifying potential investment opportunities. The insurance companies developed a learning curve involving local people who could continuously deliver intelligent investment opportunities and services. The correspondents often helped shape the investment policy of an institution. And twenty five years of problem-solving through changing economic cycles has expanded their knowledge and skills in analyzing and dealing with different properties."[35]

Commercial bank trust departments have never cultivated this link with mortgage bankers, because portfolio managers have not been interested in mortgage investments.

Many reasons have been offered as to why pension funds have invested very little in any mortgages and especially home mortgages. The reasons most often cited are: the small difference between mortgage and bond yield, default risk, illiquidity, lack of staff expertise, administration costs and inadequate inflation protection.[36] Ken Rosen, in his paper, The Role of Pension Funds in Housing Finance refutes many of the "excuses" given for pension funds lack of investment in home mortgages. For example, Rosen shows that between the years 1960 and 1974 conventional mortgage interest rates have been 1.5% higher than Aaa bond yields. Since 1974, both conventional and FHA mortgages have maintained higher yields than high grade bonds, as shown in Table #5. The rate of return has not prevented pension trusts from investing in residential mortgages.

Risk as well as return is an important element in choosing investments. With mortgages, there is interest rate risk and default risk. Interest rate risk

TABLE #5

Yields on Mortgages and Corporate Bonds, 1960-1981

	Mortgages		Corporate Bonds	
Year	FHA Insured	Conventional	Aaa	Baa
1960	6.24%	6.08%	4.41%	5.19%
1961	5.86%	5.81	4.35	5.08
1962	5.75	5.71	4.33	5.02
1963	5.46	5.84	4.26	4.86
1964	5.45	5.78	4.40	4.83
1965	5.47	5.74	4.49	4.87
1966	6.38	6.14	5.13	5.67
1967	6.55	6.33	5.51	6.23
1968	7.21	6.83	6.18	6.94
1969	8.29	7.66	7.03	7.81
1970	9.03	8.27	8.04	9.11
1971	7.70	7.60	7.39	8.56
1972	7.53	7.45	7.21	8.16
1973	8.19	7.78	7.44	8.24
1974	9.55	9.71	8.57	9.50
1975	9.19	8.75	8.83	10.61
1976	8.82	8.76	8.43	9.75
1977	8.68	8.80	8.02	8.97
1978	9.70	9.30	8.73	9.49
1979	10.87	10.48	9.63	10.69
1980	13.42	12.25	11.94	13.67
1981	16.29	14.16	14.17	16.04

Source: Alicia Munnell, The Economics of Private Pensions, Brookings Institute, Washington, D.C., 1982.

TABLE #6

Total Rates of Return and Standard Deviation of Returns for FHA Mortgages and Other Assets, 1960-1980 and 1970-1980

	Total Return, 1960-1980				Total Return, 1970-1980			
Asset	Average	Minimum	Maximum	Standard Deviation	Average	Minimum	Maximum	Standard Deviation
FHA Mortgages	5.1%	-6.7%	16.1%	5.2%	5.9%	-6.7%	16.1%	6.6%
Common Stocks	8.0	-26.5	37.2	17.0	8.0	-26.5	37.2	20.0
Long-Term Corporate Bonds	3.6	-8.1	18.4	7.0	5.4	-3.1	18.4	9.0
Long-Term Government Bonds	3.1	-9.2	16.8	7.0	4.6	-1.2	16.8	7.0
U.S. Treasury Bills	5.4	2.1	11.2	2.0	6.8	3.8	11.2	2.0

Source: Alicia Munnell, The Economics of Private Pensions, Brookings Institute, Washington, D.C., due for publication June 1982.

is often measured by the standard deviation of the asset's rate of return in a time series. The standard deviation on the rate of return over time shows the dispersion around the expected return on an asset, in this case, mortgages. Table #6 compares the standard deviations on the rates of return for mortgages, stocks and bonds. Stocks are by far the most risky of the investments and their higher returns during some periods takes into account the risk involved in making corporte equity investments. One expects bonds and mortgages to be less risky, but the risk with mortgages is below that of both types of bonds. These low risk indicators for mortgages have been in times of high inflation, where one would expect that mortgages would incur more interest rate risk losses.[37]

Default risk is the possibility that the borrower will not pay the principal or interest or both on the mortgage debt. The type of insurance or government guarantee, the credit of the borrower, loan-to-value-ratio and the value of the property are key elements in determining default risk. In the case of FHA or VA home mortgages, which have government guarantees, there is very little default risk. The lender bears practically no risk in case of foreclosure. Conventional mortgages have a slightly higher risk of default, but usually private insurance protects the mortgages from the first twenty to twenty-five percent loss, with value of the property protecting the remaining loan portion from loss.[38] Often, the probability of default risk with a conventional mortgage depends upon the value of the property and the credit of the borrower.

The recent development of mortgage-backed securities and mortgage pools has mitigated many of the issues around risk. With a pass-through mortgage-backed security, an investor, in this case a pension fund, buys a share in a mortgage pool. The amortization of the principal and interest due on the share in the mortgage pool is passed on to the investor each month. The most common type of pass-through mortgage-backed security is offered by the Government National Mortgage Association (GNMA). GNMA securities represent a share in a pool of FHA and VA insured mortgages. GNMA mortgage pools, called "Ginnie Maes" are government insured, fully guaranteed by the "full faith and credit of the United States government". Thus, there is no risk of loss by foreclosure with a Ginnie Mae security.

There are also mortgage-backed securities offered by quasi-government agencies like Federal National Mortgage Association (FNMA/"Fannie Maes") and the Federal Home Loan Mortgage Corporation (FHLMC/"Freddie Macs"). These securities are backed by the faith and credit of the agencies, and have a slightly higher risk. Conventional mortgage pools are usually covered by private insurance to minimize any default risk. Ken Rosen, who also wrote about Canada's mortgage investments, sums up the risk issue saying: "In neither country (U.S. or Canada) can risk explain the relatively small scale of mortgage investment by the pension funds. The portfolio diversification implied by a risk averting strategy should involve diversification over types of assets not just diversification within one asset type." [39]

The other reasons cited for pension funds lack of mortgage investment also do not hold much weight. For example, illiquidity should not be much of an issue for pension funds since their very purpose is long-term finance. Nevertheless, amortization on a mortgage provides a certain amount of built-in liquidity. Mortgage-backed securities, such as GNMA's guarantee monthly payments from the amortization of the principal and the interest due on the share in the mortgage pool. GNMA's also have high liquidity because they can easily be traded on the secondary market.

Mortgages are traditionally associated with high transaction, information and administration costs. Information costs can increase because there is no daily price quotes on real estate mortgages, like there is in the stock market. The mortgage market is assumed to be geographic specific which also can raise information costs. Mortgage investments do require a certain amount of staff expertise which may not be needed in publicly offered bonds. However, many of these transaction costs of mortgagees have been eliminated by mortgage bankers or brokers. A mortgage banker originates mortgages, resells the loan to an institution and services the loan for a fee (.1% - .5%). Even adding on the mortgage broker service fee, the net yield on mortgages still compares favorably with other assets.[40] Good mortgage bankers are also aware of local mortgage markets and their unique qualtities which mitigates some of the geographic barriers.

Mortgage-backed securities require fewer administrative costs than direct mortgage investing. The investor does not deal with loan origination or servicing of the mortgage. The administrative process is similar to buying a bond from a broker but the security is backed by property instead of the capital of a corporation. It is not clear that mortgage instruments today have greater transaction costs than other conventional securities. Also, mortgages are no less of a hedge against inflation than other securities. Stocks used to be considered an inflation hedge, but after the 1970's drop in the stock market, mortgages are as least as good as a protection against inflation. A variable rate mortgage would be an excellent inflation hedge for the investor.

So, if none of the reasons adequately explain why trusteed pension funds have so little of their assets in mortgages, why have the funds steered clear of mortgages? Rosen, Munnell and others attribute pension funds lack of mortgage investing to institutional factors relating to the management of pension funds. The first institutional barrier to mortgage investing comes from large commercial bank trust departments that are oriented towards stock and bond investments. Bank trustees lack knowledge about mortgage investments. Ken Rosen quotes one fund manager who states: "You do what makes you comfortable. . . which means stocks and bonds."[41] Bank trustees have never acquired any staff expertise or education about mortgages and are reluctant to change their traditional investment practices, even if mortgage investments would increase the rate of return and diversify a pension fund portfolio.

A second and related institutional barrier concerns the specific investment managers who tend to emphasize short-term portfolio gains rather than long-term returns. In both bank trust departments and large corporations with internal management of pension funds, the postion of the pension fund manager represents a step on the corporate ladder for upwardly mobile young executives.[42] These young pension fund managers need to quickly prove that they are capable money managers and thus, tend to exaggerate short-term investments. The pension officer who decides that a long-term investment policy is important may not be seen as aggressive enough. This short-term performance orientation promotes stock investments which are expected to appreciate quickly.[43] The focus on stock investments because of the institutional setting of the pension manager discourages mortgage investments.

Even, people within the institutional investor community query why pension funds have not taken advantage of mortgage investments, expecially mortgage-backed securities. A recent article in the trade magazine, Pension World states:

> "By any measurment, mortgages represent "big money". The "big money" has spawned big financing ideas. Mortgage-backed securities, introduced by the Government National Mortgage Association ("Ginnie Mae") in 1970, now amount to $116.6 billion with new originations at the level of $20.6 a year . . . . Thus far, however, pension funds have participated in this market in only a minor way." [44]

The authors ask:

> "Does this suggest a "big misunderstanding" on the part of pension fund managers? Perhaps, the funds have remained at the sidelines out of prudence, waiting for greater familiarity with these instruments to develop. Whatever the reasons, the figures do suggest that there is considerable room for growth of pension fund investment in the decade of the 1980's. For the astute pension fund manager, the pass-through security offers the potential of superior returns." [45]

They conclude by saying:

> "Taken altogether, mortgage-backed securities represent "big money" - money invested in the nation's homes and producing steady, predictable income that should have strong appeal for the pension fund investor."[46]

These statements reinforce the notion that it is not the problems with the mortgage instrument itself that has prevented pension fund participation, but rather institutional factors in the traditional management of pension funds.

Many public pension funds and jointly trusteed funds have overcome institutional management biases against mortgages by having explicit investment policies to promote mortgage investments. State pension funds have also overcome legal barriers to invest in mortgages. Until recently, most states had percent limits on how much of their fund could be invested in mortgages and some states still have these restrictions. Public pension funds have approximaely ten percent (10%) of their assets in home mortgages. Public pension funds have most of their mortgage investments with government agencies in pass-through securities, through GNMA's. The direct mortgage investments are usually FHA or VA loans. California has twenty six percent (26%) of its portfolio in mortgages investments, with most of them being in-state mortgages.[47]

Recently, some states have taken advantage of a mortgage-bakced security program offered by Morgan Guarantee Investment Corporation (MGIC).[48] In this program, the state pension fund buys a mortgage pass-through security and forms residential mortgage pools with state lenders. For example, Massachusetts state pension fund made nineteen million dollars available to MGIC to buy residential mortgages originated by twelve Massachusetts banks. This past summer the interest rate on the mortgage pool was 14.7%. MGIC is now working with pension funds in the state of South Carolina ($35 million) Kansas ($15 million) Michigan ($67 million), Alabama ($44 million) and New york

($175 million) and the city pension fund of Philadelphia ($20 million). The MGIC mortgage securities have the potential to target housing investment within a state or city. A few state pension funds have also started programs which provide home mortgages to state employees. A couple of the more innovative state programs will be discussed in the second chapter of this paper.

While public pension funds have taken advantage of mortgage-backed securities, multi-employer funds have made more direct mortgage loans than other types of funds. The Amalgamated Clothing Workers Union pension fund financed many New York City cooperatives in the 1930's. By far the most mortgage loans as a percent of pension fund portfolios has been made by large construction union funds. The International Brotherhood of Electrical Workers (IBEW), Carpenters & Joiners, Teamsters and Plumbers and Pipfitters Union have historically had over twenty five percent (25%) of their pension funds invested in mortgages and real estate loans.

It is no coincidence that public pension funds and multi-employer funds are forging ahead in financing mortgages. As well as providing a competitive financial rate of return, mortgage investments offer "social benefits" to these pension fund members (i.e. housing). Public pension funds can target mortgage investments to their state or city, adding needed housing units to a particular area. The pension fund money remains in the state rather than exported to sonewhere else and the mortgage investments can stimulate housing construction.

The social benefit of mortgage investment for union construction funds is job creation. The more mortgage investment a construction pension fund makes in a particular area, the more construction jobs there may be in that area. Public pension funds and some multi-employer funds are beginning to evaluate the social rate of return and performance of their pension fund portfolio, along with the first priority of a pension fund, a secure, optimal financial rate of return.

PENSION FUND PERFORMANCE

The performance of pension funds is traditionally measured by the total rate of return on the fund assets. Recently, workers have looked at another facet of pension fund performance, the "social return", which covers the social and economic consequences of their fund investments. The social return measures the degree to which investments are consistent with the interests of the workers who own the fund. This section focuses on the financial rate of return while the next chapter concentrates on the social and economic consequences of pension fund investments.

FINANCIAL RATE OF RETURN

We have already alluded to the fact that pension funds have had poor financial rates of return; Tables #7 and #8 present the evidence. The first table compares the rates of return for pension trusts and insurance companies. The second table adds the rate of return by investment firms and uses different time intervals. The second table, from A.G. Becker, Inc., a firm which monitors pension fund investment returns, shows the median return for pension funds was 4.1% for the fiften year period from 1965 - 1979. The rate of inflation, measured by the Consumer Price Index, during the same fifteen years was 6.2%. If 1980 is included, the median return rises to 5.5% and the inflation rate becomes 6.8%. During the recent five year period on Becker's table, the median return was 2.5% after accounting for inflation.

Pension funds have not only lagged behind the inflation rate but also performed below the stock market, measured by the Standard and Poor 500 index (S&P 500). The S&P 500 is a measurement of the rate of return on a representative cross section of all stocks on the New York Stock Exchange. During the years 1966 - 1976, the annual return on pension fund equity investments was thirty three percent (33%) below the S&P index. During those years, the annual average S&P index was 6.6% while banks only averaged a 4.4% return.[49] The period beween 1972 - 1976 was worse with the S&P index return at

TABLE #7

Rate of Return for Pension Trusts and
Life Insurance Companies, 1960-1980

Year	Pension Trusts	Insurance Companies
1960	6.3%	4.1%
1961	15.0	4.2
1962	-2.6	4.3
1963	11.1	4.4
1964	11.3	4.5
1965	8.6	4.6
1966	-5.1	4.7
1967	11.9	4.8
1968	7.6	5.0
1969	-5.8	5.1
1970	5.6	5.3
1971	16.1	5.4
1972	17.2	5.6
1973	-18.4	5.9
1974	-21.3	6.2
1975	22.2	6.4
1976	12.1	6.6
1977	-2.2	6.9
1978	4.1	7.3
1979	4.2	7.7
1980	24.4	8.0
	Average Annual Rate of Return	
1960-1980	5.2	5.6
1960-1970	5.5	4.6
1970-1980	4.9	6.5

Source: Alicia Munnell, The Economics of Private Pensions, Brookings Institute, Washington, D.C., publication date, June, 1982.

TABLE #8

Median Returns for Pension Funds By Manager Type (annualized)

	15-year (65-70)	10-year (70-79)	5-year (75-79)	3-year (77-79)	(79)
Total Fund	4.1%		10.6%		13.1%
Bank & Trust Companies	3.6	3.7	10.4	4.6	12.2
Investment Counselors	4.1	4.2	11.6	6.4	16.6
Insurance Companies	NA	3.8	11.6	7.2	14.4
Equities					
Bank & Trust Companies	3.8	3.0	13.0	5.4	19.4
Investment Counselors	4.4	3.8	15.1	8.3	24.4
Insurance Companies	NA	4.0	13.6	6.9	22.2
S & P Index	5.6	5.9	14.8	5.4	18.7
Bonds					
Bank & Trust Companies	NA	7.1	6.7	2.2	1.3
Investment Counselors	NA	6.4	6.3	2.1	1.5
Insurance Companies	NA	6.2	6.5	2.8	1.2

Source: A.G. Becker Inc., Funds Evaluation and Planning Services, in Pensions & Investments, (now titled Pensions & Investment Age), May 12, 1980.

4.9% compared to pension fund trust returns at 1%.[50] The last five years in Becker's sample, 1975 - 1979, still show the S&P index outperforming private and public pension funds, as Table #8 indicates.

These poor rates of return have wiped out a lot of pension fund assets. In 1974, when the stock market plummetted, pension funds lost thirty billion dollars.[51] During 1973 - 1974, some pension funds lost thirty to forty percent (30 - 40%) of their assets.[52] Since most pension funds are defined-benefit plans, employers had to make up for the lost assets. However, in the last five years, more employers have switched to defined-contribution plans, so the employee bears the brunt of the investment losses.[53]

Private non-insured pension funds, especially, have lost assets during periods of decline in the stock market and make some gains when the market does well. In contrast, public funds have done better than private funds during bear stock markets and worse in the face of deteriorating bond markets.[54] Over long time periods, public and private pension funds have performed approximately the same.

Also, from a long-term perspective, the different types of managers of pension funds - banks, insurance companies, and investment firms - have had equally poor rates of returns on pension fund investments. Bank trust department returns have been more volatile reflecting their emphasis on equities. Recently, investment firms have outperformed bank trust departments and insurance companies, as Becker's table indicates. In 1979, investment firms had a rate of return of 16.6%, compared with 4.4% for insurance companies and 12.2% for banks. A study of bank-administered comingled-pension funds (pension funds from smaller companies which are merged for investment purposes) also found that large bank trusts had very low investment returns, compared to other investors and market rates?[55] This study concludes:

> "The performance of (bank) comingled-equity funds has been inferior to what would have been acheived by an unmanaged portfolio or similar risk . . . the allocation of these (pension) funds to bank trust departments is at a sub-optimum level. Thus, they are partially misallocated, since an unmanaged portfolio of similar risk would have performed better."[56]

The research and statistics on pension asset performance point to the fact that fund managers have consistently performed below the market: if pension fund trustees had randomly put their money in across section of stock on the New York Stock Exchange, they would have done better than the well-paid bank managers. In fact, this random method, called market indexing, may become a popular tool for investing. Barber & Rifkin predict computers will take the jobs of money managers in the future:

> "It is not surprising then, that in recent years there has been a movement a foot to replace these so-called money experts altogether with computers, the notion being that a well-programmed machine can do better in the market than an $80,000 a year investment analyst. Market indexing is becoming increasingly popular in light of the embarrasing performance of professional money managers . . . . What this means is that all of the money banks invest in market research and high-paid analysts is a futile exercise. Proponents of market indexing have demonstrated that a well-programmed computer can beat the pros almost all the time."[57]

Why have the experts had such low financial rates of return on pension funds that a computer could outperform them? There is not one simple answer that accounts for the poor performace record, but, several explanations have been offered, each placing the blame somewhere else. One explanation is that pension funds never recovered from the fall in the stock market in 1973 - 1974 and just as the market was recovering, pension fund managers were less inclined to invest in equities due to ERISA. This assumes that ERISA created a trend of conservative investing, away from equities and toward fixed income securities, right when the stock market was doing well and the bond market was in decline. Recent studies, however, have shown that ERISA has not had adverse effects on private pension fund portfolios and if anything, may have had "a beneficial effect in encouraging more diversification and less concentration in high value stocks".[58] One reason for poor performance is bad timing of investments or "missing the market", but this has less to do with legal barriers (ERISA) and more to do with management decisions.

