



Sustainable Investing and the Financial Crisis

HOW LONG-TERM INVESTING CAN REPLACE SHORT-TERM BUBBLES

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Speculative bubbles, before they inevitably burst, are fundamentally the triumph of short-term thinking over long-term thinking, and of short-term investors over long-term investors.

The Financial Crisis of 2008 may be unique and unprecedented but it shares elements in common with previous market upheavals, such as the crisis of 1997-1998 or the bursting of the Internet bubble in 2001. In each instance, speculative bubbles fueled by greed, leverage and short-term thinking ended up wreaking havoc on markets and the underlying economy when they eventually burst. Corporations—in the current crisis, our largest financial institutions—are transformed into vehicles whose primary purpose becomes making a small group of management insiders (or select clients) enormously rich over very short periods of time.

The manic pursuit of short-term profit that characterizes bubbles works to the ultimate betrayal of shareholders, employees and the public. The bursting of the Internet bubble, for example, yielded a series of corporate governance scandals (Enron, Tyco, Worldcom) in its wake, shaking

the foundations of public trust in American business. Now it has happened again.

One distinguishing feature of financial bubbles is that we are told not to worry—prices will keep going up. During the Internet bubble we were told that classic business fundamentals no longer applied and that the business cycle itself had perhaps been repealed—supplanted by Moore's Law and miraculous productivity gains. Similarly, during the housing bubble and mortgage derivatives craze, we were assured that increasingly complex, opaque, highly-leveraged financial instruments have the salutary benefits of reducing risk and spreading it across markets.

Another distinguishing feature of financial bubbles is that government regulators are urged to get out of the way and let “the free market” work its magic. Market fundamentalism—the reigning ideology of deregulation and unfettered markets, which

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This article was originally published on the Huffington Post website on December 16, 2008. Reprinted with permission.

held full sway from Ronald Reagan to George W. Bush—has in fact probably contributed to the frequency and severity of financial bubbles over the past 30 years. Certainly, there can be little doubt that deregulation and lax oversight has played a central role in the current crisis.

Perhaps the most salient characteristic of all such financial bubbles is that they are fueled by debt. Leverage is the currency of speculative bubbles. An ever-widening gap between dizzying liabilities and meager underlying assets sets the stage for a terrible day of reckoning. This can affect the entire economy, and indeed the entire culture: rather than saving for tomorrow, people go on a debt and spending binge (bigger cars, houses, more *stuff*) in the belief that ever higher asset prices will eventually bail them out. In this sense, the recent housing bubble may simply be the latest phase of a much larger credit bubble—a toxic brew of financial leverage, consumer debt and government deficits—that has been building for decades.

Efforts by regulators to intervene in the current crisis have been made more difficult by the fact that the U.S. Government is itself the quintessential victim of short-term thinking: rather than pay as you go, which would require raising taxes or cutting spending, the federal government has been financing its activities over the past eight years with money borrowed from our children and grandchildren, as well as from China and other nations. During the presidency of George W. Bush, the federal government ran up more debt than all the previous 42 presidents combined.

The excessive speculation, consumption and risk-taking that comprise financial bubbles mark the triumph of short-term thinking in the economic sphere. Because such bubbles are fueled by debt, they essentially pit the present against the future. Debt is by definition borrowing from the future because that's

when the debt must be repaid. Our decision to borrow, spend and consume today is de facto a decision not to save, or prepare for, or think about tomorrow. By their very nature, then, short-term thinking and financial bubbles are unsustainable.

Our penchant for short-term thinking is catching up with us in other ways as well. It's not just the financial crisis. Many of our most pressing problems result from the triumph of short-term thinking over long-term thinking. Take climate change, where we are essentially borrowing from the planet's future health and jeopardizing the future of human civilization itself in order to support current consumption patterns. As the poet Lawrence Ferlinghetti once put it: "Man burns down his own house to roast his pig."

As the Obama administration prepares to take office and confront the financial crisis, there could not be a better time to devise strategies for replacing short-term thinking with longer-term perspectives and solutions. We need to explore ways of reforming markets to encourage and reward long-term investing while discouraging short-term, speculative bubbles. In short, we need to move from casino capitalism to Sustainable Capitalism, from speculative investing to Sustainable Investing.

For Sustainable Capitalism to emerge from the ashes of our current financial system, government must get involved in a major way. In the near term, of course, government must address the immediate financial crisis. But the current crisis also presents an historic opportunity to adopt more sweeping, transformational policies that address longer-term systemic issues. As incoming White House Chief of Staff Rahm Emanuel put it: a crisis is a terrible thing to waste.

