The Investor Rationale for Responsible Investment: Social Issues

As an institutional investor, Wespath Investment Management adheres to our obligation as a prudent fiduciary. As a division of the General Board of Pension and Health Benefits of The United Methodist Church, we also understand that financial transactions carry ethical implications. These two perspectives form the basis of our well-rounded investment strategy, which utilizes traditional financial metrics and also considers the impact of environmental, social and corporate governance (ESG) practices.

This paper, one of a series of Wespath research papers published at **wespath.com**, examines the relationship between shareholder value and social issues.

Introduction

For purposes of this document, social issues encompass the areas of employee relations, human rights and supply chain management. There is clearly a strong moral case for corporations to have policies that cover these areas of operation; however, there is also a compelling business case. Social issues can be difficult to quantify, but there is no doubt that their relationship to a corporation's reputation and stakeholder support can affect the bottom line.

Employee relations are typically under the purview of the human resources department, whereas the human rights and supply chain mandates are generally found in the corporate code of conduct. Wespath believes a strong code of conduct:

- Is based on international guidelines
- Clearly articulates corporate values
- Sets social performance expectations for suppliers
- Incorporates mechanisms for compliance monitoring
- Demonstrates accountability through public reporting and transparency

Transnational corporations commonly utilize global supply chains, which can be both efficient and cost-effective. To successfully capitalize on the benefits of this structure, corporate executives must be adept at managing different cultures, languages, legal systems and regulatory frameworks. Lapses in policies or procedures anywhere within the supply chain can have consequences that range from fines and lawsuits to losing the license to operate.

As a result, the risk of non-compliance with ethical social values can be material to a company and its stakeholders, with exposure to legal, financial and reputational impact. On the other hand, proper management of social issues can lead to cost savings and in turn, financial benefit.

The Investor Perspective

A study by University of Pennsylvania Wharton School Professor Alex Edmans examined the relationship between employee satisfaction and stock returns. He constructed a portfolio of stocks from Fortune's "100 Best Companies to Work for in America" that were purchased one month after the list was published. From 1998-2005, these companies averaged 14% return per year, versus 6% for the broader market. Edmans found that these companies also had more positive earnings surprises. In part, these results reflect the shift from a manufacturing economy to a knowledge economy, where employers are relying on innovation and seeking value added from employees rather than from machinery.[1]

For a closer look at how social issues can impact the corporate balance sheet, consider the following examples.

Apparel Manufacturing

In the early days of globalization, supply chain management often meant developing a code of conduct and posting it on the factory wall (which may or may not have been written in the local language). Inadequate monitoring and a "hands-off" approach resulted in several high-profile corporate missteps: The Gap, Levi Strauss and most notably, Nike.

After it was revealed that Nike products were, in some cases, being manufactured under unsafe and abusive labor conditions, universities and consumers across the U.S. boycotted the company's products. Nike's brand suffered and sales declined. As reported in the *San Francisco Chronicle* on April 17, 1999, "Last year, Nike and Reebok saw their profits fall 37 percent and 65 percent, respectively. Company executives blame the drop mainly on the overall slump in U.S. athletic footwear sales, which fell an estimated 9 percent, but also on negative publicity from the sweatshop controversy." Then-CEO Phil Knight said, "The Nike product has become synonymous with slave wages, forced overtime and arbitrary abuse."[2]

We had a leading role in conversations with Nike. Over the course of several years, staff evaluated the company's supply chain programs, provided constructive feedback and urged the adoption of best practices. Nike responded aggressively, undergoing a wholesale review of its supply chain. The company improved worker health and safety by switching to non-toxic materials, began auditing its supplier factories, and initiated a product redesign that led to drastic waste reduction and $700 million savings in raw material costs. The company also learned the benefits of transparency. In 2005 Nike was the first in its industry to disclose the names and locations of its factories — information that is often described as competitive and proprietary. Nike also publishes the results of factory audits, allowing stakeholders to analyze the data even though the results are modest. By acknowledging the challenges of a sustainable supply chain and being transparent about the progress it has made, Nike has largely neutralized the negative press that plagued it for so many years.

The results are impressive. In addition to being the industry leader in terms of market capitalization, Nike is the #1 apparel manufacturer on *Fortune Magazine's* 2010 list of World's Most Admired Companies and received a "1" rating for social responsibility.