The second and third explanations blame the management of pension funds for their poor financial performance. The second explanation says that pension fund managers have missed the market because they switch money managers too often.[59] In the 1950's and the 1960's, big banks which dominate the management of pension funds, were invested in blue chip stocks. In 1973 and 1974, when blue chip stock prices fell, many big corporations took their money out of the banks and put it with smaller investment firms or in-house staff. The smaller firms were called "market timers" because they were supposed to predict when the market would go up and down. However, these investment firms did not predict the upward turn in stocks in 1975 and 1976 and pension funds lost again. An article in Harpers magazine illustrates the recent market missing by pension funds:

> "In the late 1970's pension funds continued to move away from big banks, just as institutions like Citibank, Bankers Trust and Morgan Guaranty, which had been slow to adapt to new economic realities, were beginning to show more favorable results. By 1980, corporate pension executives became fascinated with firms that claimed to be experts in real estate. This came in response to real estate prices, which had been sky-rocketing for five years. Unfortunately, by the time pension funds began buying warehouses and office buildings, real estate prices had begun to peak."[60]

The agrument presented in Harpers blames the poor performace on the short-term perspective of corporate pension fund officers. Stan Luxembourg, the author of the Harpers article writes:

"The blame for these (poor) results can be placed on a system of investment that encourages pension managers to act like bureaucrats, not professional investors. While the professional investor seeks to maximize earnings, the bureaucrat is primarily concerned with a secure job."[61]

The pension fund officer is a big step on the corporate ladder and the officer must prove his or her money management skills quickly to advance. This leads to short-term horizons in investments, "novice investing" and often missing the market because the fund is not managed to produce good long-term results. This explanation implies that switching investments too often has sacrificed higher yields for pension funds. More rigorous research on the investment behavior of pension funds is needed to verify this explanation.

Randy Barber and Jeremy Rifkin offer a third explanation for the poor returns on pension funds. They make a convincing argument that pension funds have been used by banks, insurance companies and investment firms to prop up the stock market. As financing corporate needs has become increasingly tighter, there has been pressure on pension funds to pick up the equity financing, even if the stock market is not the locus of the best return on investment. In the last ten years, retained corporate earnings, the traditional source of new capital investment, has declined due to foreign competition, high costs of renewing plants and equipment, increasing energy costs, and other factors.[62] Although, there are many more facets to this story, the crux of the issue, is that pension funds have been used to fill the capital gap for corporations. While millions of Americans left the stock market, pension funds remained because they are a captive pool of capital for the business and financial community. Jason Epstein, of the New York Review of Books, writes: "Employee pension funds were used to prop up the market while much of the smart money got out more or less intact."[63]

The pressure on pension funds to bail out corporations has increased as financing becomes more expensive. Recently, pension funds have been buying millions of dollars worth of real estate from corporations. Pooled pension fund accounts of large insurance companies, like Metropolitan, Prudential and Aetna are buying corporate real estate such as the Pan Am Building and General Motors headquarters, both in New York. Pensions and Investment Age, a magazine for the financial investor community, calls these pension real estate investments a "bailout for corporate America".

> "Pension funds are bailing out some of America's largest corporations by buying their real estate. Some large corporations needing cash but trying to avoid high interest rates in the debt markets are selling some of their properties to pension fund investors." [64]

Pension funds are hoping that these real estate properties will provide diversification and appreciate. If pension funds hold on to the real estate, past slump periods, they could realize high capital gains. However, some investors wonder if pension funds have not entered the real estate market too late[65] A warning came from Franz Fischer, a University of Southern California professor who said that pension funds are acting like "Arab princes", purchasing properties with cosmetic appeal and sizzle instead of value.[66]

Corporations are relying on pension funds to provide much of the long-term capital they desperately need. A March, 1982 Business Week article, titled "The Perilous Hunt for Financing" states:

> "Pension funds covering state and local government employees are expected to pick up $8 billion of the net new corporate debt this year, while corporate pension plans will sop up about $3 billion. Pension funds are also expected to absorb most of the new equities . . . Pension funds, flush with cash, will be eager buyers of stock offerings expected this year . . . Public and private funds which typically buy about half of the new corporate equities annually are expected to have about fifty billion dollars to invest in all markets this year."[67]

The financial community is eager to use pension funds for corporate financing, although they clearly recognize the deteriorating health of the stock market. The article continues:

> "(A) problem is that corporate securities look increasingly chancy to lenders and investors. The average corporate balance sheet is in a precarious state of disrepair, with too much short-term debt, too little liquidity and deteriorating interest coverage. The situation stands little chance of improving in 1982, given the glum profit prospects . . . The markets will continue to be fickle as they were in 1981 . . Moreover, companies cannot altogether avoid the haunting conjecture that the economy could tumble into a full-scale depression, halting the flow of funds." [68]

With increased pension fund investment in corporate securities and this gloom and doom report, one must wonder if managers are investing pension funds with the sole interest of getting the best and safest return for beneficiaries. In light of the past performance of pension fund investments, workers have reason to worry about the financial management of their funds.

SOCIAL RETURN

Pension fund managers have historically not considered "social return" - the social and economic consequences of investment on the fund beneficiaries. It is still the case that fund managers invest pension funds in companies that trade with repressive and apartheid nations, that are non-unionized, have health and safety violations and have exported jobs abroad. Managers also ignore investments which could add social benefits for pension fund members. Social return may be of no concern to Wall Street investment bankers, but there is an increased realization on the part of workers that their own money is invested in ways antithetical to their long-term economic and social interests.

Unfortunately, most workers have no representation or voice in management of their pension fund and cannot change investment policies, if they wanted to. Workers do not have the decisionmaking power to influence investments. Moreover, financial institutions are uninterested in "social return" issues.

Jointly trusteed funds and public pension funds are starting to pursue investment policies which account for added social and economic return as well as financial yield. The concept of social return is just beginning to be explored, and is the theme of the second chapter.

SUMMARY

Pension funds began as a gratuity offered by an employer to a worker. Employers made all decisions regarding the management and benefits of the pension fund. Laws enacted, such as ERISA insured that employers pay promised benefits due to workers according to eligibility standards. In most single-employer pension plans, the employer still controls the investment policies of the fund. A few bank trust departments, insurance companies and investment firms handle day-to-day investment management of pension funds.

Bank trust departments and insurance companies have different investment policies regarding pension fund assets. Trusteed funds are heavily invested in corporate equities while insured funds emphasize fixed income investments. Insurance companies have similar financial needs to pension funds, but have a much higher proportion of mortgage investments. This difference in mortgage investments between pension fund and insurance companies reveals an institutional management bias against mortgages, by trust department portfolio managers, expecially since mortgages have had desirable financial rates of return. The few pension systems holding mortgage investments are public funds and jointly trusteed plans.

Financial performance of pension funds has been poor with annual investment returns below inflation rates and market indices. These consistently low rates raise questions about the competence of pension fund investment managers. One explanation for poor rates of return is that pension funds have been used by financial institutions to prop up the stock market, to provide needed equity financing for corporate America, even when there are better yields from other investments.

In short, there is an increased realization that workers own over eight hundred billion dollars in pension fund money, but a few Wall Street bankers control the investment of that social capital and those investments are often not in the financial, social and economic interests of pension fund beneficiaries. The long-term interests of workers can and should be accounted for in the investment of their money. The next chapter explores the issues of accounting for workers long-term interests and second, discusses the options and obstacles in alternative pension fund investments.

Chapter 1

NOTES

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CHAPTER #2

STRATEGIC INVESTING

Traditional pension fund investment practices, as described in Chapter #1, have been called into question by many different groups for a variety of reasons. First, past poor financial performance of pension funds has fueled the pension fund investment debate at all levels of government, in corporate boardrooms and in union halls. Second, traditional investing methods are under scrutiny because they ignore the social and economic impacts of the investments. For expample, there is national concern over "socially irresponsible" investments by pension funds incorporations which conduct business in South Africa and domestic companies with unfair labor practices.

Third, pension funds are under the spotlight because of their enormous structural power in the economy. Politicians, corporations and unions are realizing pension fund's potential for supporting certain sectors which need capital. Just the discussion of changing priorities for investment has caused legal and political attention. Realization of the economic power of pension funds, along with poor rates of return, and pressure for socially responsible investments have all contributed to the search for new investment strategies.

The conscious design of investment policies which consider the social and economic impact of investments as well as risk and rate of return is often called investing". In the literature, it is also referred to as divergent investing, development investing, non-traditional or alternative investing and strategic investing. I shall use the term strategic investing which refers to a strategy to explicitly account for additional social or economic goals in the investment process. Inherent in the definition of strategic investing is that the decision making process is open to debate on the social and economic consequences of investments.

This section of the paper focuses on the issues and debate around strategic pension fund investing. Three categories of strategic investing are described, including examples of existing programs and those actively considered. The legal debate around social goals in investment decisions is discussed. To date, there has been a lot of talk about strategic investments but very little chnage in policies. The final section of this chapter will discuss the obstacles to implementing strategic investing.

Advocates of both strategic and traditional investment policies agree that the primary purpose of a pension fund is to provide a steady, secure retirement income. The financial integrity of the retirement system must be the main concern of the fund's investment policy. The goal of a traditional pension fund investment policy is receive an optimal rate of return on the portfolio with a minimum amount of risk, regardless of the social or economic consequences of an investment on the beneficiaries or the general public. In contrast, the objective of strategic investing is to target investments to create social benefits in addition to a secure retirement income. These benefits from targetted investments could include:[1]

- meeting housing needs of beneficiaries of the public
- increasing employment opportunities
- making available additional services to plan participants
- supporting alternative energy development
- supporting goals of worker rights and safety
- providing capital to small businesses

Of course, there is tremendous debate among those who support the concept of strategic investing as to how to account for social benefits in the investment decision making process. Unlike risk and rate of return, there are no econometric models to measure social benefits or non-financial criteria. Some people argue that non-financial criteria should only enter into the decision making process when investments have equal return and risk. When everything else is equal, then social impacts should be considered. Others believe that strategic investing means that social and economic obectives should be accounted for in all investments whether they are equal or not. In between these two viewpoints, there are supporters of the view that a certain percent of the fund should be devoted to targetted investments, which explicitly consider social costs or benefits.

The best way to understand how social benefits can be incorporated into pension fund investments is to look at the few existing examples of strategic investing. Three categories of strategic investing can be identified from the literature:[2]

- strategies that are designed to provide direct benefits to pension fund members
- strategies designed to expand capital placement in particular sectors
- strategies designed to reward or punish particular forms of behavior

STRATEGIES DESIGNED TO PROVIDE DIRECT SOCIAL BENEFITS TO PENSION FUND MEMBERS

This category includes those investments which encourage unionization, job creation, localized economic development and housing for pension fund participants. The best example of strategic investments designed to promote unionization and job creation in the beneficiaries interest involve the AFL-CIO Building Trades mortgage investment programs which specify unionized construction labor on all its mortgages. This example will be discussed in detail in the next chapter. New York City's public pension fund's purchase of New York City bonds during the 1975 fiscal crisis is an example of a strategic investment providing direct benefits and potential costs to participants. Without the bond purchases, it was quite likely that many city pension fund members would lose their jobs entirely, thus, the investment offered direct economic benefit to most city employees.

In 1979, UAW and Chrysler reached an agreement regarding pension fund investments which potentially can provide direct social benefits to pension fund members. Overall, the agreement gave the union more voice in the pension fund administration. A key part of the agreement is that up to ten percent

(10%) of new money in the Chrysler employer pension fund may be invested in loans or bonds to non-profit nursing homes, nursery schools, health maintenance organizations, hospitals or similar non-profit institutions in communities where there are large concentrations of UAW members. This money can also be invested in residential mortgages in communities where there are substantial numbers of UAW workers.[3]

The most common method of pension fund investing to provide additional direct benefits to participants is through residential mortgage loans for members. Two public pension plans, Hawaii's and Connecticut's, have created programs to invest in home loans for their member.s

Hawaii Employment Retirement System (ERS) has about thirty percent (30%) of its pension fund invested in home loans for its members and pensioners. The mortgage investments, called the Member Home Loan Program, offer mortgage loans up to eighty percent (80%) of price. The Program started twenty years ago to help meet the housing needs of the pension system members and reduce the housing shortage in the state. Through this program, below market interest rate mortgages are made available to system members. ERS works with sixteen local lending institutions to administer the mortgages to the fund members.

The interest rate on the mortgages are about one percent to one point five percent (1% - 1.5%) below the conventional rate in Hawaii. Stanley Siu, the head of the Program discussed the rate of return on the mortgages compared to stocks and bonds:

> "As far as equities are concerned, I think the mortgage loan portfolio is still ahead because of the stock market being the way it is. In the bond area, it has been very comparable to the kinds of rate of return that we have . . . Recently, the coupon, the interest rate has gone up on bonds, but we have gone up accordingly in our interest rates."[4]

The mortgage investments are also very secure; there has not been a mortgage defualt in the history of the program. The Program provides quantifiable social benefits. Over thirty percent (30%) of the pension fund members have taken advantage of the home loan program. There has been some criticism that those who benefitted from the Program are the upper-income, white collar workers in the ERS. "This (criticism) has caused the Board concern, so ten million dollars ($10,000,000) has been invested in the Hawaii Housing Authority to provide housing for low-income public employees."[5] The Program offers direct benefits to members in addition to a guaranteed pension, as well as providing needed capital in Hawaii's economy. One report on the Program states: "Since the state is generally categorized as a capital-short state, there is some support for the notion that the fund is actually providing capital that otherwise would not be available."[6]

Another state pension fund mortgage investment program began in Connecticut this past summer. Connecticut's state employee pension fund offered forty million dollars ($40,000,000) in mortgage money through a program called "Yankee Mac". In June, 1981, the mortgage money was offered on a first-come-first-serve basis with an interest rate of 13.5% (the rate of an Aaa corporate bond at the time). The conventional mortgage interest rate was 17.25%. The mortgages were for single family homes and required ten percent (10%) down payment. Half of the mortgages were allocated to state employees and teachers while the other half was for the general public. Within eight hours after the mortgage money was offered, seven hundred fourteen homebuyers received loans and the forty million dollars was gone.[7] The social benefits of the Yankee Mac program are similar to the Hawaii program, except some of the benefits go directly to taxpayers, also. Connecticut is planning to offer four hundred million dollars ($400,000,000) more in mortgage money in the future.

Other states, such as New Hampshire and California have proposed home investment programs similar to those in Connecticut and Hawaii. Certain uions such as the American Pilots Association have also proposed pension fund investments in home loans to union members. With the management of most pension funds in companies hands, there is little incentive to make investments which have direct social benefits for fund members. The expamples cited in which strategic investments have been designed to directly benefit fund participants, are either with public funds with employee representation on the retirement board or private plans that have a labor union representative involved in the management of the fund. The connection between employee participation in investment policy and strategic investments is apparent in the other two categories, also.

STRATEGIES DESIGNED TO EXPAND CAPITAL PLACEMENT IN PARTICULAR SECTORS

The second category encompasses those strategies designed to increase the capital flow in a targetted area or in a particular sector. The investment policy would have certain economic objectives such as increasing housing stock generally or for a target population, stimulating economic growth, inducing business to move or increasing employment.[8] The goal of this investment strategy is to provide capital that otherwise would not be available, without making financial concessions to the pension fund.

To accomplish the goal of this strategy, investments must be taretted to fill a capital gap rather than displace other capital. The investments, expecially in the case of public funds, should not just replace potential private investments. The best example of displacement is public pension fund purchases of government guaranteed mortgages and mortgage-backed securities, such as GNMA's, ostensibly to increase the amount of housing in their state. Many state pension funds including California, Alabama, Oregon, Pennsylvania and New York have bought GNMA's targetted to their state, giving the impression that these investments will help stimulate the local housing market. Because GNMA securities are fully guaranteed, have a competitive return and are easy to administer, thus, highly marketable, they are sound investments for all buyers. Carol O'Cleireacain captured the displacement problem of GNMA's in an article in Working Papers Magazine. In discussing New York City's increased investments in GNMA securities, the author writes:

> "The federal guarantees carried by Ginnie Maes mean no risk and the return is competitive with Treasury securities. The net increase in available mortgage money to New York City, however, is negligible. Such schemes are proliferating among public employee pension funds around the country and are promoted as "social" investing. But, given the effeciency of the market, this generally means that the local public employee pension fund money is simply displacing other money ather than expanding the total amount of money available for mortgages." [9]

Pension fund investments in GNMA's and other government guaranteed loans do nothing to fill capital gaps, but they do deflect political pressure to increase "social investing". One article in Pensions and Investments advocated government mortgage security investments calling them "social investing without tears" and argued that " . . . there is no shortage of market instruments today which give the appearance at least of being more directly socially beneficial and which offer market returns."[10]

Political pressure for housing investments by pension funds has typically come from liberals, but recently arch-conservatives, like Orin Hatch and President Reagan lobbied for increasing mortgage investments by retirement funds. At the behest of the National Association of Homebuilders, Senator Hatch has introduced a bill in Congress which amends ERISA to ease the way for private pension funds to make more mortgage loans. The bill would allow private pension fund investment in mortgages at below market rates. It says that pension funds may invest in mortgages when the yield on those mortgages equals the average yield on the fund's investment over the past ten years or when it equals the average yield over any three consecutive years in the past ten years. The yield referred to is the yield on the whole portfolio, both stocks and bonds.[11] As we saw from the last chapter, the average yield on pension fund portfolios over the last ten years and three year periods between the ten years has been extremely low. It is Reagan, Hatch and other conservatives who are advocating that pension funds make financial concessions in their investments.