Policy makers should take this opportunity to encourage long-term thinking in the economic sector by promoting more sustainable business and investment practices as an alternative to bubble economics. Some specific steps the new administration could take:

ESG Disclosure

The Securities and Exchange Commission (SEC) should mandate disclosure of environmental, social and governance (ESG) data by publicly traded corporations. This is relevant, material information that investors should have and increasingly want. Why? Because an investor in possession of such information might reasonably conclude that companies with stronger environmental performance carry less risk, achieve greater efficiencies and are better positioned than environmental laggards to take advantage of opportunities in a global marketplace where environmental issues increasingly matter; or that companies with strong employee relations and workplace practices may enjoy higher productivity and are therefore better positioned for growth than their less enlightened competitors; or that companies with better corporate governance practices are less likely to have blow-ups than poorly governed companies.

In other words, a reasonable long-term investor may want to avoid the risks associated with substandard ESG performance while capturing the benefits associated with superior ESG performance. Accordingly, many institutional investors worldwide are now integrating ESG analysis into their investment decisions, proxy voting policies and shareholder engagement strategies.

Many are also issuing corporate social responsibility or sustainability reports. In Europe, for example, publication of CSR/sustainability reports containing detailed ESG data is becoming the norm. In France, publicly traded companies of a certain size are

required to include ESG information in their annual reports to shareholders. Regulators and stock exchanges in other markets—including Brazil, South Africa and Sweden—have also mandated or encouraged the disclosure of ESG data. U.S. companies, however, lag behind in embracing this level of transparency.

That's unfortunate, because the availability of ESG data tracking the sustainability performance of companies could have a beneficial effect on corporate, investment and market performance. Should investors conclude that companies with thoughtful long-term management of ESG issues are better-run companies, they would buy the securities of more sustainable companies and sell the securities of less sustainable companies—buying the leaders and shorting the laggards. A sort of virtuous circle would be created: investors would reward stock prices where sustainability is integrated, and companies would respond by further improving their sustainability performance. A fixation on meeting quarterly earnings estimates and other short-term yardsticks would give way to longer-term thinking as a more expansive business agenda is recognized and rewarded by investors. The disclosure of ESG information by publicly traded companies would go a long way toward setting this process in motion.

Fiduciary Standards

The incoming Department of Labor (DOL) should take immediate steps to disaffirm and reverse two interpretive bulletins issued by the Employee Benefits Security Administration (EBSA) on October 17, 2008 relating to fiduciary standards for employee retirement plans under ERISA. The DOL bulletins, prompted by a letter from the Chamber of Commerce seeking to curtail actions by the AFL-CIO, were essentially a parting gift from Bush administration officials to the business lobby. Although one bulletin focused on proxy voting and shareholder activism while the other

addressed so-called “economically targeted investments,” their clear purpose was to hinder the ability of retirement plan fiduciaries to pursue “socially responsible” or sustainable investment strategies. This would include everything from investing in underserved communities, to investing in green companies, to proxy voting and shareholder activism strategies to improve the ESG performance of publicly held companies.

The bulletins mark a clear departure from prior DOL guidance and precedent as well as established legal principles involving fiduciary duty. Premised on the notion that ESG factors are “non-economic,” the DOL bulletins are also dramatically out of step with market realities. Fiduciaries of some of the largest institutions in the world, with trillions of dollars in assets under management, have long understood that ESG issues such as climate change, outlandish executive compensation, sweatshop labor, corruption and human rights have material impacts on stock values and investment portfolio performance. It flies in the face of clear investment trends and considered academic and financial research for DOL to suggest that a fiduciary cannot reasonably conclude that a company’s environmental, workplace or corporate governance performance may have some material impact on its financial performance.

ERISA plan fiduciaries represent *long-term* investors. Whereas corporate managers tend toward a myopic focus on short-term stock price—to which stock options, bonuses and other get-rich-quick schemes are often tied—retirement plan fiduciaries, because they represent long-term beneficiaries who have a natural interest in preserving the wealth in their investment portfolios, tend to focus on longer-term issues. Proxy voting and shareholder activism by long-term investors can be important checks and balances on corporate managers.

To deprive retirement plan fiduciaries of the ability to pursue sustainable investment strategies—through proxy voting, shareholder activism, investing in “green” companies or investing in underserved communities—would only encourage further short-term thinking, and investing, at a time when we need to promote more sustainable business and investment practices. The Obama administration should disaffirm the recent DOL guidance and clarify that fiduciaries have the right—indeed, the obligation—to take ESG factors into account when they determine such factors to be material to investment performance and beneficial to retirement plan beneficiaries.

