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The dark side of your Canada Pension Plan

Nine years ago reforms steered the fund built up by CPP contributions into the stock market. Now your retirement nest egg includes nuclear-arms makers, top polluters and more than \$350M in tobacco stocks.

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If you chip in to the Canada Pension Plan every week, then your investment portfolio includes 15 of the world's top 20 weapons-makers, tobacco giants such as Rothmans and Imperial Tobacco, and nine of the top 10 air polluters in the U.S.

It also includes companies whose operations have been linked to allegations of human-rights abuses in Amnesty International reports.

Reforms in 1997 shifted the focus of the reserve fund built up by CPP contributions away from government bonds, and steered it into the more lucrative stock market, in anticipation of the baby boomers' retirement needs.

It's been a successful strategy, one that -- along with higher contributions -- has helped boost the pension fund out of financial crisis.

Now the fund is a stock-market juggernaut, with nearly \$60 billion invested in publicly traded companies.

But under the law that created it, the CPP Investment Board, which oversees the fund, has an "overriding duty" to bring in bumper returns; as a result, it does not exclude firms on ethical grounds.

Critics say that, in the race for revenues, the fund has sunk millions into firms that are embroiled in war, environmental devastation and human-rights abuses.

"The legislation is too rigid," says NDP MP Pat Martin, adding that many Canadians would be shocked to know what their pension fund holds.

Mr. Martin, along with a growing number of environmental groups and human-rights watchdogs, is calling for changes to the act that governs the fund.

"Killing people is wrong. Killing the planet is wrong. It should follow naturally that investing in killing is also wrong," says Dylan Penner of the Toronto-based environmental group Act for the Earth.

Mr. Penner says working Canadians should not be forced to invest their pension savings in weapons-makers such as nuclear-arms manufacturer Northrop Grumman Corp. and Star Wars contractor Lockheed-Martin, or Ivanhoe Mines Ltd., now in a 50-50 joint venture with a firm owned by the savage military regime of Burma.

His organization is part of a coalition of groups, including Friends of the Earth,

Physicians for a Smoke-Free Canada, InterPares and the church group KAIROS, that is pushing for changes to the rules that govern the fund's investments.

The fund has also come under fire from the Canadian Medical Association for investing almost \$370 million in the tobacco industry.

Last year the CMA called on Canadians to ask the government why it allows "pension contributions, your money, to be invested in an industry that kills more than 45,000 Canadians every year."

Ian Dale, spokesman for the CPP Investment Board, says the act that set up the board was designed to protect its investments from political interference.

The fund only shuts companies out if their activities would be illegal in Canada, he says.

For example, the fund does not invest in landmine manufacturers because Canada has signed an international ban on the weapons. Similarly, it does not invest in companies involved in cloning or forced labour.

The only other factor the board considers is financial performance.

"We do take into account (social and environmental) issues but we do so ... only from a risk-return perspective."

The fund does not hand-pick its public holdings, which account for more than 90 per cent of its equities; instead, it is a "passive investor," buying a one- to two-per-cent stake in some 2,600 stocks carried on the indices of major stock exchanges, such Dow Jones and the Toronto Stock Exchange, and giving them roughly the same weighting.

Last year, the board unveiled a "responsible investing policy," under which it commits to making social, environmental and corporate-governance issues a key factor in its investment decisions, and in its interactions with companies as a shareholder -- but only as they affect the board's mission to protect its investments from risks such as lawsuits or consumer boycotts.

"Our investment mission is to help ensure the future pensions of 16 million Canadians," he says.

The move was hailed as groundbreaking by responsible-investing experts.

"We really commend the CPPIB for its efforts," says Eugene Ellmen of the Toronto-based Social Investment Organization, an association of more than 400 Canadian members with an interest in corporate social responsibility.

The board "is one of the leaders in the pension industry in Canada," he says, noting that it was one of the first signatories to the UN Principles for Responsible Investment, which were unveiled this year.

But Pat Martin says such initiatives don't go nearly far enough, especially given the fund's burgeoning importance on the stock market.

The CPP fund is the 22nd-largest national pension fund in the world; with bonds, private equities, infrastructure investments and real estate as well as public equities, it is worth almost \$100 billion -- a figure that is expected to rise to \$250 billion within 10 years.

"This fund will soon be almost as big as Canada's national budget. It will have the ability to make or break whole industries, sectors and regions of the country."

The sheer size of the fund also means it would be relatively painless to weed out those stocks most Canadians would not want, he argues.

Tobacco firms, for example, account for only nine of the fund's 2,600 public holdings.

He tabled a parliamentary motion in 2004 to change the pension fund's rules, but it was not adopted. He plans to reintroduce it this session. Changes to the act require the consent of the federal government and two-thirds of the nine participating provinces (Quebec has its own pension fund).

The issue promises to heat up as the board forges ahead this year with plans to become a more active investor, beefing up the handpicked portion of the fund, which now makes up less than 10 per cent of the reserve -- stocks in private companies, infrastructure projects and real estate.

In October the board embarked on its first major infrastructure venture, spending \$1.05 billion for a piece of British water giant AWG Plc.