There is good reason for President Reagan to support Hatch's bill - - after slashing all government housing finance programs, Reagan is feeling pressure to do something to stimulate the slumping housing industry. Private pension funds are the perfect captive pool of money and no one will know if they finance below market rate mortgages. Reagan is lobbying for the Hatch bill and recently had a meeting with the top fifty corporate pension fund sponsors to urge them to invest more money in home mortgages.[12] This type of encouragement could help diversify portfolios and even increase total return, but, if the mortgages are way below market-rate (which Hatch's bill encourages), workers retirement money may be threatened, without their consent. Pensions and Investment Age denounced Hatch's bill saying:

> "The lower cost mortgages are thus subsidizing the housing industry through an invisible tax on the plan participants and consumers. Since they have no say as to whether these investments should be made, it is taxation without representation; . . . If it is appropriate to direct special attention to subsidizing the housing industry it should be done openly through government tax relief or appropriations, not "under the table."[13]

National Association of Homebuilders is also lobbying states pension funds to increase mortgage investments. In New Jersey, for example, the New Jersey Homebuilders Association is lobbying for a bill to mandate the public employee pension plan to invest ten percent (10%) of the fund in mortgages that are two percent (2%) below market rate.[14] They call the program, "Jersey Shares". Unlike the programs in Connecticut or Hawaii, "Jersey Shares" would finance houses that most public employees could not even afford. The houses average ninety thousand dollars ($90,000) and need at least a median income of forty thousand dollars ($40,000) to finance the home. None of the houses are rental. The housing benefits are not going to most public employees who take the risk of the financial concessions, (the 2% discount).

There are ways for pension fund to strategically invest in housing to fill capital gaps without threatening return. For example, Oregon has started a targetted pass-through mortgage-backed security program, whereby, the state pension fund buys shares in a conventionally financed mortgage pool put together by a lending institution.[15] The mortgages are originated by Oregon lenders who also hold the insurance policy on the mortgages. The principal balance of each mortgage loan is at laest twenty thousand dollars ($20,000) and cannot exceed seventy five thousand ($75,000). At least ninety percent (90%) of the loans must be for moderate-income single family detached houses with no more than ten percent (10%) of the mortgages for condominiums.

In 1978, ninety percent (90%) of the loans were less than sixty thousand dollars ($60,000) and one hundred thirty million dollars ($130,000,000) was invested in this residential mortgage program.[16] It is difficult to measure whether these mortgage investments would have been made without the public pension fund investment. But, because these mortgages are targetted geographically and by income level, pension fund investments have a good chance of increasing the amount of moderate income houseing in Oregon, by at least a little bit, while still maintaining a competitive rate of return for its beneficiaries. A private pension fund could conceivably create a similar program which invests in targetted conventional mortgage-back securities.

New York City Council member, Ruth Messinger, has proposed a strategic housing investment plan financed by city pension funds.[17] This proposal suggests that the New York City Employment Retirement System (NYCERS) invest in moderate rehabilitation loans for existing housing stock. The moderate rehabilition loans would be originated and pooled by the Community Preservation Corporation, a private, non-profit consortium of local savings and commercial banks which already have financed moderate housing rehabilitaiton projects. The pension's rehabilition loan investments would be insured by certain state agencies. This program takes advantage of existing institutions to facilitate strategic investing. The strategy for NYCERS housing investments is one of the most targetted pension fund housing programs proposed. It is designed to maintain the security of the fund investment and to fill a needed capital gap.

Two other housing investment strategies for pension funds are suggested in a new book titled, Pension Funds and Economic Renewal, by Lawrence Litvak.[18] The first suggestion is pension fund purchases of graduated payment plan mortgages which potentially have benefits for both borrower and investor. The second proposal involves public pension fund investment in limited equity housing cooperatives. Both proposals are geared toward contributing to the shelter needs of moderate income households and are intricately designed to provide a competitive rate of return to the pension fund.

Besides housing finance, some strategic investments have been designed to increase capital flow to small businesses. The single largest problem for small businesses is access to capital. Pension funds have "patient money" - money that can be invested for a long time period, which is exactly what small businesses need. Small businesses especially need equity financing in exchange for a portion of the firm's future income. Typically, pension funds invest in firms that have a market value of over one hundred million dollars ($100,000,000) and often when they buy or sell stocks, it is in blocks of twenty five million dollars ($25,000,000) or more. The argument is that pension funds should invest more in small or medium-size businesses and venture capital firms, because of their job-generating potential. The research by Massachusetts Institute of Technology Professor, David Birch, found that small firms (those with twenty employees or less) were responsible for sixty six percent (66%) of all new jobs generated in the United States.[19] Birch's results are often cited to support the argument that investments in small businesses may increase employment opportunities.

A few pension funds have invested in small businesses through venture capital partnerships, Small Business Investment Corporations (SBIC's), private debt placement and by purchasing Small Business Administration (SBA) guaranteed loans. The major problem for pension fund investment in small businesses is the costs of research, packaging and administering these investments. Despite high transaction costs, pension funds have recently invested a small percent of their money in venture capital partnerships, because of the high returns. The median annualized cummulative return between 1960 and 1980 for venture capital partnership was twenty seven point 1 percent (27. 1%). [20]

In 1980, pension funds supplied twenty nine percent (29%) of new capital to venture partnerships. Major corporate pension funds such as General Electirc, Hughs Aircraft, Union Oil, Chrysler, Continental Group, Alcoa and Grumman Corporation, have invested a small percent of their portfolios in venture capital limited partnerships.[21] The Ohio State Teachers Fund has point two percent (.2%) of the fund (total fund has four billion dollars in assets) in venture capital partnerships. The spokesperson for the fund is quoted as saying: "Our ventue capital investments have turned around and have provided cummulative returns substantially in excess of any other investments we've seen in a long time".[22] California has a bill in legislature to allow one percent (1%) of the state pension fund portfolio to be invested in firms with less than one hundred million dollars ($100,000,000) in assets. If passed, there would be three hundred million dollars ($300,000,000) to invest in small or mdeium-sized businesses and potentially could be targetted to growing industries and job-generating businesses.

A few pension funds have invested in SBIC's which are venture capital partnerships that have access to federal subsidies and financing through loans, grants and leveraging arrangements. SBIC's must invest only in businesses which meet SBA eligibility requirements. One example of a pension fund capitalized SBIC is the Energy Capital Corporation formed with contributions from the pension funds of Allegheny Ludlom, Air Canada and American General Insurance Company. [23]

Public pension funds, such as those in Kansas and Milwaukee, have also purchased SBA guaranteed loans with the stated intent of increasing capital to small businesses. Like GNMA's these SBA loans usually displace private investors, because the securities are in high demand and marketable, thus, doing little to increase economic development in an area. The California Public Investment Task Force and Lawrence Litvak, in his new book, have proposed new investment vehicles which mitigate the risk that is involved in small business investment, either through state or private insurance or through the pooling of funds. If a small percent of a pension fund is devoted to small business investment, it could take on a slightly higher risk in compensation for a petentially higher return and the possibility of creating new job opportunities.

Some pension funds have also designed strategies which geographically target areas presumed to need capital. Many state and city pension funds have adopted in-state or in-city preferences for their investments, in the hope of generating more income for their locality. The potential multiplier effects of in-city investments by a pension fund are used to justify these geographical mandates. These often-cited multiplier effects should be taken with a grain of salt. First, multipliers are difficult to measure because of leakage, the income flowing into other localities or states, and usually are overestimated. Second, an increase in one area's multiplier usually means a decrease in other area's multipliers. Michael Kieschnick, author of a report titled, "Investing in the Public Interest, The Case of Public Pension Funds" writes:

> "These multiplier effects are generally constant-sum games . . . . There is not a magic power to create new income through the multiplier unless there is also an increase in effeciency (e.g. the more rapid development of small businesses) or unless residents choice about savings and consumption change. In addition giving in-state investments a preference is somewhat like using tax breaks. The first state which favors in-state investments will probably not provoke a response from pension funds of other states, but eventually, if the first state is successful, all states will adopt in-state preferences . . . The in-state preference should therefore be used carefully and should come into play when competing investments are very close by standard financial criteria."[24]

Usually, these geographic mandates are not targetted will enough to fill capital gaps, but are used for political purposes to foster local pride. Pension fund investments strategies, in this second category, which are geared toward increasing capital flow to housing, small businesses or to a geographic aea, need to be carefully designed so they do not just displace other money and so they don't make financial concessions with workers money. If investment vehicles are designed well, pension funds can fill actual capital gaps.

STRATEGIES DESIGNED TO REWARD OR PUNISH PARTICULAR FORMS OF BEHAVIOR

This third category refers to strategies designed to incorporate the economic interests or philosophical preferences of pension plan members in the funds investments. The method to acomplish this strategy is to invest in securities of corporations which are not oppossed to the pension fund members' philosophical or economic interests. For example, some pension funds have made attempts to avoid investments in corporations that deal with countries that follow discriminatory or repressive policies, such as South Africa. Other pension funds have emphasized divesting from or avoiding future investments in corporations which have unfair labor practices or violate work safety and health requirements.. The objective of these strategic investment activities is to further human rights and advance the goals of workers rights.

In the 1970's, United States corporate investment in South Africa became a passionate issue, especially in universities. Public and private pension funds invest huge amounts of money in the same corporations which tacitly support this segregationist regime. Students in major U.S. universities campaigned for divesting from those companies that do business with South Africa. University of California, Stanford, Harvard and Yale have all set up regular committees to advise pension fund trustees on the "social responsibility" issues around their investments. The University of Wisconsin, University of Massachusetts, Smith College and Hampshire College have already divested themselves of some South Africa related holdings.[25] The Service Employees International Union, Longshoremen and Warehousers Union, United Auto Workers and the National Union of Hospital and Health Care Employees have called for their pension fund trustees to divest holdings in companies which invest in South Africa.[26]

Unfortunately, it is difficult for any pension fund to actually divest themselves of South Africa related holdings, because the vast majority of the top five hundred corporations do business with South Africa. It is debatable whether pension funds would sacrifice yield on their portfolio if they did divest from South Africa related holdings, but, there certainly would be high transaction costs to switch out of the top five hundred corporate securities.

Although, it has been difficult to implement a divestment from South Africa policy, the public spotlight on American corporate investments in South Africa gave credibility to the notion of "socially responsible" investing. Some investment firms, such as Drexel Bernam Lambert, Merrill Lynch, Martin Segal Company, Dreyfus Fund, and Shearson Loeb Rhodes, have set up special "socially responsible" accounts which avoid investing in corporations which do business with repressive regimes. In its agreement with Chrysler, UAW may submit to the pension fund trustees annually a list of up to five companies that conduct business in South Africa and recommend that the trustees refrain from investing in the securities of those corporations. The Investor Responsibility Research Center, The Interfaith Center on Corporate Responsibility and Council on Economic Priorities and other groups monitor American business, providing information to churches, colleges, banks, investment firms, pension funds and individuals on the social implications of investment strategies.[27]The South African issue exposed the connection between an investment and its social and economic implications. John Harrington, a representative of Service Employees International Union in a roundtable discussion on socially responsible investments stated:"

> "Now it may be, as someone had pointed out earlier, and on occassion I've pointed out, that we can make more immediate dollars off slave labor. Perhaps that's so. and I think we ought

> to be very clear and say we can make more money for our retirees in South Africa off slave labor. That maximizes our total financial and economic return. and I think we ought to be honest and do it." [28]

The South Africa issue also made public and private unions question their other pension fund investments. Major unions found that they have large investments in companies which have fought all forms of organized labor in their firms, such as Halliburton, Inc. and Texas Instruments. Recently, the AFL-CIO Building Trades and Construction Union discovered that their pension fund money managed by the Prudential Life Insurance Company, financed the National Right to Work Life building in Springfield, Virginia which was built by non-unionized construction labor. This made a clear, tangible connection between the union's pension funds investments and the impact those investments can have on their members own economic well-being. They are financing their own competition. Prudential Insurance has since set up separate accounts for union pension funds to support mortgage investments that stipulate unionized construction labor. Similarly, Aetna Insurance and a few banks have set up separate "socially responsible" accounts for pension funds. [29]

In a recent pension fund report, the AFL-CIO urged their local unions to invest "in firms that have good labor relations records and that support their employees exercise of organizational rights under the Federal labor laws in order to encourage positive labor relations, employer compliance with the labor laws and industrial stability: and exclude from union pension plan investment portfolios companies whose policies are hostile to worker's rights."[30]

One corporation, Corporate Data Exchange, consciously tried to avoid investing their pension fund asset in non-unionized firms, OSHA and EEOC violators and major investors in South Africa. There has been a lot of controversy around CDE's efforts because of the difficulty in drawing a line between socially responsible and socially irresponsible companies and some firms have complained of blacklisting. For CDE, it has been hard to find companies which do not violate some aspect of the social repsonsibility criteria.[31] CDE's investment program is an experiment in explicitly looking at the social implications of corporate investments instead of ignoring them.

The best example of a successfully implemented strategic investment policy involves J.P. Stevens Corporation and the Amalgamated Clothing Textile Workers Union (ACTWU). J.P. Stevens has long ben the "number one labor law violator" in the country.[32]Since 1929, Stevens has fought unionization in its textile mills. The National Labor Relations Board has charged Stevens with numerous labor law violations including illegally interfering in elections, coercing workers and firing prounion sympathizers. The ACTWU had been unsuccessful in its organizing drives despite strikes and a five-year worldwide consumer boycott of Stevens products.

In 1979, ACTWU took a different tactic and used an investment strategy aimed at isolating Stevens from the financial community. The targets of the ACTWU campaign were Manufacturers Hanover Trust, Avon Products, New York Life Insurance, Goldman Sachs & Company, The Sperry Corporation and Metropolitan Life, all of which had interlocking directorates with J.P. Stevens.[33] First, Manufacturers Hanover Trust was threatened with a withdrawl of hundreds of millions of dollars in pension fund accounts; the International Ladies Garment Workers Union withdrew $6.4 million from its account, the IAM threatened to withdraw $160 million and other unions threatened to withdraw their money if Manufacturers Hanover Trust did not sever their ties with Stevens.[34] Second, the industrial companies were threatened with a freeze-out on pension fund investments. Third, the ACTWU ran union-backed candidates for director seats on Metropolitan Life and New York Life. Just before the election both insurance companies cut their ties with Stevens. The final blow was when Manufacturers Hanover Trust Director, James Finley, who also was Chairman of J.P. Stevens, resigned from the bank's Board. The investment punishment stategy worked well. In October, 1980, ACTWU won union contracts at Stevens huge textile complex in North Carolina and at three other plants. In the union contract there was a clause pledging the union to "refrain from future efforts to force resignations from the Stevens Board or to upset its financial or credit relationships with other companies."[35] This clause illustrated the success of the ACTWU strategy.

In 1979, the Retail Clerks Union threatened to withdraw two billion dollars from Seattle First National Bank unless the bank negotiated a contract with the Union and the bank has lost over five hundred million from other union accounts, due to its labor practices.[36] Punishing union busters by withdrawing money may prove to be a better organizing strategy than strikes or boycotts. It is precisely these strategies of punishing or rewarding firms with pension fund money according to "social criteria" that creates legal questions. Although, there are a variety of legal issues involved in alternative pension fund investing, the case law and legislation related to this subject does not prohibit strategic investing. Contrary to what many people think, the law is not the major obstacle to implementing alternative investment policies. Nevertheless, the legal debate is important to understanding the issues and constraints surrounding all three types of strategic investing.

LEGAL DEBATE

Strategic investing, as we have seen from the above discussion, can involve a variety of issues - job creation, housing, unioin campaigns, labor practices, racism - with different methods for achieving those objectives such as divestiture, packaging of mortgages, exclusionary policies, inclusionary rules and amendments to state statutes.[37] The legal debate concerns how and when trustees should consider the multitude of issues and methods mentioned above. The intricacies of the pension fund legal debate are well beyond the scope of this paper, but breifly, I will mention the issues and cases around two major questions regarding strategic investments. First, what types of strategic investments are likely to be legal? Second, when are there legal requirements to consider the social impact of a pension fund investment on the beneficiaries of the fund? There are still unresolved legal issues in this new field of strategic investing, but so far, the laws do not prohibit the consideration of social benefits when making pension fund investments.

The basic tenets of all trust law are that a fiduciary must be loyal to beneficiaries and invest the trust with reasonable care. These general guidelines have most recently been codified in ERISA. Under ERISA (which only applies to private pension funds) a fiduciary must make all investments 1) solely in the interest of the beneficiary (no self dealing) 2) for the exclusive purpose of paying benefits and 3) with prudence. There are ambiguities around all three issues, but espcially around what is prudent.

The common law prudence rule was generated in 1830 from the Harvard College v. Amory case. Harvard College sued their trustee, Francis Amory, for mismanaging their trust and losing money, because he invested in manufacturing and insurance company stocks. Harvard said Amory had "exposed the capital to great loss" by not investing in government securities, or other conservative holdings. The Court sided with Amory saying that thiere is risk in all investments and "no sharp distinction between safe and unsafe investments". [38]

> "All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculations, but in regard to the permanent disposition of their funds, considering probable income, as well as the probable safety of the capital to be invested."[39]

The Harvard College v. Amory case gave more latitude around prudence than previously existed. Since this case, the Court interpretation has become rigid and has often implied that a fiduciary is prudent as long as he or she follows what other fiduciaries are doing. As Randy Barber says: "As long as you can prove that you are doing what the rest of the pack is doing, you are prudent." [40] (This "herd instinct" has helped justify past poor financial performance of pension funds.)

The most recent legal case concerning the prudence issue in questionable investments was Withers v. Teachers Retirement Systems of the City of New York. Beneficaries of a New York City pension fund challenged the trustees of their fund for making investments in New York City securities in 1975 when the City was in a severe financial crisis. The court held that the Comptroller, who was the trustee of the fund, 1) did not act in self interest by investing in New York City bonds, 2) the trustees decision to buy even "highly speculative" bonds in large amounts over two years apart of a plan to save the employer "was a prudent one in view of the fact tht the City was a major contributor to the pension fund and ultimate guarantor of the benefits", and 3) enough care was taken in considering and making the investment.[41]

The Withers case, first, demonstrates that non-traditional considerations can be appropriate in pension fund investments. Second, the case underscores the idea that the process of decision making is central in deciding whether an investment is prudent or not. The discussion, motives and considerations of the potential investment before it is made is evaluated in any questions about prudence. In the Grumman Corporation case cited earlier the trustee's stock purchases were called imprudent, in part becasue there was only a half hour of discussion before investing and the trustees motives were questioned. A prudent investment does not have to have a maximum rate or return, but it does have to be undertaken with "reasonable case" and no evidence of "self dealing".

