zation among the participating nations. The creation of a global central bank is admittedly a long way off—but there has never been a better time to start debating and designing such an institution.

Chapter 15
A Human Face for Finance?

The discouraging state of Canada's real economy during most of the last two decades has prompted a chorus of calls for alternative investment vehicles and institutions. Stock markets, banks, and the real businesses which they finance have clearly failed in their responsibility to put Canada's huge sums of new money into motion in the real economy, creating the jobs we need and producing goods and services that we can consume.

The contrast between the paper boom of the financial industry on one hand, and the general stagnation of the real economy on the other, has motivated a widespread questioning of existing financial institutions on the part of many Canadians.

One broad response to the financial system's poor record of raising and investing funds for economically and socially useful projects has been a range of initiatives aimed at trying to redirect the flow of private finance into more constructive (or at least less destructive) endeavours. The most noteworthy of these "activist investment" initiatives include ethical mutual funds, labour-sponsored venture capital funds, and efforts by some unions to win more say over the investment of workplace pension funds.

Participants in each of these strategies aim to gain more control over the raising and investing of financial capital by becoming directly active as concerned investors; these strategies can all be described, therefore, as efforts to reform our system of financial investment "from within." This immediately raises a fundamental question, in that we have already seen (in Chapter 12) that most Canadians, contrary to the hype of the mutual fund industry, are *not* investors.

The ownership of most capital, in reality, is concentrated among a small elite of very well-off households. This would seem to inherently limit the prospects of any strategy which mobilizes concerned Canadians as *investors* (rather than as citizens, taxpayers, or voters). And indeed, while each of the "activist investor" strategies surely holds some potential for effecting some change in the investment process, and enforcing a higher standard of accountability on the part of both money managers and the executives of real businesses, each also has its pitfalls which we will consider.

Ethical Mutual Funds

The most spectacularly successful activist investment initiative is the group of mutual funds in Canada which claim to base their investment decisions on ethical and social criteria, rather than just bottom-line returns. The largest ethical mutual fund sponsor in Canada is Ethical Funds Inc., conceived by the VanCity Savings Credit Union (English Canada's largest credit union) and now owned by a segment of the Canadian credit union system.

Its flagship fund, the Ethical Growth Fund, represented about $750 million in invested assets by the end of 1998, and hence ranks among the top 10% of mutual funds in Canada. Total assets contained in Ethical Funds' eight different mutual funds exceed $2 billion. Thanks to some great publicity and good financial performance (it is one of the few mutual funds which have actually matched or exceeded the average returns of the stock market during much of its history), the Ethical Growth Fund has grown exponentially in recent years. The fund was even selected as "Fund of the Year" by high-profile mutual fund analyst Gordon Pape in 1997.

More recently, sales have been spurred by a series of hard-hitting and effective television and print ads trumpeting the ethical approach to personal investing. By any standard, the company is one of the greatest success stories of the entire mutual fund industry—and yet it claims to be motivated by a higher cause than simple greed.

Other companies have also tried to cash in on the ethical investing craze. For example, the Investors' Group, one of Canada's largest mutual fund companies, with close to $20 billion under management, has its own $600 million ethical "Summa" fund. The Desjardins Trust group (associated with Quebec's credit union movement) has a $125 million "environment" fund. And several smaller, specialized funds have also sprung up, purportedly to channel investors' money into environmentally-aware companies and other worthy endeavours.

The notion of being concerned with principles—not just principal—in making investment decisions has helped the sponsors of ethical mutual funds to carve out a unique identity for themselves in a mutual fund marketplace that is cluttered with hundreds of competing providers. Indeed, while the intentions of the ethical investment pioneers who started this initiative were clearly laudable, it may not solely be a higher calling which explains their subsequent spectacular growth.

For example, the vice-president of Investors Group (which manages close to $20 billion in *non*-ethical investments in addition to its $600 million ethical fund) explained his firm's move into the ethical marketplace in the following pragmatic terms: "Based on the feedback from our sales reps, who are in touch with the public, we detect a market for this kind of product."

The ethical funds movement was initially ridiculed by investment professionals, on grounds that it could never match the rates of return generated by money managers who were not constrained by any social or ethical criteria. By artificially limiting the "universe" of investment options available to the fund's managers, the ethical investing approach would inevitably limit the returns available, too. But the ethical funds have proven these critics wrong. Returns on most ethical funds have been at least as high as average returns for other mutual funds—although, recall (as illustrated in Chapter 3) that mutual funds in general, despite their high management fees, do not match the performance of simple weighted stock market indices.

The success of the ethical funds industry, however, has raised a whole new set of controversies for the well-intentioned financiers who started it, concerns that may not be as easy for the industry to refute. Just how "ethical" is the ethical funds industry? And to what extent can individuals realistically promote a vision of social change through their mutual fund portfolios, rather than through traditional outlets for their social and political ideals?

This quandary was dramatized by an incident involving the Ethical Growth Fund in 1998. A Vancouver paper ran an exposé on how the fund—which is supposed to screen all of its investments to weed out companies associated with tobacco, military procurement, child labour, and other unsavoury practices—had invested in a strange-sounding financial beast called TIPS 35 units. These units essentially constitute a "no-brain" index-based mutual fund, in which an investor buys a portion of a bundle of different stocks constructed to precisely mirror the performance of a particular stock market.