The move has drawn fire from groups such as the Council of Canadians, which objected that Canadians' pension fund shouldn't be used to fuel the privatization of a vital basic need.

The group also argued that privatization in Britain led to sharp hikes in water prices and mass disconnections in the 1990s. Last year, water companies ranked as the worst polluters in Britain for violations such as illegal sewage disposal, according to Ralph Nader's group, Public Citizen.

But Mr. Dale says the CPP board researched its investment thoroughly, and is confident AWG has a "sound environmental track record." He also notes that the British Office of Water Regulation has attributed price hikes to upgrades and the expansion of water systems.

He says the board believes environmental, social and corporate-governance factors affect a company's performance, and will study those issues closely as it selects stocks.

Meanwhile, it has been doing everything in its power to ensure the companies in which it invests observe high standards, he says.

In its responsible investing policy, the fund pledged to push the publicly traded companies in which it invests to observe high standards through "quiet diplomacy," and by voting as a shareholder at annual meetings.

It also helps fund research on the financial impact of social, environmental and corporate governance issues, and participates in coalitions of like-minded fund managers, such as the Carbon Disclosure Project, which rates the climate-change efforts of more than 900 companies worldwide.

But some say the board's latest efforts amount to a feeble effort at damage control.

"My feeling is that (the board) has probably been embarrassed into taking a position on socially responsible investment, and to date I see no evidence of this affecting its investment decisions, although this might change," says Jack Quarter, a professor at the University of Toronto who is heading a major international research project on the socially responsible investment of union pension funds.

Pat Martin scoffs at the key strategy in the board's policy -- quiet diplomacy with the company.

"So they shake their heads and go tut-tut-tut now and then over some of their investments ... or maybe have a coffee with the directors and say, 'Please be more responsible' Come on ...

"They've got to say, 'We're going to sell our shares in your crappy company until you elevate your standards.'"

To date, the board has not screened out or divested from a single stock because of social or environmental troubles.

But there are several cases where critics say it should, if only to protect returns.

Pat Martin cites the example of tobacco firms, which have faced a series of multimillion-dollar lawsuits in recent years.

This fall a U.S. court gave the green light to what could be the biggest such case yet -- a class-action lawsuit for as much as \$200 billion against the makers of "light" cigarettes for allegedly marketing light cigarettes as a healthier alternative (the tobacco-makers are appealing the class-action designation).

Named in the suit are two tobacco companies in which the CPP fund holds a total of \$31 million worth of stocks.

Ivanhoe Mines is another example, says Beatrice Olivastri of Friends of the Earth.

Vancouver-based Ivanhoe is in a 50-50 joint copper-mining venture with a firm owned by the pariah state of Burma, notorious for human-rights abuses such as forced labour and torture.

In 2005, the regime collected \$5 million U.S. in royalties from the mine's operations; the state-owned mining company's share of the profit was \$10 million U.S.

The CPP fund held \$32 million worth of stock in Ivanhoe as of March 31, 2006, the last date for which the fund's portfolio profile is available.

Ivanhoe says it's a model corporate citizen, bringing jobs and top-notch workplace standards to a desperately poor country, adding that its environmental management, workplace safety and occupational health programs are inspected every year by an independent, Australia-based analyst.

But Ms. Olivastri says there's no way of knowing for sure that Ivanhoe's venture has not benefitted indirectly from forced labour, in its access to infrastructure, for example.

"Ivanhoe ... has monitored operations since inception," replies Williamson. "Ivanhoe also has satisfied itself that the (mine) is not using infrastructure built by involuntary labour ... nobody has ever produced any evidence to the contrary."

But Ms. Olivastri says rights groups only have Ivanhoe's word for it, arguing that, in a country like Burma, international human-rights groups have no way of verifying the firm's claims.

For that reason, she argues, the board can't be certain the venture would pass the "legal-in-Canada" test. Nor should it pass the cost-benefit test, she argues, pointing

out that last year, U.S. sanctions against Burma threatened to hinder the importing of mining equipment.

Ian Dale says the CPP board did approach Ivanhoe about the sanctions, adding that "our discussions will be ongoing."

But Ms. Olivastri says that, above and beyond the ethical concerns, Ivanhoe's venture presents "an incredible investment risk. What if people rise up and attack the facilities? What if there's a civil war down the line?"

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What would happen if the Canada Pension Plan fund screened its stocks?

Ian Dale says any change to the fund's mandate to protect returns could spell disaster for the nest egg it has built up for retirees.

"We think screening increases risk and reduces return" because it limits choice, he explains.

"There may be some exceptions, but (ethical funds) tend to underperform," agrees David Bruce, a senior investment adviser at ScotiaMcLeod in Toronto.

Mr. Bruce says screening out stocks or whole sectors limits an investor's choice; and the screening itself adds to the cost of managing the fund.

Christopher Geczy of the prestigious U.S.-based Wharton School of business co-authored a study of ethical mutual funds last year. The report found that portfolios limited to ethical funds that were also tailored to an investor's preferences, such as rapid-growth stocks, can be expected to lag significantly behind portfolios of their conventional counterparts -- as much as 40 per cent over 10 years.