The case law has made a distinction between "self dealing" and the consideration of non-financial criteria. Blankenship v. Boyle (1971) involved beneficiaries suing United Mine Workers pension fund trustees for mismanagement. The fund invested in coal company stocks and utilities which benefitted union members. However, in this case there was evidence of conflicts of interest with union officilas and pension fund trustees. The fund had huge losses because trustees had put the money in non-interest bearing accounts. By themselves the coal and utility stocks may not have been imprudent, but the conflicts of interest made it clear that the fund was not being administered "solely in the interest" of the beneficiaries. The Court stated: "In short, the Fund proceeded without any clear understanding of the trustees exclusive duty to beneficiaries, and its affairs were so loosely controlled that abuses, mistakes and inattention to detail occurred."[42]The key difference between Withers and Blankenship is the "self dealing" in the later case.

The three major cases, cited here have given loose boundaries and definitions to prudent investing. The leglities of current strategic investments are still being defined. Ian Lanoff, the administrator of pension programs in the U.S. Department of Labor (DOL) has issued statements on how DOL believes non-financial criteria should enter into investment decision making. The current rule of thumb is that if two investments have approximately equal expected rates of return and risk, then, the social and economic impact of the investment can be considered. Under ERISA, fiduciaries must diversify plan investments to minimize risk, and thus, should broaden the range of posible investments. Ian Lanoff writes: "If fiduciaries can assure that a broader range of investment vehicles will be examined, they can more likely assure that they will be presented with choices among economically equal but socially unequal investments." [43]

The argument that portfolios must be diversified can help and hurt supporters of strategic investing. Lanoff has taken a stand against a broad exclusionary investment policy, such as not investing in companies which do business in South Africa. He writes:

> "The argument is made that there are so many investment choices, the exclusion from consideration of a number or class of investments does not violate ERISA standards. But as a practical matter this "so many fish in the sea" argument is only persuasive when you know you haven't eliminated the big fish. Exclusion of a significant segment of the investment opportunity universe, without consideration of investment merit would generally not be prudent." [44]

Lanoff discourages exclusionary policies and supports inclusionary rules, such as asking a trustee to include more mortgages in a plan portfolio.

As more questionable cases arise, the Department of Labor administrators define the boundaries of strategic investing. DOL and many in the legal community recognize the use of non-financial criteria in investment decision making. The major legal text on trust law, Scotts Law of Trusts acknowledged strategic investing in its recent edition:

> "Trustees in deciding whether to invest in or retain the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in or to retain the securities of coporations whose activities or some of them are contrary to fundamental and generally accepted principles. They may consider such matters as pollution, race discrimination, fair employment and consumer responsiblity. . . . Of course, they may well believe that a corporation which has a proper sense of social obligation is more likely to be successful in the long run than those which are bent on obtaining the maximum amount of profits. But, even if this were not so, the investor through a trustee of funds for others is entitled to consider the wefare of the community and refrain from allowing the use of funds in a manner detrimental to others." [45]

The second question extends beyond whether a trustee may consider non-financial creiteria, and asks whether a fiduciary legally must consider the social and economic impact of the investment on the beneficiaries. There are two lines of reasoning to support the idea that trustees have a fiduciary responsibility to consider social impacts.

First, the prudent person principle states that trustees must make investment decisions as if a "prudent man" were investing his own money. No "prudent man" would invest in a company that was harmful to his own economic interests. For example, it is doubtful a "prudent man" would invest in his own competitor. Karen Ferguson, the Director of the Employee Benefits Research Institute (EBRI) presents this argument in a roundtable discussion on the legalities of strategic investing: "Since no reasonable prudent man would be so shortsighted as to invest his money to undercut his own interest, "social considerations" would automatically be factored into the investment process." [46]

Secondly, it is argued that it is incumbent upon a trustee to consider social impacts of investments because these impacts may affect the long-term financial rate of return. A company which has continually had poor labor relations could have a secure yield now, but in the long run may be prone to strikes or boycotts, which could jeopardize the financial rate of return. Comapnies which violate OSHA, EPA or EEO regulations may not have internalized their costs adequately and could also be poor economic investments in their long run.[47] Trustees already do implicitly account for economic impacts of different investments. For example, if a company has offices in Iran or another anti-American country, there are economic and social consequences from the investment which may make it a poor choice from a long-term financial perspective. In order to make an informed investment, social impacts should be accounted for.

Both these arguments suggest that a secure pension fund demands that trustees consider the social implications of their investments. At a conference on this subject, Karen Ferguson stated:

> "Retirement income security of participants can only be protected if certain social considerations are taken into account and that the fiduciary provisions of ERISA make sense only if they are read to require fiduciaries to take these social considerations into account." [48]

There has yet to be a legal case in which beneficiaries claimed their trustees failed to consider the social impacts of investments. Also, there has been "no case in which legal sanctions were imposed upon trustees, a trust manager or a trust for giving non-self-serving weight to the social or non-economic impact of an investment even when investment promising a high return were available."[49] One problem with clarifying what is legal in this field, is that most strategic investing cases involve state or local pension funds, not covered by federal statutes. There have been too few non-traditional investment cases in the private sector to test the range of legal issues in strategic investing. Ironically, the most innovative investment programs have come from public pension funds, despite that fact that state statutes are more rigid than ERISA. If anything, purely legal barriers to strategic investing should be stronger in the public sector. Legal obstacles are not the reason for lack of strategic investing in the private sector for two resons: First, many public funds have overcome even more rigid legal barriers than private sector funds encounter and second, legal rulings thus far, have been flexible enough to at least try different forms of strategic investing. There are, however, many other real constraints which prevent implementing strategic investing of pension funds.

OBSTACLES TO STRATEGIC INVESTING

With so few examples of strategic investment, it is clear that there are practical, institutional and ideological constraints to achieving a non-traditional pension fund investment policy. This section identifies seven major obstacles to implementing a process for strategic investing: 1) employer control, 2) institutional management, 3) lack of information, 4) information costs, 5) evaluation problems, 6) consensus problems, and 7) conventional wisdom.

EMPLOYER CONTROL

The first and foremost obstacle is discussed throughout this paper - - employees have virtually no control over the investment of their pension fund assets. There is no incentive on the part of employer trustees to look at the social or economic impacts of their investment policies on the owners of the fund. Infact, there may be incentives for management to purposely invest against the interests of workers, because management and labor interests are traditional quite different. As noted earlier, the few examples of strategic investing occur either in the public sector or with jointly-trusteed funds, in which there are employee trustees. In all the cases mentioned, there is employee input in the management of the fund. It is evident that employee trustees have more incentive to make sure investments coinicide with workers long-term economic interests. Management will fight to maintain control over pension fund investment and to insure that those assets are heavily inveted in corporate stocks and bonds. Employees must negotiate for more control over the management of their funds, if they want to be assured that their assets are being invested in their economic, social and financial interests.

INSTITUTIONAL MANAGEMENT

Even when emplolyees have some control over their pension fund, they usually contract out investment responsibility to institutional money managers. Professional money managers, the second obstacle, also have no incentive or inclination to look at non-financial consequences of investments. Bank trustees and other investment professionals are typically unfamiliar with government mortgage programs, for example, or the needs of their clients. Professional pension fund managers are trained and accustomed to investing only in the top five hundred corporate stocks and bonds; it is very difficult to retrain these managers to look at mortgage or medium-sized business investments.

LACK OF INFORMATION

Institutional money managers often blame their absence of interest in strategic investing on the third obstacle, lack of information on the non-financial aspects of investments. For example, there is practically no data on the impact of targetted mortgage investments or small to medium-size business investments. There is very little access to information to compare the social responsibility of different corporations. It is difficult to get current information on corporation employee practices. There is also a lack of information on pension fund holdings in the Federal mortgage market (i.e./GNMA's, FNMA's). The Federal Reserve's Flow of Funds lumps all federal mortgage programs under a category called "federal agency securities", thus, making it hard to discern how many mortgage securities pension funds actually hold.

Besides insufficient information on mortgages, small business investment opportunities, impacts of targetted investments and corporation practices, there is a lack of accessible information on how particular pension fund investments are made. Most employees have no idea where their pension money is invested. ERISA mandates companies to file forms with Department of Labor on the management and investments of the pension fund, but most employees are not aware that they have full access to those forms. Although the information is available, it is difficult to even find out how your pension fund money is used.

INFORMATION COSTS

Even when needed information is available, there is the fourth obstacle of high costs in retrieving the infromation. One reason investment managers place pension money in top corporate stocks and bonds is that it is the cheapest form of investment transaction for the institution. Mortgage and small business investments traditionally are associated with higher transaction and information costs, although GNMA'a, FNMA's and SBA loans have no higher costs than stocks and bonds. For targetted mortgage investments, trustees may need to hire mortgage bankers to get access to information, thus, increasing costs. Investment institutions, such as banks, don't want to spend more money to receive more investment information, even if it means a higher expected return, because they can not always pass the costs on to clients. It is also expensive to find information on corporate business practices. The Council on Economic Priorities performs social performance audits of major corporations, but at substantial cost. Like any new field, information costs in strategic investing are higher than doing business as usual.

EVALUATION PROBLEMS

The fifth obstacle concerns the evaluation of non-financial criteria in investments. Trustees are unwilling to try to look at non-financial criteria, first because they do not know how to prioritize the multitude of strategic goals and second, because they do not know how to evaluate the performance of the fund. There is no systematic order for evaluating one company investment against another when there are a variety of social goals involved in the investment process. For example, one company may be unionized but invests in South Africa, while another company does not do busines in South Africa, but pollutes nearby rivers with toxic wastes. Trustees say they do not want to make "social judegements". In a democratic investment process with employees represented, these social judgements would be explicitly discussed and different funds will find different ways to account and prioritize non-financial criteria for investments.

The second evaluation problem concerns the measurement of performance of a fund when social criteria is involved. The financial rate of return is the best indicator of the performance of a pension fund, even in a strategically invested fund. Well-designed strategic investment programs do not sacrifice rate of return and potentially will have higher yields than the past performance of pension funds. Nevertheless, there is no numeric method for accounting in the yield the beneifts of increased union jobs or increased shelter to participants. Trustees often view non-traditional investment policies as too difficult to implement, because strategic investment goals are hard to measure and are not conducive to precise modelling.

CONCENSUS PROBLEMS

Some of the evaluation difficulties are caused by obstacle six, consensus problems. There are obviously differences about social and economic goals among employees which prevent consensus on investment priorities. New workers, older workers and retirees may all have different priorities for their pension fund investments. For example, new workers may want to invest part of their fund in low interest mortgages for themselves, while retirees may see this investment as a threat to their retirement income. Different investments have different impacts on groups of employees, often preventing consensus on strategic investment policy.

CONVENTIONAL WISDOM

The seventh obstacle is what I call conventional wisdom. These are prevailing attitudes and ideologies which constrain the implementation of strategic investing. First, for example, pension funds are only thought of by the public as a retirement income and not as an enormous pool of capital. For sure, the primary purpose of a pension fund is income for retirement security. However, strategic investing will only be implemented when people understand that pension funds are also the largest single source of investment capital in the United States. This fact has largely been hidden from the American public; there is a sense that pension fund assets are invisible money which only appears when one retires.

The second conventional attitude is that capital markets work efficiently, thus the entrance of any non-financial criteria in investments is inefficient. Concommitantly, it is assumed that any divergence from traditional investment policies will reduce portfolio yields. This ideology is pervasive, even if not always based on facts. Certainly, many capital makets are efficient, but there are also market imperfections which deny capital to profitable mortgage markets and productive firms. It is quite possible for pension funds to make profitable investments, if the investment vehicle is well designed for underfinanced markets.[50] Nevertheless, the prevailing notion that strategic investment cannot be profitable is a large barrier to changing traditional investment policies.

A third attitude is that strategic investing will cause conflicts of interest and subject pension funds to political decision making. It is doubtful strategic investing is amy more political or prone to conflicts of interest than traditional methods, but the political debate is explicit in a strategic investment policy. Infact, strategic investing may avoid some of the blatant conflicts of interest bewteen banks and their commerical clients. Again, the attitude is the obstacle.

Another conventional wisdom is that strategic investing proponents want to enhance their own power and do not represent the viewpoints of employees. In other words, union officials and politicians benefit from strategic investments at the expense of their membership. This is another attitude which is difficult to prove either way, because there is no polling of all employees on their pension fund investments. However, organized employees elect union officials and do not elect corporate or bank trustees who manage their pension fund. Because of past union abuses with pension funds, management has tried to show that they represent the long-term interest of workers better than elected union officials. The conflicts of interest among corporations and the poor financial perfomance of professional managers are unknown facts.

The final "conventional wisdom" is that investment experts are the only ones who can be trusted with pension fund money. Clearly, it is in the interest of professional money managers to perpetuate this attitude. It also intimidates union officials and employees from getting involved in the investment process. The attitude that only experts know what is best and "neutral" for pension fund investments is patronizing, but a prevalent viewpoint, nonetheless and one tht serves as a stumbling block to strategic investing. Most of these prevailing attitudes or conventional wisdom are dubious, however, taken together, they pose a large obstacle to non-traditional pension fund investment policies.

SUMMARY

In summary, strategic investing is offered as an alternative to traditional investment policies because of the past poor financial and social performance of pension funds. There are a broad rnage of prudent investments, such as housing mortgages, small business loans and government-backed securities which are underutilized by pension funds. A strategic investment plicy should diversify portfolios and account for particular social or economic goals coinciding with interest of beneficiaries, while maintaining a safe, comptetitve rate or return. Like any new field, there are tremendous institutional and ideological obstacles to implementation. In the case of strategic investing, these obstacles are 1) employer control of funds, 2) institutional management of funds in which there is no incentive to broaden investment practices, 3) the lack of information, 4) high informtion costs, 5) difficulties in measuring performance of a strategically invested fund, 6) consensus problems and, 7) prevailing attitudes that are captivating, but often false. Despite these obstacles, a few pension funds have implemented alternative investment policies. This next chapter will explore how and why the largest of these strategically invested funds, the AFL-CIO Building Trades and Construction Union have pursued a non-traditional pension fund investment policy.

Chapter 2

NOTES

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CHAPTER #3

MORTGAGE INVESTMENTS BY AFL-CIO BUILDING TRADES UNIONS

For over twenty years, unions within the AFL-CIO Building and Construction Trades Department have strategically invested their pension funds in mortgages to provide direct benefits to their membership by increasing the number of unionized construction jobs. Why have these unions been able to implement strategic pension fund investments when other funds have not?

There are a variety of explanations which enable construction unions to overcome stategic investment barriers. They include: joint trusteeship, the creation of institutions and investment vehicles to facilitate their policies and mutual incentives for labor and management to participate in mortgage programs. Construction union morrgage programs are "pareto optimal" or what some call an "ideal type", because all parties benefit from these mortgage investments. By looking at the "pareto optimal" case, we can better understand the elements which support the implemetation of strategic investing.

The first section of this chapter gives a brief background on building trades union pension funds. The next section describes the methods and programs used by particular union pension funds for mortgage investments. The last section of this chapter explores reasons for construction union funds success at overcoming strategic investment obstacles.

BUILING TRADES UNIONS AND THEIR PENSION FUNDS

There are over twnety national construction unions with hudnreds of locals throughout the United States. Most of them are affiliated with the Building and Construction Trades Department (BCTD) of AFL-CIO. The BCTD represents about 2.5 million workers. Unions within BCTD are organized around certain trades and responsibilities in the building sequence.[1] Some of the trades, such as the carpeneters, steam fitters, painters, plumbers and sheet metal workers have been nationally organized for over one hundred years. BCTD acts as a national umbrella organiztion working for the interest of unionized construction through political lobbying, organizing and research activities.

Local unions are responsible for negotiating collective bargaining agreements and making job referrals. Contractors and local unions negotiate not only on wages but also on hiring and training practices because of the mutal need "to develop and retain a skilled labor force" and "to preserve job opportunities for craftsmen".[2]

There is a unique set of labor and management relations in construction caused by the unstable economic conditions the industry faces. Hence, employment patterns in the construction industry are very different from other industries. These differences are summarized in The Construction Industry, by Julian Lange and Daniel Quinn Mills, who characterize construction employment as follows:

- " Considerable shifting of employees among work sites
- Considerable shifting of employees among employers
- Identification by the employee with his craft or occupation, not with his employers
- A relatively large proportion of skilled workers
- Much self supervision
- Very unstable employment opportunity
- Dangerous and often difficult work conditions
- Intermixture of employees of different employers in a single project site
- Construction of non-standard (that is custom-designed) products"[3]

With these employment attributes, collective bargaining for a form of secure work life is crucial to construction workers. Building trade unions help mitigate many of the negative consequences of working in the cyclical construction industry.

Construction unions also play an important role in the organization of the pension fund system. Historically, they have been active in setting up pension funds and negotiating benefits. Today there are hundreds of construction union pension funds with total assets of twenty five billion dollars. [4]

Construction union pension funds are multi-employer, non-contributory plans, meaning that there are a number of employers who participate and these employers make all the contributions to the plan. The amount of contributions is defined in the collective bargaining agreement, and usually stated as a certain amount of money per employee (e.g. .50¢ per hour, per employee). This defined contribution relieves the employer of guaranteeing a set pension fund beneift.

All building trade union pension funds are jointly trusteed. Union officials and employer representatives (who are from contractor associations) generally appoint three trustees to manage the investments of the fund. Typically, the trustees turn over the day-to-day managment to a bank, insurance company or investment firm. Funds with less than five million dollars are often administered by an insurance company or in-house. The mean amount of assets in a construction union fund is roughly thirty million dollars, however, there are many pension funds with less than five million dollars and quite a few with over one hundred million dollars in assets. Like other pension funds, these assets are usually invested in stocks and bonds, and trustees take a passive role in the management of the fund. Recently, however, many building trades union trustees have taken a more active interest in the management of their fund.