Gap Inc. Senior Vice President for Global Responsibility and Human Resources Dan Henkle echoed this sentiment when he said that "Good supplier compliance is good for business." Mr. Henkle described Gap's belief in the correlation between working conditions and product quality, saying that when it comes to lowering the defect rate, "It doesn't take much to be (financially) meaningful."[3]

Food Production-Meat Processing

In meat-processing plants, workers perform dangerous jobs under difficult conditions. Common injuries include repetitive stress injuries, cuts, and adverse reactions to gases and chemicals. These risks can be exacerbated — or mitigated — through management of line speed, climate control, staffing levels, job rotation and other factors. In early 2005, Human Rights Watch released a report entitled “Blood, Sweat, and Fear: Workers’ Rights in U.S. Meat and Poultry Plants,” which concluded that the working conditions in America’s meat-packing plants were so hazardous they violated basic human and worker rights. This was the first time the human rights organization had criticized a U.S. industry.[4]

The Forms 10K of several large meat companies disclose fines, lawsuits and settlements reaching into the tens of millions of dollars, mostly related to processing plant operations.

Resource Extraction

Much of the world’s mineral and fuel resources are located in remote areas that are inhabited by indigenous communities. Embracing best practices in environmental management and the precept of “Free Prior and Informed Consent” [5] are key elements to obtaining the local community’s support of corporate operations. By securing a social license to operate, companies can avoid:

- Cost overruns caused by project delays
- The cost to implement corrective or counter measures
- Risk to brand and reputation

In the Philippines, Shell Philippines Exploration (a subsidiary of Royal Dutch Shell) embarked on a joint venture to develop the Malampaya Deep Water Gas-to-Power Project, designed to supply approximately 30% of the Philippines’ electric power needs. By employing the principles of Free Prior and Informed Consent, Shell reported no project delays and approximate savings of $50 to $72 million. According to Shell, only 0.13% of project costs were needed to secure community consent, and the cost of maintaining community consent is 0.43% of net project revenues.[6]

Conversely, Vedanta Resources did not appear to work collaboratively to address the local community’s concerns over its plans to mine bauxite in Orissa, India, with significant adverse results. There were prolonged protests and divestment by some institutional shareholders. Despite assurances from the company that the project would go forward, a March 2010 evaluation report conducted by India’s Ministry of Environment and Forests found the company had not given adequate consideration to the project’s impact on the Dongria Kondh people and was violating environmental guidelines. As a result, the company was denied permission to begin mining.[7] The company’s stock price was affected, declining 28% during the three-week period of August 9 through August 27, 2010. Furthermore, Vedanta’s newly-constructed aluminum refinery in Orissa, costing $5.4 billion and built in anticipation of sourcing the local bauxite, is operating at approximately 25% of capacity, and “further expansion has been put on hold,” according to an October 7, 2010 Vedanta press release.

Areas of Conflict/Repressive Regimes

Operating in areas of conflict (Sudan, Eastern Democratic Republic of Congo, the Middle East) or in countries that are ruled by an oppressive regime (Burma) is particularly challenging and can expose companies to allegations of corruption and/or that their products are being used to abuse human rights. Companies will frequently respond by allocating resources above and beyond normal project costs in an attempt to circumvent reputational damage and legal liability. For example, companies may fund the construction of schools, hospitals and homes, or provide electric power to a remote village. To be truly useful, there must also be teachers, doctors and nurses, and the company should be responding to a desire for these services.

The Prince of Wales International Business Leaders Forum argues that a business case for human rights can be formed around eight strategic opportunities. By mitigating risks of human rights, companies can:

1. Safeguard reputation and brand image
2. Gain competitive advantage
3. Improve recruitment, retention and staff loyalty
4. Foster greater productivity
5. Secure and maintain a license to operate
6. Reduce cost burdens
7. Ensure active stakeholder engagement
8. Meet investor expectations[8]

Workplace Discrimination

Costs associated with workplace discrimination are often avoidable and can place an unnecessary burden on stakeholders. In a study of the reputational costs of race and gender discrimination, it was found that "Upon the announcement of a race or gender discrimination lawsuit, the average two-day loss in the equity market value of the 163 firms in our sample was $168.5 million (per company)."[9] Companies that sell to consumers or government were found to have higher reputational risk than companies that sell to other businesses.

The study goes on to say, "The average loss in [firm] value is over 40 times the estimated legal damages ($4.2 million average) of the litigation. The estimated reputational costs for the 163 firms in the sample averaged $164.3 million."

Within the United States, many companies have faced large discrimination lawsuits. For example, Wal-Mart has paid tens of millions of dollars to settle numerous labor-related lawsuits, including a 2009 payment of $17.5 million to settle a racial-discrimination lawsuit filed by African-American truck drivers.[10]

Wal-Mart is not alone.

- In 2004, Abercrombie & Fitch, Boeing and Morgan Stanley each paid more than $50 million to settle discrimination lawsuits.
- In 1977, Texaco paid $176 million to settle a racial discrimination lawsuit.
- In 2000, Coca-Cola paid over $475 million to settle a racial discrimination lawsuit.

Ultimately, these costs are borne by shareholders, employees and consumers.