He did find that ethical market index funds -- those that simply track a large array of acceptable stocks in the market -- delivered returns comparable to those of conventional market index funds.

"That was a shocking result," recalls Mr. Geczy. "The difference was only about five basis points per month." But even that, he cautions, can add up to a 20-per-cent gap over 30 years -- "and that's the minimum difference."

"That's nonsense," says Jack Quarter of the University of Toronto. "There's quite a large literature that shows screening doesn't affect performance in an adverse way," says Mr. Quarter, whose three-year, \$900,000 project on pension funds and responsible investing involves seven universities in Canada, the U.S., and Britain.

He says a 2003 comprehensive review of more than 50 studies on the question found it pays off to invest in corporate virtue.

"The California state pension fund (CalPERS) is one of the largest state pension funds in the world. They are very aggressive in terms of screening, and they do very well financially."

CalPERS shocked the business community in 2002 by deciding to ban entire countries from its portfolio, recalls Tessa Hebb, an Oxford University professor and pension-fund expert who is involved in Mr. Quarter's project.

Based on factors such as political stability, labour practices and transparency, CalPERS

shut out businesses with dealings in 12 "emerging markets," including China, Russia and Thailand. Since then, it has also excluded businesses involved in Sudan, saying companies may be "unwittingly furthering or condoning the egregious human-rights violations in Sudan."

Similarly, Norway's \$200-billion national pension fund excludes companies that it sees as complicit in human-rights abuses, environmental violations or armed conflict. The fund has shut out 18 companies so far, from Wal-Mart to Boeing.

In the year that ended in December 2005, the fund's stock portfolio outperformed standard benchmarks, posting a 22.4-per-cent rate of return, according to British-based Mercer Investment Consulting.

"By and large, the vast majority of studies show (socially responsible) companies perform better than those that ignore the new reality of the market," says Michael Jantzi, founder of the Toronto-based Jantzi Social Index, a selection of 60 companies rated as having high corporate standards.

He applauds the CPP fund for committing to taking social, environmental and governance issues into account.

"If you don't look at these issues, you put yourself at risk," he warns, recalling how the Canadian mining firm Manhattan Minerals ignored local opposition to a proposed mine in Peru, until tensions became so high that it was forced to abandon the plan.

Similarly, he says, "How can you look at an oil and gas company or a utilities company without taking climate change into account?"

Mr. Jantzi warns that even the most rip-roaring "sin stocks" can be vulnerable. He gives the example of tobacco, which has brought bumper returns in recent years. But he warns there are long-term risks to consider.

"Jurisdiction after jurisdiction has banned public smoking. Who would have thought, for example, that Ireland would ever ban public smoking? And yet they did."

Your Portfolio at a Glance

Among the Canadian Pension Plan Reserve Fund's stock market investments are weapons-makers, cigarette producers, top air polluters and firms whose activities have been linked to allegations of human-rights abuses.

Company note *value of holdings

NUCLEAR ARMS

Northrop

Grumman (U.S.) Develops, maintains nuclear arms \$44 million

Lockheed Martin (U.S.) Produces cluster weapons and munitions coated with depleted uranium, a radioactive and toxic material \$27 million

EADS (Netherlands) Involved in joint venture to produce nuclear missiles \$26 million

BAE Systems PLC (UK) Involved in a joint venture to produce nuclear missiles \$24 million

Finmeccanica (Italy) Involved in joint venture to produce nuclear missiles \$18 million

HUMAN RIGHTS CONCERNS

Ivanhoe Mines Ltd. (Cdn) Involved in a 50-50 joint venture with firm owned by pariah state of Burma \$32 million

Glamis Gold (Cdn) Local opposition to Guatemalan mine led to shootings, car bomb last year \$63 million

Anvil Mining Ltd. (Cdn) Military court in Congo wants three ex-staff charged for complicity in war crimes; firm denies charges \$4 million

TOBACCO MANUFACTURERS

Altria Group (U.S.) \$196 million

Imperial Tobacco (UK) \$28 million

Rothmans Inc. (Cdn) \$27 million

British American Tobacco Plc. (UK) \$49 million

Japan Tobacco Inc. (Japan) \$26 million

Altadis (U.S.) \$15 million

Gallaher Group (UK) \$15 million

Loews Corp. (U.S.) \$6 million

Swedish Match (Sweden) \$6 million

TOP U.S. AIR POLLUTERS **

Exxon-Mobil (U.S.) \$500 million

General Electric (U.S.) \$364 million

ConocoPhillips (U.S.) \$126 million

E.I. Du Pont de Nemours & Co. (U.S.) \$44 million

Archer-Daniels-Midland Co. (U.S.) \$31 million

Alcoa Inc. (U.S.) \$24 million

Ford Motor Co. (U.S.) \$14 million

Tyson Foods (U.S.) \$8 million

Eastman Kodak (U.S.) \$6 million

* Holdings as of March 31, 2006 the last available public record ** According to the University of Massachusetts Political Economy Research Institute

Ran with fact box "Your portfolio at a glance", which has been appended to the story.

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