Increasingly, trustees are adding more mortgage investments to their portfolios to support their own jobs. New union construction jobs also increase employer contributions to the pension fund, creating "new money" in the fund. Table #9, from a study by the Construction Industry Research Board, shows the employment multipliers and the increased pension contributions from certain levels of mortgage investment. Both the job creation effects and new pension

TABLE #9

SUMMARY OF ECONOMIC IMPACTS --Alternative Levels of Investment
(1981 dollars)

	Level of Mortgage Investment				
	$100,000	$1 Million	$100 Million	$1 Billion	$2 Billion
New Housing Units	1	10	1,000	10,000	20,000
Employment*(person-years)	9	87	8,670	86,700	173,400
Business Activity*(thousands)	$496	$4,966	$496,580	$4,965,800	$9,931,600
Income*(thousands)	$186	$1,859	$185,940	$1,859,400	$3,718,800
Tax Revenues(thousands)	$ 50	$ 500	$ 50,030	$ 500,300	$1,000,600
Pension Contributions Returned**	$ 7	$ 68	$ 6,830	$ 68,300	$ 136,600

*Includes impacts from housing unit as well as support and related construction. Also included is the multiplier effect on the general economy of California.

**Pension fund contributions returned to construction trades as a group in proportion to the hours worked and hourly pension contributions.

Source: Construction Industry Research Board, Summary of Economic Impacts: Investment in New Housing Mortgages, State of California, CIRB, Los Angeles, CA, September 22, 1981.

contribtuions are important non-financial considerations to building trades funds, when evaluating possible investments.

The following section discusses examples of mortgage investment programs by building trades unions. In all of the building trades unions, the pension funds are jointly trusteed. These unions mentioned below have found responsive institutions, such as mortgage bankers or labor-related financial institutions, to facilitate their mortgage investments. From these examples, we get a clearer picture of how strategic investing is implemented.

CARPENTERS PENSION FUND TRUST FOR NORTHERN CALIFORNIA

The Carpenters Pension Trust Fund for Northern California has been at the vanguard of pension fund mortgage investment. Since 1960, the Carpenters Fund has invested a significant percent of their portfolio in home mortgages in Northern California supporting their homebuilding jobs. Carpenters Pension Trust Fund, which includes five thousand employers and thirty five thousand employees in Northern California, has four hundred sixty million dollars in assets; and one hundred sixty one million dollars of those assets are real estate purchase leasebacks and mortgages, of which more than half of these are residential mortgages. [5]

The Carpenters Fund finds its mortgage investments through mortgage bankers. Trustees hire the mortgage bankers to originate and service the Fund's mortgage investments. The mortgage bankers present a list of proposed mortgage investments which fit criteria set by the trustees. The Fund's investment committee, then, decides on whether or not to make the mortgage commitments. The trustees of the Carpenters Fund also hire a mortgage investment consultant who assists the trustees in screening, analyzing, designing mortgage standards and recommending each loan investment.

The Fund sets the standard that mortgage loans must go to a "contractor acceptable to the Fund". This is an indirect way (and a way to avoid

Department of Labor investigations) of saying that all contractors who use the mortgage must hire union labor. The Fund also sets criteria relting to geographic diversity of their mortgages. This Carpenters Fund has employees in the northern two-thirds of California, covering an area over six hundred miles in length. Thus far, the Fund has been able to sufficiently diversify their mortgages within Northern California. However, it is now considering making mortgage investments in Nevada, Arizona and New Mexico to prevent any losses that may come from investing in one area. The Fund plans to make mortgage investments in these other western states if they receive commitments form building trade unions in those states to reciprocate by investing in mortgages in Northern California.

Currently, the Carpenters Fund loans its mortgage money out at 13.7/8% whch is not considered a below market rate. (Savings and Loans are offering mortgages at 14%.) In the past, the Fund has invested in a number of FHA-VA loans. Recently, the Fund has also invested in shared appreciation mortgages (SAM's) and are confident SAM's are sound investments for the Fund.[6] In their commercial mortgages, the Fund has added "equity kickers" to the loan, whereby the Fund participates in the income generated by the commercial business. For example, with a mortgage for a hotel, the Fund may stipulate that it will receie ten percent (10%) of the income generated after the hotel makes a certain amount of money (i.e. one million dollars).

So far, the Carpenters Fund is pleased with its mortgage investments and calls the program a "20 year continued success story". Mortgage rates have skyrocketed in the last couple years, so, many of the Fund's older mortgages have lower yields and value than its newer ones. Despite some losses due to high interest rates, Mr. Sutherland, administrator of the Carpenters Fund stated: "Our returns have been better than those pension funds that have stayed in equities." [7]

It is difficult to judge whether or not the Fund has actually increased the number of union construction jobs in Northern California or simply replaced other investors. The investments in government insured mortgages such as FHA-VA loans, most likely just displace other investors. However, the Fund's current mortgage investments, such as its SAM's and "equity kicker" loans, probably do increase jobs, because they are providing capital when it may otherwise not be available; these new mortgage instruments are not widely accepted by other lenders. The Fund is offering money at slightly lower rates in return for future income from the borrower. The construction industry is at such a low point, that practically any new mortgages add jobs.

The Carpenters Fund, confident about their own mortgage investments, encourage other pension funds to make more real estate investments. When asked why other funds have not followed the Carpenters lead in mortgage investing, Mr. Sutherland stated that "large funds have been shy about mortgage investments because of lack of staff (underwriters and appraisers) and the smaller funds have not had sufficient funds to start a program of their own".[8] Mr. Sutherland goes on the say that he believes the Carpenters' success story is available to all pension funds. He concludes:

> "Mortgage and purchase-leaseback investments offer pension funds safety, consistently higher yields over the years, diversification and also a constructive purpose. New construction has to be financed and pension fund investments can be utilized to assists in keeping America growing and ading to our nation's economic growth by providing jobs—jobs not only for the construction industry, but all kinds of jobs." [9]

RETIREMENT FUND TRUST OF THE PLUMBING AND PIPING INDUSTRY OF SOUTHERN CALIFORNIA

The largest plumbing pension fund in the nation has announced that it will get out of equity investments and concentrate on mortgage investments.[10] A trustee of the fund stated: "The yield in our equity portfolio is so poor, we feel we can do a lot better with our first trust deeds."[11] This Plumbing Fund which includes ten thousnd active participants and has one hundred eighty one million dollars in assets, has adopted a mortgage investment policy to directly increase new construction. Two-thirds of the Fund's assets are in mortgages which have financed over one hundred new construction projects in the Los Angeles area.

Like the Carpenters Fund, the Plumbers Retirement Fund hires mortgage bankers to originate, service and package the mortgages. The mortgage bankers are instructed by the trustees to look for projects which best utilize facets of the plumbing trade, "thereby creating jobs and generating additional revenues for the pension fund".[12] The Plumbers Fund has invested in a number of apartment buildings and hospitals, projects which require a lot of plumbing work.

At the end of 1981, the mortgage investments in the Plumbers Fund had a yield of ten percent (10%), a return with which the trustees are pleased. Although, the yield is satisfactory, there is some problem with diversification in this fund. From most investment advisors viewpoint, the Plumbers have too high a percent (66%) in mortgage investments. One investment manager told me that he would not recomend more than twelve percent (12%) in mortgages while another consultant set twenty percent (20%) as a limit. The Department of Labor is investigating the International Brotherhood of Electical Workers (IBEW), because some of their locals have over fifty percent (50%) of their pension fund in mortgage investments, which could violate ERISA diversification standards. The Plumbers may run into the same trouble. The trustees of the Plumbers Fund are confident their pension fund mortgage loans are secure investments. They have hadeno delinquincies on their mortgage loans in the fifteen years they have made these investments. Mr. Reed, a trustee of the Fund, calls the program "extremely successful". They have had a satisfactory and safe return and have created at least some additional jobs for their members.

UNION LABOR LIFE INSURANCE COMPANY (ULLICO), New York, NY

Union Labor Life Insurance Company (ULLICO), a labor-financed insurance company established in 1927, has opened a separate mortgage account, called J for Jobs Account, for union pension fund investment. This is a pooled mortgage account which stipulates that contractors of the mortgaged projects employ union labor.

Fifty building trade union pension funds currently invest in the J for Jobs Account. A union pension fund purchases units in the fund, which initially were valued at one thousand dollars each. Monthly, the assets of the account are divided by the total number of outstanding units which produces a new unit value. This new unit value applies to all new purchases and redemptions.[13] There is a small annual administration charge of 25/100 of one percent (1%) which is based on the average account balance of ech participating pension fund, but this charge is much less than the fees of bank trust departments, investment firms or other insurance companies.

J for Jobs finds mortgages through regional mortgage correspondents in over twenty five cities, who are aware of the investment criteria of the Account. Often they find out about mortgage investment opportunities through local building trade unions that recommend a construction project in their area for ULLICO financing.

J for Jobs Account only makes loans on income producing property and have financed apartment complexes, office buildings, shopping centers, warehouse buildings, hotels, community centers, health maintenance organizations and other medial complexes. These mortgages are at market rates, according to the underwriting and appraising criteria set for the Account. The Account has over one hundred twenty five million dollars in mortgages. ULLICO has total assets of eight hundred ninety two million dollars and twenty seven percent (27%) of their general account for investments is also in mortgages.[14]

The yields on J for Jobs Account have varied. The Account started in 1977 and their earlier mortgage yields hav suffered from the recent high rates and some poor investments, but the Account's latest yields have been competitive with corporate bond returns. Most likely, the Account is not creating new mortgages because large income producing properties typically have access to capital. The Account claims to seek out "imaginative opportunities" (i.e. community center), so possibly a few of their investments are ones that otherwise would not be financed. However, the Account increases the number of union construction jobs, especially in the South where there are "right to work" laws. This Separate Mortgage Account of ULLICO is primarily designed to stimulate union jobs in the depressed construction industry and at least according to one ULLICO representative, they are not displacing union jobs, but adding to them.

HAWAII'S GALZIERS AND GLASS WORKERS PENSION TRUST FUND

The Hawaii Glaziers and Glass Workers Pension Trust Fund has proposed a member home loan program, currently under review by the Department of Labor. The Glass Workers Pension Fund with assets worth five million dollars, want to offer their one hundred fifty eligible members shared appreciation mortgages (SAM's) in exchange for below market mortgage rates. Unlike the other programs mentioned, this plan's goal is not to stimulate union jobs, but to increase housing opportunities for pension fund members.

Under the proposed plan, the mortgage rates would be two-thirds of the yield sought by the Federal Home Loan Bank Board at the weekly auction held immediately preceeding the closing of the loan.[15] In addition to the yield to the fund, the pension plan would receive one-third of the appreciated value of the home.[16] The appreciation value would be collected when the pension plan member sells the home or at the end of fifteen years, or which ever comes first.

An example demostrating how this Glass Worker program would work is discussed in a Pension & Investment Age article:

> "If the yield sought by the Federal Home Loan Bank Board is seventeen percent (17%), as it was in mid-December (1981), than the mortgages issued based on this rate would be eleven point eight percent (11.8%) with an eleven point four percent (11.4%) yieled to the fund . . . The bank (Bank of Hawaii) would get the difference betwen the mortgage rate and the yield to the fund and also would receive one point five percent (1.5%) of the amount of the loan to cover processing fees . . . If the appreciation on the home was thirty thousand dollars, the pension fund would get ten thousand dollars and the homeowner twenty thousand dollars." [17]

If the mortgage was ninety percent (90%) of the price of the home and the property appreciated at six percent (6%) annually, the yield to the fund would be an additional two percent (2%) per year, making the annual rate of return thirteen point four percent (13.4%) for these mortgage investments. These are conservative figures since most mortgages are for seventy to eighty percent (70% - 80%) of the total price and because an annual appreciation rate of six percent (6%) may be low for Hawaii.[18] The Glass Workers Fund has tried to designed a program that offers a safe, competitive rate of return and provides housing to at least a few of their members. If the Department of Labor approves this program, the Glass Workers may put up to twenty percent (20%) of their fund in this member home loan program.[19]

Most likely, DOL will approve the program as they have already set regulations for member home loan programs. According to DOL, member home loans must be:

> "(A) available to all such participants and beneficiaries on a reasonable equivalent basis, (B) not made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees, (C) are made in accordance with specific provisions regarding such loans set forth in the plan, (D) bear a reasonable rate of interest and, (E) are adequately secured."[20]

A favorable DOL ruling may encourage other pension funds to consider the shared appreciation mortgage as a viable imvestment option.

CONSTRUCTION INDUSTRY REAL ESTATE DEVELOPMENT FINANCING FOUNDATION OF SOUTHERN CALIFORNIA

Thirteen building trades pension funds have created a mechanism to invest in union built construction projects in Southern California, called the Construction Industry Real Estate Development Financing Foundation of Southern California. The Foundation provides a way for construction union funds to jointly participate in financing residential and commercial buildings which will be constructed by members of the participating unions. Monthly, the building trades within the Foundation are presented with potential investments by mortgage brokers. Each member fund can invest a certain share in a mortgage or decline to participate in that particular project. The pension funds have the option to invest in those projects which especially benefit ltheir members.

The Foundation ws established in August, 1980 with combined assets over two billion dollars from the thirteen trusts. Two pension trusts, the Carpenters and the Plumbers were active in organizing the Foundation. Both of these unions already were investing a significant portion of their assets in mortgages and saw the Foundation as a means to encourage other trade unions to make more mortgage investments to support local union construction jobs. Smaller funds were encouraged to join because they would benefit from participating in large loans they otherwise could not finance.

The Foundation has been propelled by Albert Brundage, an attorney for a San Francisco firm, Daivs, Frominger, Jessinger, as well as the California State Building Trades and the Union Mortgage Bankeers, the mortgage company hired by the Foundation. Brundage was also a member of the California Public Investment Task Force and has been called "the prime mover in setting up the Foundation". He continues to be the spokesperson for the Foundation and plays an active role in the organization as well as working to set up other Foundations across the country. There is at least discussion about other Foundations for mortgage investment by building trades in Boston, Buffalo, Baltimore, San Francisco, San Diego and Portland.

Thus far, the Foundation in Southern California is the only one actively making mortgage investments. Since August, 1980, the Foundation has invested over one hundred sixty million dollars in Southern California mortgages. Potential investments are brought to the attention of the Foundation by two mortgage banking companies,Union Mortgage Bankers and Wallace Moyer Company. Both of these firms primarily have unions as clients. The Foundation must work through mortgage banking firms to avoid any allegations of dealing with "parties in interest". Because contractors participate as representatives of pension trusts, and potentially could directly benefit from some mortgage investments, the Foundation must document that there is an independent mortgage selection process. These experienced mortgage companies also screen and evaluate a wide range of different projects.

Each member pension fund, sends two trustees, one from labor and one from management, to monthly meetings, where the mortgage bankers present potential investments. The pension funds independently decide whether they want to invest in a mortgage. "This arrangement has the advantage of involving a large number of trusts, while allowing trustees to make individual decisions on the prudence of each investment", says Al Brundage.[21] Typically, five or six of the pension funds decide to subscribe to the mortgage investment. When a loan is fully subscribed, meaning enough pension funds participate to cover the mortgage investment, all the parties enter into a "Transaction Trust". Each project has a separate "Transaction Trust" which is administered by Crocker Bank. The Transaction Trust defines the agreement to collectively finance the mortgage by the participating pension funds.

Each participating fund has one unit for every one hundred thousand dollars contributed to the Trust (the mortgage investment).[22] The pension funds have one vote for every unit they own. The mortgage can be liquidated upon a decision by the pension funds holding at least seventy five percent (75%) of the total units of the Trust. Crocker Bank is responsible for servicing each Trust. They distribute earnings generated by each Transaction Trust to the contributing pension funds and also provide regular balance sheets and income statements to the Foundation. If the mortgage is not fully subscribed, participating perions funds can increase their share or outside funds, banks, or public pension funds can be brought in on specific proposals. [23]

As of February, 1982, the Foundation had entered into thrity two Transaction Trusts, for mortgages on residential and comercial buildings. Table #10 shows the type of mortgage, the yield, the amount of the transaction, and the participating pension funds of the thirty two financed projects by the Foundation. The Foundation fee on the chart is a non-refundable lender fee to cover the borrowers commitment and the costs incurred by the foundation for business advice, normal legal expenses and other adminstrative costs. The mortgages are approximately eighty percent (80%) of the price of the project. Most of the projects have mortgages between thre to five million dollars.

Over half of the projects listed on Table #10 are for residential mortgages. The code on the chart for hosuing is SFR and it refers to tract homes or condominium complexes. For example, Transaction Trust #2 with a mortgage for seven point two million dollars may finance seventy single family residences, either tract homes or condominiums. The Foundation has set price ceilings on the homes or condos ranging from one hundred thousand dollars to one hundred fifty thousand dollars. "The aim is to keep contractors from using pension fund money to underwrite luxury development beyond the reach of unionists and their families."[24] These residential mortgages are twleve point five percent (12.5%), which is a bargain for a borrower, however, the Foundation and the Department of Labor feels these mortgages have a secure and reasonable return while providing an additional benefit of more union jobs and possibly increasing the number of homes for middle income buyers.

TABLE #10

THE DEVELOPMENT FOUNDATION OF SOUTHERN CALIFORNIA

STATUS REPORT AS OF FEBRUARY 4, 1982

PE OF RANS- TION	YIELD	COMMIT-MENT EXECUTED	FOUNDA-TION FEES REC'D.	TOTAL SUB-SCRIBED	CPT	IBEW	L.A. PAINTERS	L.A. CONSTR. LABORERS	ENGINEERS	L.A. METAL LATHING	PLUMBING, HEATING & PIPING	PLASTERING	SHEET METAL WORKERS	CEMENT MASONS
S	12.5%+P	yes	27,000.00	5,400,000	2,400,000	1,000,000	500,000				1,000,000			
SFR	12%	yes	56,500.00	7,200,000	2,900,000	1,000,000					1,800,000			
LL	20.83%	yes	52,000.00	3,000,000	1,000,000	250,000	500,000				500,000			750,000
SFR	12.5%			6,600,000	1,500,000	750,000	500,000				2,250,000			1,600,000
SFR	12.5%	yes	77,900.00	10,060,000	4,380,000		500,000	2,500,000			1,000,000	700,000		1,000,000
C	12.5%+P	yes	43,750.00	5,500,000	3,250,000		250,000				2,000,000			
03-C	13.5%+P	yes	16,937.50	1,925,000				1,000,000						925,000
SFR	12.5%	yes	43,750.00	5,500,000	3,500,000	1,000,000					1,000,000			
SFR	12.5%	no		4,500,000	3,000,000						1,500,000**			
SFR	12.5%	yes	41,500.00	5,200,000	3,200,000		300,000			200,000	1,500,000			
OB	15%	yes	16,000.00	1,800,000								200,000	1,600,000	
SFR	12.5%	yes	40,000.00	5,000,000	4,000,000						1,000,000			
OB	13.5%+P	yes	15,000.00	1,800,000		700,000		500,000				300,000		300,000
C	13-5/8%+P	yes	49,000.00	6,200,000		1,500,000		2,000,000		500,000			1,500,000	700,000
I	15%	yes	25,000.00	3,000,000				2,000,000				300,000		700,000
SFR	12.5%	yes	11,500.00	1,200,000	700,000						500,000			
CFR	12.5%	yes	40,000.00	5,000,000	3,500,000						1,500,000			
SF2	12.5%	yes	32,500.00	4,000,000	3,800,000					200,000				
SFR	12.5%	yes	22,937.50	2,725,000	1,750,000	225,000								

pe of Transaction Codes: OB-Office Building; I-Industrial; C-Commercial;
I-Hotel/Motel; A-Apartment; R-Restaurant; SFR-Residential; LL-Land Loan;
Other.