Another study examined the effect of management gender diversity on corporate performance. Starting with the Fortune 500 and adjusting for mergers and acquisitions, and eliminating those with less than four years of historical data, a total of 353 companies were analyzed. The study found that companies with the highest representation of women on their top management teams experienced better financial performance than companies with the lowest women's representation. Return on equity was determined to be 35% higher, and total return to shareholders was 34% higher.[11]

Conclusion

Increasingly, companies are recognizing that their approach to social issues can affect their bottom lines. Providing a non-discriminatory work environment and comprehensive management of supply chains are complex activities whose benefits are evolving away from the category of "risk avoidance" and into "competitive opportunity." To capitalize on the available opportunities, leading corporations are developing close relationships with suppliers, working with auditors and/or local non-governmental organizations, and building operational capacity while respecting human rights.

United Methodist Instruction

John Wesley firmly believed that the person of faith must be involved in his or her community. Consequently, Methodists always have been active in social issues. In a strikingly modern statement on social problems adopted by the General Conference of 1908, the Methodist Episcopal Church recognized "the gravity of the social situation and the responsibility of the Church collectively, and of its members severally, for bringing about better conditions, through the application of the ethics of the New Testament."

Significantly, the 1908 statement called for:

- Equal rights and complete justice for all men in all stations of life
- The protection of the worker from dangerous machinery, occupational diseases, injuries and mortality
- The abolition of child labor
- A living wage in every industry

Today's Social Principles (¶162) echo this early statement: "We affirm all persons as equally valuable in the sight of God. We therefore work toward societies in which each person's value is recognized, maintained, and strengthened. We support the basic rights of all persons… Our respect for the inherent dignity of all persons leads us to call for the recognition, protection, and implementation of the principles of *The Universal Declaration of Human Rights* so that communities and individuals may claim and enjoy their universal, indivisible, and inalienable rights."

The Social Principles also discuss the rights of workers. Paragraph 163C asserts that "every person has the right to a job at a living wage" and that workers have the right "to refuse to work in situations that endanger health and/or life without jeopardy to their jobs."

Resolution 4052, *Economic Justice for a New Millennium*, recognizes that "the increasing ability of large corporations to shift their resources around the globe has contributed to an erosion of worker rights everywhere." The resolution calls upon the whole Church to address the issues of "jobs with livable wages and benefits, debt, plant closing and relocation, public education, homelessness, affordable housing, and meeting sanitation, clean water and energy needs" through advocacy and economic development.

Resolution 4135, *Rights of Workers*, recalls that "through public policy work, shareholder advocacy, and consumer power, the church and its members have sought to influence political and corporate decisions affecting working conditions around the world." In keeping with this historical aspiration, we are encouraged "to invest in companies that set high standards for treatment of workers throughout the world and to file or join shareholder resolutions that encourage such high standards." The Church also extends its support for "the conventions of the International Labor Organizations that advance safety in the workplace; freedom from bonded or forced labor; the elimination of discrimination in respect to employment and occupation; effective abolition of child labor; fair compensation; just supervision; and the right of collective action for employment in all nations."

Find Out More

If you would like more information on Wespath's investment products, services and commitment to responsible investment, please contact Derek Casteel at **1-847-866-4100** or via e-mail at **investmentinfo@wespath.com**.

[1] Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, Alex Edmans, University of Pennsylvania — The Wharton School, June 2010.

[2] Quoted in Bob Herbert, Nike Blinks, *New York Times*, May 21, 1998.

[3] Remarks made in a November 2010 webinar, "Toward a Just, Safe Workplace: Apparel Supply Chain Compliance Programs Webinar".

[4] "Meatpacking in the US: Still a 'Jungle' Out There?", PBS, December 15, 2006, found at http://www.pbs.org/now/shows/250/meat-packing.html.

[5] Free, Prior, and Informed Consent recognizes indigenous peoples' inherent and prior rights to their lands and resources, and respects their legitimate authority to require that third parties enter into an equal and respectful relationship with them. It is based on the principle of informed consent. As such, it encompasses 1) information and consultation on any proposed initiative and its likely impacts on the indigenous people's lands, culture and livelihood; and 2) meaningful engagement and participation of indigenous peoples in the negotiations (based on a compilation of United Nations papers).

[6] http://www.sarpn.org/documents/d0002569/7-WRI_Community_dev_May2007.pdf (p.25).

[7] http://timesofindia.indiatimes.com/India/AG-tells-ministry-it-can-refuse-forest-clearance-for-Vedanta-project/articleshow/6202075.cms.

[8] Lucy Amis, Peter Brew and Caroline Ersmarker, Human Rights: It Is Your Business, IBLF 2005.

[9] William Bradford, Discrimination, Legal Costs and Reputational Costs, University of Washington, 2005.

[10] http://walmartwatch.com/issues/discrimination/.

[11] The Bottom Line: Connecting Corporate Performance and Gender Diversity, Catalyst Organization, 2004.

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