Shareholder Access to the Proxy Ballot

It is also important that the SEC, following Chairman Cox’s departure, take steps to reverse a pattern of recent staff decisions closing the door on shareholder access to the proxy ballot. As a result, the balance of power between shareowners and management has swung heavily in the direction of management.

The Chamber of Commerce, The Business Roundtable and other conservative business groups have been urging the SEC for some time to curb shareholder rights. They argue that proxy access would open the way for “special interest” shareholders—by which they mean labor unions representing the people who work at these companies, institutional investors concerned about how these companies are managing a range of ESG issues and, I suppose, any shareowner who may disagree with corporate management on just about anything. (Interestingly, the business lobby does not consider corporate managers to be “special interest” shareholders, even though by controlling their own boards, such managers set their own pay. Logic and history would suggest that they are in the best position to place their own interests ahead of other shareholders through excessive compensation, stock options and other self-dealing.)

The United States is one of the only developed countries that prevent shareowners from placing director nominees on the proxy ballot of publicly held companies. In fact, the election of directors to corporate boards somewhat resembles the “elections” that were once held in the Soviet Union: in Soviet elections there was only one candidate for each office, backed by the party; in U.S. corporate director elections there is only one candidate for each board seat, backed by company management. Shareowners can’t even vote “no”—they can only withhold their vote. If shareowners wish to nominate their own directors, they must undertake the costly, burdensome process of a separate proxy solicitation—so costly and burdensome, in fact, that it is almost never done. This process is undemocratic and is quite an anomaly, as directors are supposed to represent the shareholders, not management.

In recent years the SEC has also disallowed shareholder resolutions on a range of ESG issues, categorizing such matters as within the “ordinary business” of corporate management not subject to the purview of shareowners. In 2003, for example, the SEC struck down a proposed shareholder resolution at Xcel Energy asking the company to report on the economic risks associated with carbon dioxide and other toxic emissions, including the economic benefits of reducing such emissions. Within the past year, the SEC struck down a proposed resolution at Washington Mutual asking the company to discuss its potential financial exposure as a result of the mortgage securities crisis. The SEC has also disallowed resolutions at several insurance companies asking them to report to shareholders on climate risk, again invoking the “ordinary business” exemption.

In other words, the SEC has effectively limited shareholder resolutions on an array of ESG issues that shareowners may, in fact, consider vital to the future prospects of the companies whose shares they own. As

with the recent DOL guidance mentioned above, those in the best position to act as a check and balance on corporate management and advocate for longer-term perspectives—that is to say, long-term shareholders—are being frozen out of the corporate governance process.

These are important rights. Shareholders are the owners of public companies. They should have the right to meaningfully participate in electing directors without having to incur the undue cost of a separate proxy solicitation, and they should have the right to place proxy resolutions on the corporate ballot addressing a range of ESG issues they deem material to companies’ long-term financial performance. Strong leadership from the White House will be needed in encouraging the SEC staff to rethink their approach.

What’s ultimately at stake is the balance between short-term interests and long-term interests, between a fixation on short-term profit and a commitment to sustainable business practices over the longer term. In under-regulated markets where investors are deprived of information and influence, business corporations have a natural tendency to focus on short-term profit and share price to the detriment of a broader, more spacious concept of corporate mission that encompasses both long-term shareowner value and the imperative of sustainability. The resulting speculative bubbles are taking their toll—on investors, on society and on the planet.

As a new political and regulatory era begins—in response to both the immediate financial crisis and a clear electoral mandate for systemic change—it is imperative that we find ways to promote sustainable business and investment practices. It is increasingly clear that companies that do a better job integrating ESG considerations into their business models are

better positioned than their less enlightened competitors to provide superior investment performance over the long term. The best companies—and the best investments—are those that act in the public interest by pursuing wealth creation strategies that are sustainable. Simply put, pursuing sustainability makes *economic* sense.

The immediate financial crisis obviously requires that the first order of business is to get credit flowing again and stimulate spending. At some point, however, financial regulators will need to pivot from this short-term strategy to a longer-term one, and rather than encouraging spending and consumption, they will need to encourage saving and investing. In this regard, they need to look at ways to alter corporate, investor and market behavior to facilitate better long-term outcomes. One important strategy for doing this will

be to promote sustainable business and investment practices.

Over the next 20 years it will be necessary for market capitalism to undergo a Sustainability Revolution equal in significance to the Industrial Revolution that ushered in the modern period. We can help usher in this transformation by encouraging long-term investing and strengthening the influence of long-term shareholders. We can improve corporate governance as well as the environmental, social and *financial* outcomes that businesses and markets create. We can pursue policies that help us move from a bubble economy to a sustainable economy. We can seize the opportunity of the financial crisis to make enduring changes.

Yes we can.

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