Prepared by C

rticipation Symbols: "P"-Participation in annual proceeds; "PS"-Participation
sale proceeds.

ansaction Trusts Subscribed but commitments not issued: 4,7,22,23.
scription amount not yet received by Trustee.

TABLE #10 (con't)

THE DEVELOPMENT FOUNDATION OF SOUTHERN CALIFORNIA

STATUS REPORT AS OF FEBRUARY 4, 1982

C	COMMIT-MENT EXECUTED	FOUNDA-TION FEES REC'D.	TOTAL SUB-SCRIBED	CPT	IBEW	L.A. PAINTERS	L.A. CONSTR. LABORERS	ENGINEERS	L.A. METAL LATHING	PLUMBING, HEATING & PIPING	PLASTERING	SHEET METAL WORKERS	CEMENT MASONS	GLAZIERS
C-?+PS	yes	25,000.00	5,200,000				2,000,000				300,000	2,900,000		
1	no		2,500,000	1,500,000						1,000,000				
%	yes	10,000.00	2,000,000	1,000,000	1,000,000									
/4%	yes		2,556,000	1,050,000		250.000**				1,256,000**				
	yes		1,100,000	300,000								800,000		
	no		1,650,000				500,000					1,150,000		
/2%	no		3,500,000	1,500,000			1,000,000			1,000,000**				
/4%	no		2,900,000	1,450,000**						1,450,000**				
/2%+P	no		50,000,000	29,000,000		250,000**	5,000,000	10,000,000**		5,000,000**			500,000	250,000**
/4%	no		2,000,000**	1,000,000**		250,000**								
		648,275.00	159,036,000	75,680,000	7,425,000	3,300,000	16,500,000	10,000,000	900,000	25,256,000	1,800,000	7,950,000	6,475,000	1,250,000

OB-Office Building; I-Industrial; C-Commercial; SFR-Residential; H-M-Hotel/Motel; A-Apartment; R-Restaurant;

P"-Participation in annual proceeds; "+PS"-Participation in sale proceeds.
sed but commitments not issued: 4,7,22,23
t received by Trustee.

Prepared by

California is one of the few places in the United States that employs primarily union labor in housing construction. There is a history of tract housing in California which traditionally has been built by union labor. In most other parts of the country, residential construction is built by non-union workers. Therefore, building trade unions in other states typically will not invest in any residential construction. In Boston, where a Foundation has recently been established, the construction union pension funds will not invest in home mortgages because there are few Boston-area residential contractors who hire union labor. In Maine, there are only two housing contractors who employ union construction workers. Thus, the Southern California Foundation has a unique advantage because they can diversify their portfolio with residential mortgages and potentially stimulate the local housing industry.

The Foundation has also made a number of commercial and industrial mortgages. Most of these commercial loans include participation in the annual income of property in exchange for an initial below market interest rate. Lenders and borrowers agree on a below market interest rate, plus a specific percent of all increases in the owners gross income after a determined base figure. For example, on a five story office building project, with a $5.2 million mortgage, the participating pension fund members and the developer agree on a thirteen and one half percent (13.5%) interest rate plus thirty percent (30%) of the property's gross income over $998,400.00. With this "equity kicker", the mortgage's average yield over the life of the loan would be 16.52%.[25] The Foundation first determines their desired yield on the project and then calculates the needed "equity kicker" or participation in gross income, to receive the expeected return. The Southern California Foundation also has financed a shared appreciation commercial mortgage in which contributing pension trusts participate in the sale proceeds. To date, there have been no foreclosures on any of the mortgages, residential or commercial financed by the Foundation.

The Fohdation has carefully designed its mortgage investment policies to comply with ERISA regulations. The Department of Labor has already conducted an investigation into the policies of the Foundation and in June, 1981, closed the case finding no ERISA violations. DOL was concerned that the pension funds in the Foundation would only consider "union construction projects in Southern California which would be artificially limiting their potential investment opportunities for non-economic reasons."[26] Instead the DOL decided that the Foundation "broadens rather than restricts the range of investment opportunities available for plans",[27] especially since each plan independently decides whether to invest in a mortgage and evaluates the Foundation's mortgage proposals against other possible investments.

The Department of Labor raised a concern about who takes fiduciary responsiblity in the Foundation. The legal documents relieve the Foundation and the mortgage bankers from any fiduciary responsibility. Hwever, this statement in the documents may not be too important, because fiduciary responsibility refers to a function not a structure in a document. If the mortgage bankers act or function as fiduciaries according to ERISA section 3 (21), then, they can be liable as fiduciaries, even though the documents may state otherwise. The DOL stated that upon the completion of a different investigation, "it may be possible for the Department to determine whether the Foundation or the mortgage bankers, in practice, maintain a fiduciary relationship to specific employee beneift plans".[28] Most likely, if someone wanted to sue the Foundation over one of its investments, trustees of participating pension plans, investment advisors, mortgage bankers and the Foundation itself, could all be liable as fiduciaries.

The DOL's investigation did not mention the legal issues of antitrust, but they are relevant to the Foundation case. It is possible that the clause requiring union labor on all Foundation mortgages could be interpreted as a "restraint of free trade" and in violation of antitrust laws. The union clause was written to avoid legal hassles. It states:

> "Developer recognizes Lender's concern tht the work stoppages resulting from union organizational efforts or

> picketing of from the traditional refusal of union members to work alongside non-union workmen on the same construction job site might unforseeably extend the time of completion of the project or impair or jeopardize the underlying security interest of Lender or both. Therefore as material consideration for this Commitment, Developer hereby represents and agrees; . . . that said general contractors and subcontractors shall each be signatory to an appropriate current collective bargaining agreement with an appropriate labor organization affiliated with the Building and Construction Trades Department, AFL-CIO or International Brotherhood of Teamsters."[29]

Although, the beginning of the union clause obscures the intentions of the Foundation, it is clear from the Foundation documents that a goal of the organization is to promote unionized construction work. There are antitrust questions that have yet to be pursued, but the Foundation is sufficiently concerned that they have sought legal guidance on the matter. The fear is that the largest non-unionized contractor association, Associated Building Contractors (ABC) would start a law suit against the Foundation.

The Foundation has taken many of the necessary precuations to insure that their investments are prudent and have reasonable rates of return. All of the investments by the Foundation are for permanent financing which is less risky than construction loans. Although, there has been some discussion about building trade investment in construction loans. The pension fund has actually financed a construction loan. The California state pension funds have talked with members of the Foundation about creating a joint construction loan and permanent financing mortgage program with the state and building trades pension funds. Any program of this nature would have provisions to minimize risk and guarantee a secure rate of return to both the public and union pension fund.

The members of the Foundation and the California state pension funds are currently working on a joint residential mortgage program. Under this program, the building trade union funds would invest in the permanent financing of a residential mortgage and then sell the mortgage to the California state pension fund. The union would "roll over" mortgage investments in one or two years instead of twenty five years, allowing them to invest in similar projects and create more jobs for their members.[30] The state pension fund would assist in creating a secondary mortgage market for the Foundation mortgages.

The state of California has its own motives for working with the Foundation. The construction industry has one of the highest employment multipliers of any industry. Investment in construction generates additions to the state and local tax base. A study by California Department of Water Resources found that for every job created in the construction industry, an additional 2.66 jobs are created in linked industries.[31] If the state and the Foundation jointly participate in pension fund construction investment to stimulate employment in California, the mortgage investments must be targetted so as not to displace private investors.

The Foundation wants to create new union jobs and avoid replacing a mortgage investment in which union labor would otherwise be hired. One way to avoid displacement is to geographically target investment. For example, the Foundation could target a mortgage investment in a traditionally non-unionized area like Fresno, California, where a contractor may normally use non-union labor, but with a Foundation agreement will hire union workers. It is even possible that potential financing from the building trades Foundation would encourage a contractor to sign a collective bargaining agreement with a construction union. A major goal of the Foundation is to support building trade union jobs, in a time when open shop (non-unionized) construction is increasing. The Foundation is an innovative mechanism to strategically invest pension funds providing a safe rate of return and increasing employment security for union members.

OVERCOMING STRATEGIC INVESTMENT BARRIERS

There are many other building trades mortgage investment programs similar to the ones mentioned. Construction union-related pension funds in Milwaukee, St. Paul, Miami, Phoenix, Rochester and San Francisco have set aside a portion of their assets for mortgage investments. This nationwide activity points to the fact that it is easier for the building trades union to pursue a strategic investment policy thatn it is for other organized workers.

There are three major reasons why many building trade unions have managed to overcome strategic investment obstacles. First, there are mutual incentives for labor and management to invest in mortgages. Second, construction union-related funds are jointly trusteed and third, the funds have created mechanisms to facilitate strategic investments.

MUTUAL INCENTIVES

For the construction union funds, there is an obvious connection between new mortgage investment and the creation of construction jobs. Mortgage investments for union job creation are mutually beneficial to employers and employees who participate in the fund. Both union workers and the contractors who hire them benefit from the increased amount of work. The mortgage investment programs offer contractors who employ union labor an edge over their competitors who only hire non-union employees.

Union contractors and union labor have another incentive to participate in mortgage programs. The unionized construction sector is facing severe unemployment, threatening the livelihood of both union employers and employees, therefore, any job creating investments are welcome. The last few years, has witnessed a tremendous expansion of the open shop and an assault on the legal protections union construction workers have had, such as the Davis-Bacon Act.[32] The President of the International Union of Operating Engineers (IUOE) writes about the depressed constrcution industry:

"we (building trades) are experiencing massive unemployment in the construction industry . . . construction workers lucky

> enough to have a job are being forced to give up wage increases instead of receiving their fair share of these rising corporate profits. We see non-union contractors underbidding union wages by two, three, four and more dollars. Ten years ago, the hiring hall was respected. Today a huge non-union workface is being created and there is no stability in labor relations." [33]

According to many union officials, there has been a planned campaign by major corporations in this country, who are also the largest industrial construction users, to destroy the building trades.[34] Unions point to a concerted effort carried out through the Business Roundtable, U.S. chamber of Commerce and non-union contractor associations to lower construction costs by supporting non-union contractors, ignoring traditional bargaining practices and attacking labor laws on overtime, working conditions and wages. The Business Roundtable has set up a Construction Users Anti-Inflation Roundtable, headed by teh chairman of U.S. Steel, and has published two volumes of a book titled Coming to Grips with Some Major Problems in the Construction Industry. These books provide contractors information on labor issues and the restoration of the management role in construction work. They tell developers and contactors that union hiring halls give unions too much power over the personnel functions, and thus, recommend the creation of management operated data banks for job referrals.[35] One speaker at the U.S. Chamber of Commerce conference on the construction industry suggested a national hiring hall where the workforce is "computerized, inventoried, recruited, trained, referred and managed by professionals as a personnel office for industrial contactors."[36]

The campaign to undercut union construction work has been successful, spawning the burgeoning open shop mevement, changes in hiring practices and three bills pending in Congress to repeal the Davis-Bacon Act. Naturally, these trends are frightening to union construction workers. Contractors which have collective bargaining agrements with union workers also fear losing work and income to non-union contractors. Thus, both union workers and contractors have incentive to participate in mortgage investment programs to stimulate union contruction work.

Because there is a clear connection between mortgage investment and employment security, the building trades overcome some of the "conventional wisdom" obstacles. For example, there is little question that union officials represent the interest of their membership by investing in mortgages. No one has accused union trustees of pension funds with mortgage programs, of acting in their own self interest at the expense of their membership. Employer and employee trustees have the same goal - - to maintain a safe rate of return and increase union construction jobs, especially during a time when there is an attack against the unionized construction sector. This mutual goal facilitates strategic investing.

JOINT TRUSTEESHIP

Joint trusteeship gives the building trades the power to implement strategic investing. Otherwise, employees would have to depend on their employers benevolence to invst pension funds in workers interests. It is impossible to know whether or not employers would invest in mortgages if the building trades did not have jointly trusteed funds. Certainly, as we saw in the last section, there are incentives for the employer to invest in mortgages. Joint trusteeship, however, encourages the pension fund to invest in mortgages which support union jobs. Without joint trusteeship, contractors may invest in mortgages, but they have more incentive to go "double breasted", hiring non-union constuction labor on the pension fund mortgage investment. Contractors could hire non-union labor at cheaper cost and feel little responsibility to the union. Thus, without joint trusteeship, it is still possible employers would invest pension fund money in mortgages, but not necessarily in projects which support union jobs. Joint trusteeship helps to insure that pension funds are invested in the employees interest.

Some forms of strategic investing by the building trdes require joint trusteeship. For example, the Hawaii Glaziers Pension Fund would not invest in home mortgages for employees if they had a solely-employer invested fund. There would be no incentive for employers to design a program to create housing opportunities for employees. Also an employer-invested fund would have no incentive to divest from blatantly anti-union corporations. Employee trustees have the incentive to make investments with added social and economic benefits for plan participants.

Joint trusteeship also overcomes "conventional wisdom" obstacles. Union trustees realize that pension funds are relatively large pools of capital as well as retirement income, because they are part of the investment process. The investment process is demystified for union trustees, thus, they are less intimidated about offering innovative investment ideas. With joint control, there is at least a potential for strategic invetsing, while with employer controlled funds, there are no incentives to design strategic investment programs for the benefit of union members.

INSTITUTIONS AND INVESTMENT VEHICLES TO FACILITATE STRATEGIC INVESTING

Union trustees have had to design innovative programs and invest in supportive institutions to overcome strategic investment barriers. Some unions have given a portion of their funds to a non-traditional investment company like Union Labor Life Insurance Company (ULLICO) or union-owned banks. These institutions are more inclined thatn traditional banks to look at non-financial consequences of their investments. They are also more likely to be familiar with mortgage instruments, because they have experience in such investments.

The building trades have also used mortgage bankers to locate potential investments. Mortgage bankers help to overcome the information barriers concerning real estate investments. Some of the builing trades have taken advantage of mortgage pooling mechanisms, such as ULLICO's special mortgage account, Prudential's separate union mortgage account and the Southern

California Foundation. The Foundation, especially, is an innovative mechanism designed by union representatives which facilitates strategic investiung. If the Foundation hooks up with public pension funds in mortgage investing, they may create yet another type of institutional mechanism. At least one building trades fund has proposed investing in residential shared appreciation mortgages, a new investment vehicle to provide a reasonable rate of return to the fund and possibly increase housing opportunities.

All of these mechanisms, union banks, separate accounts, mortgage bankers and mortgage pools get around traditional institutional barriers and information obstacles against mortgages. It is important to note that joint trusteeship provides the incentive to find institutions and investment mechanisms which facilitate strategic investing. The connection between joint trusteeship and supportive institutions to encourage strategic investing will be explored further in the next chapter.

SUMMARY

Unlike the vast majority of pension funds, the building trades have strategically invested their assets in mortgages to support their own jobs. Clearly, the connection between a mortgage investment and a job opportunity makes it much easier for building trades to strategically invest their pension funds. There are three other reasons why the building trades have overcome strategic investment obstacles. First, there are mutual economic incentives for both employer and employee trustees to participate in mortgage investments. Second, joint trusteeship has given the building trades the power to implement strategic investment policies. Third, in order to make non-financial investments, the building trades have used existing institutions, like mortgage banking companies and created their own investment vehicles, such as mortgage pools, separate accounts, and organizations like the Foundation.

Although, the building trades' mortgage investments are a "pareto optimal" example of strategic investing, the case presents the elements which support a strategic investment policy. The final chapter explores how these policies and institutions for overcoming strategic investment obstacles are applicable and practical for other pension funds interested in changing traditional investment practices.

Chapter 3

NOTES

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CHAPTER #4

JOINT CONTROL AND NEW INVESTMENT INSTITUTIONS

From the building trades case, we learn that it is much easier to implement strategic investing if there are: 1) clear connections between the investment and your own job opportunity, 2) mutual incentives for employer and employee to participate, 3) joint trusteeship and, 4) institutions to facilitate the non-traditional investments. The capability to directly invest in ones own job and the opportunity for mutual incentives for employers and employees are specific to the building trades funds. But, the last two elements, joint trusteeship and developing institions to facilitate innovative investment policies are common to all the other examples of strategic investing. The experiments with strategic investing, discussed in the two previous chapters, show that employee participation in pension management and responsive investment institutions are crucial to implement non-traditional investment policies.

Having identified the common and necessary elements which support strategic investing, we need to look at how workers can first attain more control over their penison funds and then use new investment mechanisms. This chapter concentrates on the intermediate steps needed to gain more worker control and build responsive institutions for pension fund investing. The first section describes how a few unions have attained joint trusteeship. Its primary focus is on the alternatives to joint trusteeship when the former is unrealistic. These alternatives represent ways employees can obtain a voice in the management of their pension fund when joint trusteeship is not an opetion. The second section suggests alternative investment mechanisms which overcome information barriers and facilitate strategic investing. The chapter concludes with recommendations for future research in the emerging field of "strategic investing".

JOINT MANAGEMENT

The United States is characterized by diffuse, fragmented political decisionmaking and highly concentrated economic and investment decision making. There are democratic processes for making political decisions concerning capital and land owned in common by the public. But, when it comes to pension funds, which are also social capital, technically, owned by workers, democratic processes over investment decisions hardly exist. The idea that workers own pension fund assets has become accepted to the point that even conservative management consultant, Peter Drucker, author of The Unseen Revolution: How Pension Fund Socialism Came to America, wrote:

> "If "socialism" is defined as "ownership of the means of production by the workers" - and this is both the orthodox and the only rigorous definition - then the United States is the first truly "socialist" country. Through their pension funds, employees of American business today own at least twenty five percent (25%) of its equity capital, which is more thatn enough for control . . ." [1]

But, as we have seen, this "ownership" means little, because most workers have no way to exercise typical ownership rights. "The worker cannot borrow the money, trade it, use it as collateral or do any of the other things ownership normally allows . . . These decisions are made on the worker's behalf by trust departments of America's giant banks", writes Derek Shearer and Martin Carnoy in Economic Democracy. [2]

Typically, workers in the United States have had little say in economic production and investment decisions. In contrast, European countries have more of a tradition of union-management cooperation and involvement in economic decisions.[3] It follows, then, that joint management of pension funds is much more prevalent in Europe. Infact, in many Western European countries, joint management is required by law. [4]

In the United States private and public employee unions are just beginning to negotiate for more control in economic production decisions in exchange for wage concessions. The larger unions are also starting to push for more of a voice in pension management decisions. For most unions with single-employer pension plans, joint trusteeship is currently not a realistic option. And for non-unionized employees, the alternatives to joint trusteeship may also be unrealistic, because there is no negotiation process over pension fund management. Thus, the steps toward gaining more control over pension fund investment will be most useful or practical to workers who can bargain over pension management issues.

Employers will not give up full control of pension funds easily. According to Randy Barber, the expert in this field, there are realistically only two opportunities for a union to sucessfully negotiate for joint trusteeship of a pension fund.[5] The first opportunity is at the creation of the pension plan. It is much easier to start the plan with joint trusteeship thatn trying to wrest control from employers once the plan has been in operation. The second opporunity is when the pension plan is being reorganized. During this time, employers may be more open to changing the management of the fund. For example, if a pension fund switches from a defined-benefit plan to defined-contribution plan, a union would have more of a claim to joint trusteeship. If a union represents workers in a company where a pension plan is just starting or being reorganized, the union has a good opportunity to negotiate with the employer for joint control.

The first step toward preparing for a negotiation process is to secure information on the pension plan if it exists.

The Industrial Union Department of AFL-CIO lists the type of information a union should request from an employer. It includes:

- "a list of the investments of the fund
- the earnings of each investment
- the original purchase price and current market value of each investment
- the identity of firms managing the fund and fees paid to such managers
- the relationships between the firms managing the funds

and those financial institutions that service the employer

- an itemized breakdown of the cost of administering the fund

- instructions trustees have given to investment managers

- how stock voting rights have been exercised" [6]

Some of this information can be obtained from annual reports on pension fund investments, filed by every employer with DOL, called "5500 forms". These "5500" reports are available to workers through their employer or through DOL. Unfortunately, the "5500" forms are cumbersome and not always accurate or up-to-date. Researchers usually use the Money Market Directory to verify investment manager information on the "5500" forms.[7] The best source of information on a particular pension fund investments are the employers own records. Access to this information is crucial to taking further steps toward joint administration of a pension fund.

Once the union or employees have accurate information and have seriously researched the operation of their pension plan, they potentially can negotiate for joint trusteeship or alternative forms of employee participation in pension fund administration. A handful of unions have successfully negotiated for joint trusteeship in a single employer plan. They may serve as a model for other pension funds which have the realistic opportunities to negotiate for joint control. For example, the Amalgamated Transit Union negotiated joint trusteeship agreements in the 1950's with Greyhound Corporation.[8] The trustee board has responsibility for administering the plan, determining benefits, selection of investment managers and acutaries and setting investment policies. Another example involves the Newspaper Guild Local 3 which went on strike at the New York Times and one of its main demands was joint administration of the Times pension fund.[9] After a long strike, in 1965, the Times agreed to set up a jointly trusteed pension fund administered by four union and four managment trustees. Other Newspaper Guild affiliates have since gained joint control of pension funds with other newspapers throughout the country.

The Airline Pilots Association (ALPA) has successfully negotiated with Eastern Air Lines, TWA, Pan Am, United and Republic for joint trusteeship of their pension funds. The joint retirement boards have the "right to establish, select, review or change any assumptions, goals or procedures adopted under the Plans, and to review any individual or firm employed to assume duties and obligations regarding said assumptions, goals or procedures under the Plan . . . and the power to select, approve, terminate or replace any Trustee, Investment Manager, Actuary, Insuring Company or Consultant as the case may be."[10] These examples demonstrate that successful negotiations for joint control is quite possible, expecially if the timing is at the creation of the plan or when it is being reworked. If negotiating for joint control is too big a leap or an unrealistic option, there are a variety of alternative ways workers can increase their participation in pension fund management. For example, the union might negotiate to participate in the selection of investment managers. Also, the union may arrange to review the performance of investment managers. The union could set up a tracking system to monitor investment managers' performance.

Another option, suggested in the AFL-CIO report on pension funds, is for unions to negotiate an agreement specifying that a certain portion of the fund's assets be invested in residential mortgages.[11] This type of agreement is similar to the one reached by the UAW and Chrysler.

Still another strategy is for the union to arrange to participate in the selection of actuaries who evaluate the amount of employer contributions needed to properly fund the plan. The actuarial assumptions determine the amount of money in the pension fund for benefits. It would be an especially important step toward joint administration, for the union to participate in deciding the "interest assumptions" set by the actuary. Interest assumptions represent the income the plan expects to produce through its investments. For example, Eastern Air Lines' one billion dollar pension fund had an interest rate assumption of seven percent (7%) on its investments. Eastern, recently, increased their interest rate assumption to nine percent (9%) which had the effect of reducing their contribution to the pension fund.[12] Infact, the increased interest assumption created a quarterly profit for Eastern when they otherwise would not have had one. Pension & Investment Age is quoted as saying tht "a $5.9 million gain from updating actuarial assumptions meant the big difference between the "black ink and the red ink" for Eastern.[13] This interest assumption of nine percent (9%) is very high, considering the average interest assumption for the top one thousand corporations in 1980 was six point three percent (6.3%).[14] If the union participates in the selection of actuarial assumptions, they can decide if the company is manipulating their money to the detriment of their own retirement benefits.

The Airline Pilots Association are now negotiating an agreement with Eastern Air Lines to allow the union and employer to each appoint an actuary. Together, the acutaries would make recommendations to the trustees on interest assumptions, wage and salary assumptions and required employer contributions.[15] The union has proposed joint acutuaries in light of Eastern's increased interest assumptions. One union official was quoted by Labor and Investments as saying:

> "We negotiated a level of pension benefits based on calculated cost to the company. The company then turned around and raised its interest assumptions, thus saving it a significant amount of money in terms of total labor costs. But we gave up other potential benefits on the basis of the old calculations. We think it is extremely important for us to have a role in setting interest assumptions since they can affect the whole range of benefits our members receive."[16]

Another intermediate step toward joint administration involves unions exercising equity voting rights on the stock their pension fund holds. Usually, management votes proxies or abstains without any input from workers. A union may want to get involved in voting on stockholder issues to enhance the security of the stock and to influence corporate policies which are of interest to beneficiaries.[17] Many different pension funds must coordinate their stock voting to win a shareholder resolution.

Already, a number of public pension funds and jointly trusteed funds have coordinated their stock voting on "social issue" resolutions such as South Africa-related investments, nuclear power, miltary conversion, redlining, the infant formula issue, domestic labor practices and trade with repressive governments.[18] Recently, three California pension funds voted three hundred fifty thousand shares of their stock in U.S. Steel against that company's takeover of Marathon Oil. If enough pension funds organized around stock voting, shareholder resolutions and proxy voting they could influence corporate policy and even be used as a tool for organizing and bargaining efforts.[19] First, however, employees must bargain for the right to participate in the voting of their pension fund's stock. A least, workers should arrange to have access to their employers proxy voting records.

A few public pension funds have attempted to elect a representative to the Board of Directors of a company in which the fund is a primary stockholder. Most top stockholders have some say or control in corporate rights to a portion of control of the companies in which they are large stockholders. There are exceptions, however. Hawaii's public pension fund elected a representative of their fund to the Board of Directors of the Hawaiian Independent Refinery, a company in which the pension fund owns sixteen percent (16%) of the stock. California's pension fund ran two candidates for corporate directorship in Bank of America, in which the fund is among the top five stockholders.[20] "Any wealthy individual that is the fourth largest stockholder of Bank of America is sure going to be on the board", said one state official defending the pension fund's move to seek corporate directorship.[21] If California's state pension fund coordinated its voting with the University of California and Los Angeles County

Retirement System, they would have the potential to elect memers to boards of companies. Private corporations resist having public pension fund representatives on their Boards. It is quite possible that a public pension fund representative may have different views about corporate planning than businesspeople and bankers who traditionally are on Boards. Nathan Gardels, chair of the California Public Investment Task Force referred to this different viewpoint in an Investment Age article:

> "Perhaps if California public employees had more direct input on major decisions, General Motors might have more fuel efficient fleets of automobiles and General Motors would be better off in the marketplace today and their shareholders would be getting a better return on their investment."[22]

The implication is that a public employee retirement fund representative may take more of an interest in long-range economic planning and profitability than those who typically are corporate directors.

Even if public employee representatives do not have different economic planning viewpoints from traditional directors, at least the pension fund is excersising its ownership rights by acquiring a portion of control of the company. In 1976, two public pension funds in Pennsylvania financed a one hundrd thirty five million dollar loan to Volkswagon to encourage them to locate a new plant in the state. The public pension funds received no controlling influence in the operations of Volkswagon. "At least in the private sector, when banks sink hundreds of million of capital dollars into a venture, they demnad and receive a degree of control over the operations in return", said Randy Barber. He continued: "At the minimum they often get a director or two placed on the Board of the company. All Pennsylvania received was a pledge by Volkswagon to pay interest on its one hundred thirty five million dollar outstanding loan and a few thousand jobs brought into the state, jobs that Volkswagon could decide to move out of the state five or ten years hence if the company receives a better deal from some other state or country."[23] Public pension funds, expecially those with employee representatives as trustees are just now beginning to push for their stock ownership rights and are considering electing its members to company boards.

Private pension funds are usually not large enough to elect representatives to corporate directorships. Several pension funds would have to coordinate a strategy for a successful Board election of a pension fund representative. Again, first the employees must have an agreement with their employers that worker representatives have to power to vote on shareholder actions such as resolutions and election drives.

These four strategies, 1) reviewing investment managers, 2) arrangements to set aside a portion of the funds assets for a specific reason such as residential mortgage investment, 3) participating in the selection of actuaries, and, 4) voting the stock the pension fund holds, have all been experimented with by different unions. The best strategy for a particular pension fund depends on the size of that fund, the interests of the union members and the willingness of the employer to negotiate on pension fund management issues. For example, a small pension fund would not pursue issues about voting stock or setting aside a portion of assets for mortgages, because they would not have enough assets to make those strategies worthwhile. Thus, the strategy which offers the most amount of employee input in management decisions varies depending on particular pension funds.

Arrangments between employees and management to vote on shareholder issues, or review investment managers or appoint actuaries are all intermediate steps toward joint tursteeship. Joint trusteeship includes the power to vote on all the issues mentioned above and have a voice in investment policies.

A goal of any union interested in strategic investing should be joint control of the penison fund, but if that is not a realistic option, there are alternative measures, such as access to information, arrangements to review investment managers and actuaries or the right to vote on shareholder issues, which may eventually lead to joint trausteeship, and at least give wokers more of a voice in the management of their pension fund.

INSTITUTIONS TO SUPPORT STRATEGIC INVESTING

Joint trusteeship by itself does not lead to strategic investing, and there are many jointly trusteed funds which have not made any strategic investments. Supportive and responsive institutions are needed to implement strategic investing. By "supportive and responsive", we specially mean that there is a need for institutions which 1) overcome information barriers, and, 2) facilitate non-traditional investments.

INSTITUTIONS TO OVERCOME INFORMATION BARRIERS

New institutions which provide information on pension funds need to be created. This section will first discuss information organizations which already exist. Second, we will look at two necessary information organizations which are not yet developed. Both existing and suggested organizations can serve as models for pension funds interested in designing their own organization to overcome information barriers.

The AFL-CIO has organized two vehicles, a trustee training program and a newsletter, to increase information on pension fund management, for thier membership.

The AFL-CIO has recognized that union trustees need education and training programs if they are to participate in strategic investing. The George Meany Center for Labor Studies has recently scheduled two-day pension seminars for union trustees. The seminars have sessions on The Need for an Expanded Investment Policy, Pension Fund Investments, Principles of Pension Planning, the Impact of ERISA and Financial Analysis.[24] Although the training seminars are geared toward union trustees, union representatives who do not have direct participation in pension fund management are encouraged to attend. The AFL-CIO pension fund report states:

> "Armed with better knowledge and information concerning investment policy, representatives of unions without management rights will be better able to use the means at their command to obtain information and even influence investment policies followed by the employer managers of the pension funds covering their members."[25]

The AFL-CIO has also participated in the creation of a nationwide monthly newsletter, Labor and Investments, which provides information on public and private pension fund investment issues. Labor and Investments has articles on strategic investing and is one of the best written resources for unions interested in taking more control over the management of their pension fund.

At the state level, California has recently set up a pension fund information organization, called the Pension Investment Unit (PIU), which is located in the Office of Planning and Research. The PIU serves as a clearinghouse on state pension investment issues, conducts research, develops proposals and has the large job of gradually implementing the Public Investment Task Force recommendations. To implement the recommendations, the PIU must draft legislation, provide supporting research and help coordinate innovative pilot investments allowed under existing state laws.[26] If the PIU remains adequately funded, they could provide needed information on pension fund investments to state and local employees and trustees. Governor Brown has also created a Council of Pension Trustees and Managers which includes persons at decision making levels in the state public teacher and employee pension fund system. The Council meets to hear and advise about potential new investment vehicles.[27]

There are information organizations which have been suggested, but not yet implemented. For example, the AFL-CIO report on pension funds discusses creating a centralized system for coordinating the exercise of shareholder rights, which would be operated by the AFL-CIO. This information organization would keep abreast of shareholder issues in certain companies. It also could develop its own resolutions and disseminate information about shareholder actions which are in the general interests of the labor movement. The staff would also work on alerting unions to "companies that were deemed particularly unworthy-or worthy- of even the appearance of union support through investment or stock purchase."[28] This same organization should also provide workers with information on how to find out about the investments of their pension fund. For example, staff could help locate "5500" forms and assist in interpreting them.

The New York State Building Trades have also suggested creating a pension fund information organization. Infact, they have adopted a resolution to establish a statewide coordinating committee for the exchange of investment information, but the committee has not yet been formed. According to the resolution, this committee will:

1) "collect current data on Building Trades Funds in the state
2) review existing investment vehicles and circulate lists of investments for the consideration of various trusts which meet the Prudent Man Test and advance the use of union labor in this state
3) act as a coordinator in putting together diverse groups of trustees by geographical or other grouping to foster common programs of investment
4) conduct economic studies such as the effect of investment on employment and on Fund soundness
5) establish machinery to deciminate in cogent, useable form some or all of the information gathered in subparagraph 1-4
6) work with government agencies to advance their support of its projects and utilization of guarantees to protect trustees investments and to foster a National policy which recognizes the validity of investing both for full return and the advancement of the participants."[29]

Both of these suggested information organizations should be developed.

Finally, there are organizations that need to be created which have not yet been formally suggested. For example, an information organization should be developed at the local level as well as at the state and national level. Several unions in a particular area could create an information network and even each contribute a small amount of money for one staff person to keep abreast of investment issues. This staff person could inform pension funds about particularly profitable local investments, inform members of the unions as to where their money is invested and answer general pension fund investment questions. Data on the financial performance of pension funds, would be especially useful and could cut down on costs paid to consulting firms which monitor and evaluate pension fund performance. A local information disseminating organization of this kind could be useful and supportive to smaller pension funds interested in strategic investing.

In summary, workers first need to be aware of the existing places to find pension fund investment information, such as AFL-CIO seminars, the newsletter, Labor and Investments, and the California Pension Investment Unit. Second, suggested organizations like a nationwide system for coordinating shareholder voting, operated by the AFL-CIO , and the New York State Building Trades Investment Information Committee, should be developed. Third, local information organizations which can identify profitable local investment opportunities, need to be created.

Pension funds wheih have implemented strategic investing have used formal and informal information channels. The building trades often use their own informal information networks to find out about mortgage investments. Active public pension funds have set up task forces which have pushed them further along the learning curve for strategic investing. Education for trustees and beneficiaries on "pension fund power" and available information on investments weakens the barriers to strategic investing.

INSTITUTIONS WHICH FACILITATE STRATEGIC INVESTING

In addition to information organizations, innovative investment vehicles and financial management institutions are needed to support strategic investing. The existing strategic investment examples use a variety of non-traditional investment vehicles, such as mortgage pooling, rehabilitation loans, mortgage-backed securities, small business investments and a separate mortgage account in a union insurance company. All these investment vehicles need to be expanded and reworked according to the needs of different pension funds to increase the use of strategic investing. Four general types of vehicles or organizations which especially need to be expanded or created to facilitate strategic investing are: 1) insurance mechanisms, 2) pooling mechanisms, 3) institutions to increase mortgage investing, 4) institutions to facilitate economic develpment investments. The institutions are interrelated and often their functions overlap.

INSURANCE MECHANISMS

Pension funds are risk-averse, hence, institutions designed for pension fund investment need to minimize the risk invovled in that investment. Pension funds are more likely to participate in strategic investing if they are guaranteed a certain return on their investment. First, I'll briefly mention two insurance programs which already exist and facilitate strategic investing. Second, we'll look at two other insurance programs proposed in California, but which have not yet been implemented. Again, both the existing and suggested programs may serve as models for state and private financial institutions interested in supporting strategic investment.

One existing private insurance program is offered by Morgan Guarantee Investment Corporation (MGIC). This program, already discussed in Chapter 1, insures mortgages for pension fund investment. MGIC has primarily insured public pension fund mortgage pools, but private pension funds can also purchase mortgage insurance. Other financial institutions are starting to design mortgage insurance for pension funds. Private insurance, even for a small percent of a loan can minimize risk and encourage strategic investing.

There are already federally insured investment vehicles which pension funds have not taken full advantage of. Pension funds could easily substitute the one hundred percent (100%) government instured Ginnie Maes, Fannie Maes or SBA loans for corporate bonds. A portfolio manager can balance low risk investments, like GNMA's against high risk investments, such as venture capital securities. Pension fund managers are often unaware of the variety of federally insured securities. These government insured loans could be marketed toward pension fund investment to provide managers the option of a guaranteed investment return. It would be relatively easy for pension funds to participate in either of the existing privately or publicly insured investments.

Proponents of strategic investing in California have developed two insurance programs, which have not yet been approved by the state legislature. Under the first program the California Housing Finance Agency (CHFA) insures rental housing mortgage loans made by pension funds.[30] Under this program, a pension fund makes an "equity kicker" mortgage loan with a below market interest rate in exchange for a portion of the appreciation in the future. The program stipulates that the developer maintains the building as rental housing for at least fifteen years. CHFA insures the loan principal and current interest rate.

> "The purpose of CHFA's insurance program is to provide a substantially reduced risk to the lender (pension fund) for the types of loans provided. An intensified underwriting of each development will take place as if CHFA were making the loan with the purpose of determining that each development demonstrate a reasonable probability of success and represents a should investment." [31]

The second program would create an Industrial Investment Insurance Authority to insure small business loan pools for sale to pension funds.[32] The Authority would certify a bank to pool small business loans for purchase of plant facilities, land and equipment. They, the bank, would sell a mortgage-backed security to a pensin fund. The Authority would insure up to seven and one half percent (7½%) of the mortgage pool and the bank would obtain private insurance to satisfy pension fund standards. Plant and equipment loans in the pool must be for a company located in California, with five hundred employees or less, with a maximum eight-year mortgage term for equipment and fifteen years for plant facilities. With the public and private insurance, pension funds can prudently purchase small business loans "to generate acceptable returns with minimal risk while encouraging investment in priority sectors of the California economy."[33]

Under both the rental housing insurance program and the Industrial Insurance Investment Authority, the insurance is offered by the state, but available to public and private pension funds interested in participating. Both insurance programs have a good chance of passing the legislature by 1983 and if successfully implemented in California, other states should be encouraged to design similar programs.

POOLING MECHANISMS

Pooling of pension funds also serves to minimize risk. Strategic investing is more readily pursued when pension pooling takes place.[34] The Southern California Foundation is a good example of facilitating stratgic investment through pooling. Recently, a mortgage pool financed by public and private pension funds was set up in the cities of St. Paul and Minneapolis.[35] The mortgage pool, called the Family Housing Fund (FHF) offer mortgage loans to moderate income familes. FHF is financed by local public pension funds, union pension funds, a foundation, a UDAG grant and a tax-exempt mortgage revenue bond. The UDAG, foundation and bond monies help to insure the pension fund investment. This is one of the few programs in which public and private pension fund monies are pooled for a strategic investment purpose and that aspect of the program could be a model for other pension funds.

Many strategic investment objectives could be acheived by consolidating the management of different pension plans. Theoretically, the AFL-CIO could offer a large consolidated pension fund management service. The model for this consolidated pension plan is the Teacher Insurance Fund (TIAA-CREF), one of the larget pension funds in the nation.[36] About six hundred fifty thousand (650,000) teachers participation TIAA/CREF. The teachers are employees of 3,400 two and four year colleges who contribute to this pension fund. Although, AFL-CIO has mentioned pooling many union funds under on management, such as TIAA/CREF, the unions believe it is unrealistic and not a useful strategic investment mechanism. The AFL-CIO Stucy on pension funds states:

> "The survey of union officials confirmed that the present system of diffuse but autonomous and independent pension funds managed by hundreds and even thousands of individual boards of trustees is not generally regarded as a problem, but as a good thing, well worth preserving. Whereas, individual board of trustees might be willing to turn over a part of their fund's assets to a separate fund, such as an employment-oriented reindustrialization or social fund, they would not go along with relinquishing all control over the management or investment of pension contributions made in behalf of their mebers."[37]

Realistic pooling institutions need not consolidate entire pension funds, but instead, pool small portions of different funds' assets. Financial institutions, investment brokers, mortgage bankers and state agencies can all facilitate the pooling of pension funds.

INSTITUTIONS TO INCREASE MORTGAGE INVESTING BY PENSION FUNDS

This paper has already discussed many of the institutions which can facilitate pension fund investment in mortgages. The pooling and insurance mechanisms mentioned above are often designed to increase mortgage investing. The following mortgage institutions also need to be developed, expanded and marketed to support strategic investing:

Institutions to Package Mortgage-Backed Securities

More conventional mortgage-bakced security programs need to be developed to encourage pension fund investment in mortgages. MGIC has pooled conventional mortgages and offered insured pass-through securities to state and local penison funds. MGIC's program is specially designed for pension fund investment and might serve as a model for other financial institutions capable of offering conventional mortgage-backed pass-through securities.

Private pension funds can work directly with a bank in designing a conventional mortgage-backed security program. For example, a group of union funds can issue forward commitments to purchase mortgages, according to specifications, if a bank pools and insures the mortgages and then offers a pass-through security to the funds.

A state institution could be very useful in coordinating a conventional mortgage security program. California has two pending bills in the state legislature to create an institution called "Callie Mae" to aggregate mortgage loans from banks and assemble them into pools for concurrent resale to pension funds.[38] The mortgage pools would either be insured through a private company or the California Housing Finance Agency. "Callie Mae" is designed to facilitate public and private pension fund investment in housing and to develop a secondary mortgage market for home loans. If it accomplishes these goals, it may also be a model other states can use to encourage targetted mortgage investment.

Mortgage Banking Firms

Pension funds need to develop and expand relationships with mortgage banking firms that already know local mortgage markets. Mortgage banking firms, in turn, should market their services for pension fund needs. Mortgage bankers can identify areas in which there are financing gaps in the mortgage markets. A mortgage banker can recommend local profitable investments which have been underinvested in because of market failure. Pension funds could benefit from mortgage bankers' expertise in the unique qualities of a local mortgage market, on the risk involved in certain loans and their knowledge about the cyclical and spatial variation on housing financial markets.[39] Expanding mortgage banking firms to include special pension investment divisions would facilitate more mortgage investing by pension funds.

Expansion of Existing Labor-Related Mortgage Acccounts [40]

Th two main labor-related institutions involved in mortgage investments are ULLICO through its J for Jobs Account and the AFL-CIO through its Mortgage Investment Trust (MIT).[41] Labor unions have not taken advantage of these institutions, often, because of a lack of knwledge among union trustees concerning the services these institutions offer.[42] First, these institutions need to market their servics to union pension funds. Second, they should attempt to invest in mortgages from the areas in which the beneficiaries of the pension funds live and work. Local building trades union want to create jobs for their members and may be reluctant to invest in a national mortgage pool unless they have an opportunity to increase jobs in their areas. These labor institutions are important in supporting strategic investing, but need to be better marketed and designed for different pension funds.

State mortgage agencies, banks, insurance companies, labor-related financial institutions and mortgage bankers could all play a facilitating role in encouraging pension funds to invest in new mortgages, such as graduated payment mortgages, shared appreciation mortgages, cooperative mortgages and "equity kicker" mortgages. Often, pension funds are well suited for investment in these new mortgage instruments because of their small liquidity needs and long-term liabilities.

Pension funds have already started to invest small amounts of their assets in mortgages. The mortgage institutions have been developed and just need to be expanded to accommodate pension funds. The expansion of these mortgage institutions is feasible and realistic. Advancing cooperation between pension funds and existing mortgage institutions will increase the investment options for pension fund trustees.

Institutions to Facilitate Economic Development Investments

In contrast to mortgage institutions, there are few institutions which already exist to facilitate pension fund economic develpment investments. Infact, institutions to support economi development investment are still in the proposal stages. Most of the institutions mentioned here are future options for pension funds rather than present ones.

A variety of mechanisms need to be developed to offer pension funds the opportunity to invest in small and medium-size businesses. One proposal is that public pension funds set aside a small percent of their assets, such a one percent (1%) for venture capital partnerships. Some states would have to enact legislation to permit their pension funds to invest in venture capital firms. The goal of the set-aside fund would be to establish a supply of venture capital in a state and create an opportunity for higher yields to the pension fund.[43] A few pension funds have already invested a small proportion of their assets in establishing venture capital firms. Set-aside venture capital funds are realistic current options for large pension funds, expecially those with in-house managment.

A group of pension funds could set up a pooled venture capital account, in which each pension system would commit a small percentage of their assets to the account, managed by a financial intermediary. California's Task Force suggested establishing the California Venture Capital Allocation Fund, which would function like a pooled venture capital account. The California Fund would invest in California-based ventue capital partnerships. "Allocating a very small portion of pension assets to this fund and the pooling of risk will make such an arrangement prudent for pension funds, while offering opportunities for higher yields and providing a constant supply of venture capital for the state's economy." [44]

In the last five years, a few states have started ventue capital intermediaries, such as the Connecticut Product Development Corporation, Massachusetts Technology Development Coporation and the Alaska Renewable Resources Corporation. These intermediaries invest in young, technologically-oriented companies which are "economically viable" but not capable of obtaining sufficient capital on reasonable terms.[45] Pension funds have never invested in these public venture capital firms and it is unlikely, they will do so in the near future. There is still too much risk attached to these public venture capital investments. However, for pension funds interested in small business investments, these intermediaries may be better able to manage the small firm investment process than in-house management. These public intermediaries can reduce risk involved in venture capital investments, through transferring it to the government or pooling it away.[46] There is at least a potential to match a small percent of a pension fund's assets with these public venture capital intermediaries to provide needed financing to small and medium-size businesses and an opportunity for a higher return to the pension fund.

Larry Litvak, author of Pension Funds & Economic Renewal has proposed an institution called a public investment broker to assist in matching small and medium-size loans for private and public pension funds. New York City has established a similar institution called the Economic Capital Corporation to "create financing packages on a joint and cooperative basis with private and public capital sources";[47] but it is not necessarily designed for pension fund investment. The public investment broker would serve as a major source of information to pension funds on small and medium-size business opprotunities. Litvak writes:

> "Besides influencing the menu of local investment opportunities that receive consideration by pension funds, the combined efforts of development authorities and public investment brokers can eliminate the possibility that pension funds will have to bear excessive administrative costs as a result of the development dimension of these investments. Any costs involved in searching out and evaluating such investment opportunities greater, than those experienced in a similar but not-targetted investment strategy would be in effect, underwritten by these public sector institutions. These institutions could in turn charge fees to the venture they assist."[48]

A public investment broker has minimal start-up costs and potentially can provde a needed link betwen profitable businesses and pension fund capital.

A final approach to facilitating economic development is to create state-owned banks to manage pension fund assets. The only state owned bank in the country, Bank of North Dakota, acts as the fiduciary agent and manages the state pension fund's portfolio. Bank of North Dakota has a reputation for sound financial management and has pursued a socially conscious investment policy.[49] For example, the Bank gives priority to loans for small farmers and people needing housing loans.[50] In the last few years, proposals for state owned banks have been introduced in Massachusetts, New Jersey, New York and California and if passed, they could be a serious threat to private commercial banks who use pension funds. Both private and public pension funds could put their money in state owned banks, if the bank is staffed with trust departments competent to invest pension fund accounts.[51] State-owned banks are not current options for pension fund investment, especially in today's political and economic climate.

But, state-owned banks certainly have the potential for being responsive to strategic investment goals. Bank of North Dakota may serve as a future model in creating state banks capable of managing pension funds.

In addition to creating responsive financial institutions, pension funds should have their assets managed by institutions supportive of strategic investing. Anumber of invstment banking firms have set up special "social issues" and labor advisory committees. These committees are set up to help pension funds avoid purchasing stocks from companies operating antithetical to the pension fund's social and economic goals. Financial institutions with committees and special "social action" funds play only a limited role in a pension fund's strategic investment policy, but, nevertheless, are worthly of support, since there are so many traditional financial institutions that refuse to look at the social and economic impacts of their investments.

As we now can see, numerous institutions are required to support strategic investing. These is a need for institutions to disseminate information and educate, as well as institutions which expand investment options for pension funds. Finally, there is a need for research on the experiments with strategic investing.

FUTURE RESEARCH

Eduction of the public as to who owns pension fund assets, how and where those assets are invested and their financial and social performance, is essential for widespread implementation of strategic investing. In addition to education, there is a need for more research on current pension fund investment practices and evaluations of experiments with strategic investing. For example, we need to know more about why pension funds have had such poor financial performances. Is it because managers only look to the short term, or have they been negligent with pension fund money? More rigorous research detailing bank trust department decision making on pension fund investment is needed. It would also be helpful to know more about the interlocking directorships between companies with pension funds and the institutions investing those funds.

Secondly, research is needed to evaluate present attempts at strategic investing. Methods of measuring displacement are especially needed. Thus far, pension funds have no tool to estimate the degree of displacement of other investors created by the entry of pension funds investing in mortgages or small businesses, for example. In evaluating a strategic investment, researchers could conduct economic studies to try to account for capital displacement effects.[52] Regional or state input-output models could be used to measure net change in income and employment resulting from a given pension fund investment.[53] The growth in income or employment to the region could be compared to the administrative costs of implementing the non-traditional investment.

A researcher could also evaluate the decision making process of pension funds involved in strategic investing. Are the decision making processes any more democratic than traditionally invested funds? Finally, research is needed to better understand the obstacles to strategic investing. This paper identifies two salient features common to the existing examples of strategically invested pension funds: employee representation on a trustee board and the use of innovative investment mechanisms. There may be other common features to strategic investing, which if researched and identified, could help in overcoming the obstacles.

SUMMARY

Joint trusteeship and non-traditional investment vehicles, were identified as two important elements which support strategic investing. Once identified, this chapter explored the intermediate steps toward gaining joint trusteeship of a pension fund and the alternative investment vehicles needed to facilitate strategic investing. Information dissemination on pension funds is especially needed, along with institutions permitting pension funds to invest in mortgages and growing businesses. Numerous institutions should be created or expanded to support strategic investing, such as insurance and pooling mechanisms use of mortgage bankers, morgage-backed securities, labor-related mortgage accounts, venture capital funds, public investment brokers and state-owned banks.

Some of the institutions mentioned are currently available for penison fund investment, while other institutions have yet to be developed. A pension fund interested in strategic investing should begin with currently feasible institutions. For example, first, a pension fund could put some of their assets in "social accounts" of financial institutions. Seond, the fund could substitute federally insured mortgages for corporate bonds.[54] As the trustees became more familiar with mortgages investments, they could invest in more mortgage-backe securities, develop relationships the mortgage bankers, and take advantage of labor-related mortgage institutions. Investments in economic development are for pension funds which are more advanced at strategic investing, because there are currently less exisiting insitutions to facilitate these investments. State venture capital funds, public investment brokers and managment by state-owned banks, may be future options for pention fund investments.

Finally, more research is needed to better undertand how the billions of dollars in pension funds are currently invested and evaluate the consequences of strategic investing by pension funds.

Chapter 4

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CONCLUSION

Eight hundred billion dollars of social capital in the form of American workers' pension funds are controlled by a financial elite who make major ecnomic planning decisions for this country. Pension fund money is circulated among the largest United States corporations. The Fortune 500 (pension funds) finance the Fortune 500, with a handful of bankers acting as middlmen. And the capital they are using is workers "deferred wages".

There are serious problems with this pension system which concentrates financial power in the hands of a banking elite. The first problem is that there are conflicts of interest between banks and the large companies in which they invest. Second, under the present investment system, the largest companies are in the best position to receive financing, while medium-sized businesses are overlooked. As one pension fund observer stated: "As long as financial control of capital remains so tightly concentrated, competition for funds will be heavily weighted in favor of the needs and priorities of the large corporations." [1]Third, and most significantly, pension fund money is often not invested in the financial, social or economic interests of workers who own the money.

There is potential, though, to invest pension funds in securities which have added social benefits for fund members as well as secure financial returns. Chapter Two suggests three potential forms of strategic investing. First, pension funds can make investments which have direct benefits for members, such as home mortgages. Second, pension funds can invest in the sectors of our economy which tend to be underfinanced, but profitable. Instead of investing all of the assets in "big business", pension fund trustees could set aside a small percent of assets to invest in new companies which generate jobs and stimulate economic growth. Third, there is the potential for workers to remove their pension fund money from companies or banks which operate against the interests of labor.

Of course, there are tremendous obstacles to the implementation of these strategic investment possiblities. The largest barrier to strategic investing is employer-controlled pension funds. Employers have no incentive to consider the consequences of pension fund invstments on workers. Traditional financial institutions which invest pension funds are also a barrier to strategic investing. These institutions are accustomed to investing in Fortune 500 stocks and bonds and are uninterested in strategic investment goals Unfortunately, trustees must turn over pension fund assets to traditional money managers, as there are too few alternative investment institutions.

Pension funds which have implemented strategic investment policies have had employee participation in investment decision making and sought out non-traditional investment vehicles, overcoming both of the barriers mentioned. From the examples, in Chapters Two and Three, we find that joint trusteeship and access to alternative investment opportunities are key elements which support strategic investing.

Identifying supportive elements to strategic investing is only a small step toward the goal of changing traditional pension fund investment policies. The battle to actually change traditional policies needs to be fought on a variety of fronts.

First, workers in single-employer plans should negotiate for some form of employee participation in pension fund management. For example, workers could review investment managers, select actuaries, have control over a certain percentage of the assets, or vote on the stock the pension fund holds. These are intermediate steps toward a goal of joint control of the pension fund.

Second, unions and state governemtns must educate their constituents about the prospect of using their pension funds to advance their own interests.[2] Information campaigns are needed of workers, trustees and the general public on the possiblity of using pension funds to invest in housing and job creation in a region. State governments and unions could set up pension investment clearinghouses to provide information on possible strategic investments, to coordinate the voting of stock by different pension funds and to inform trustees about companies which are blatantly anti-union. Turstees must have access to investment information to begin changing traditional policies.

Third, unions and state pension fund trustees should invest more of their assets in existing alternative investment vehicles and institutions. For example, trustees could place some of their assets in those financial institutions with "social accounts" and labor advisory committees. Next, trustees could gradually invest more of their assets in mortgages by using federally insured securities, conventional mortgage-backed securities and mortgage accounts in labor-related institutions.

A fourth strategy is for unions and state pension funds to develop alternative institutions to facilitate strategic invseting. Insurance and pooling mechanisms designed for pension funds are needed. California's proposal for an Industrial Insurance Investment Authority and mortgage insurance for rental housing may serve as a model for the development of innovative insurance mechanisms. The Family Housing Fund in Minnesota and the Foundation in California are examples of creative pooling mechanisms for pension funds. Investment vehicles are especially needed to facilitate pension fund investment in economic development. State government should create public investment brokers and state venture capital funds to offer the opportunity for higher returns to pension funds and stimulate local economies. Both unions and state should work toward the development of state-owned and union banks, which are financially competent and responsive to pension fund investment goals. Barber and Rifkin write: "By establishing viable alternatives for depositing pension assets, unions would greatly increase their leverage with existing banks." [3]

Finally, none of thees battles will be won easily. Employers will resist giving up their monopoly control over pension funds. but, as the wealth of this country is more and more concentrated in a few corporations, it becomes even more important that workers assert control over the assets they hold claims over. As workers take more control in pension fund investment decisions, they have the oppotunity to assure secure financial returns for retirees and control the direction of capital investment in this country.

Conclusion

NOTES

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