In this case, a purchaser of TIPS 35 units would be guaranteed a return equal to the performance of the Toronto Stock Exchange's TSE 35 index, which in turn reflects the share prices of Canada's 35 largest publicly-traded companies. Investing in this type of product (or in other similar funds, such as the low-fee index funds now being sold aggressively by Canada's increasingly competitive mutual fund industry) ensures that an investor won't do any better or any worse than the market average.

Considering that most mutual funds cannot even match the performance of their respective market benchmarks, this isn't bad—although it begs another question. Why would a mutual fund buy units in a separate index fund, when the fund's clients could make that investment directly (and thus avoid the 2% annual management fees charged by actively managed mutual funds, including the Ethical Growth Fund)? As of the end of 1997, the $25 million cost of Ethical Growth's TIPS 35 units represented the fund's largest single asset purchase to date.

Whoever decided to put Ethical Growth money into the TIPS units either didn't realize that they were actually investing in all 35 of the largest companies in Canada, or else they thought that this indirect investing approach would not constitute a violation of the fund's ethical criteria. But three of the top 35 companies clearly violate the Ethical Growth fund's criteria: Imasco, which sells tobacco products, Bombardier, which is a military contractor, and Placer Dome, which had theoretically been excluded from the fund's portfolio following a disastrous mine spill in the Philippines.

After this inconsistency hit the newspapers, Ethical Growth changed its policy to prevent similar index-fund lapses in the future (in fact, the Fund had already sold its TIPS units by the time the controversy became public).[1]

End of story? Well, not exactly. The whole episode raises more fundamental doubts about the exact nature of Ethical Growth's social mandate. The outcome of the TIPS 35 controversy seems to imply that modern corporate capitalism in Canada must be a 91% ethical state of affairs, since 32 of the 35 companies (or 91%) represented in the TIPS 35 units *did* pass the fund's ethical screens. Consider a list of these companies:

- all six of Canada's largest banks
- family-run empires like Laidlaw, Seagram, and Thomson
- fiercely anti-union auto parts giant Magna International
- resource producers, including Abitibi-Consolidated, Alcan Aluminum, Barrick Gold, Inco, Macmillan Bloedel, Noranda, and Suncor
- relentless downsizers like Bell Canada, Canadian National Railway, and Northern Telecom—each of which has laid off thousands of Canadian employees during the 1990s in the search for higher profits

Even the least ambitious of social advocates would be unlikely to consider these corporate icons to represent the ethical cutting edge of Canadian society.

Perhaps the managers of Ethical Funds—not to mention the investing public—should have been less concerned with the fact that three large "unethical" corporations accidentally slipped through the fund's screening process, than with

Just A Bunch of Ethical Guys

Executive:	Peter Munk	Al Flood	Frank Stronach	Derek Burney
Company:	Barrick Gold Corp.	Canadian Imperial Bank of Commerce	Magna International Inc.	Bell Canada International Inc.
1997 executive compensation:	$3.6 million	$3.2 million	$26.1 million	$1.0 million
Famous Quote:	"That man [Augusto Pinochet, former Chilean dictator] ... had the courage to single-handedly change the direction of a whole continent."	"Austerity is not pleasant; but self-imposed austerity ... is infinitely preferable to externally-imposed austerity *following* disaster."	"To be in business, your first mandate is to make money, and money has no heart, soul, conscience, or homeland."	"Our much admired social safety net has led to a culture of entitlement which must be changed quickly."
Ethical Fund holdings, end-1997.	$12.8 million	$38.5 million	$34.0 million	$2.5 million

Source: Ethical Funds Inc. 1997 Annual Report; *Globe and Mail*, May 10, 1996 and April 18, 1998; *Financial Post*, March 29, 1994; *Perspectives*, Business Council on National Issues, Autumn 1994; *New York Newsday*, August 7, 1992.

the fact that even when correctly applied this screening process has virtually no impact on the composition of the fund's investments. An investment in an ethical mutual fund, for all intents and purposes, is pretty much just an investment in the broader stock market.

A small number of controversial companies is excluded from consideration on specific and narrow criteria (such as involvement in tobacco or weapons).[2] But, by and large, the ethical funds' holdings mirror those of the stock market as a whole. This will come as a jarring surprise to many well-intentioned investors who felt they were actually dedicating their money to good works. And the incredibly modest criteria applied to the funds' investment decisions contrasts strikingly with the powerful and emotional images evoked by the funds' advertising.

Stark images of dying cancer patients, chain-smoking Third World teenagers, and squads of grim commandos marching into battle: these are the emotional symbols that have moved thousands of investors to channel their money into the ethical funds' coffers. But, aside from a handful of companies directly involved in tobacco or military production, it is clear that most corporate behaviour (and most of the stock market) is quite okay, thank you, for the ethical money managers.

The heavy emphasis on investments in the major banks by the ethical mutual funds is particularly problematic in this regard. As of the end of 1997, the Ethical Growth Fund had invested a full 16% of its common equity assets in the shares of just three banks: the Bank of Montreal, the Bank of Nova Scotia, and the Royal Bank. The fund's $33 million stake in the Bank of Nova Scotia represented its largest single investment. Its $31 million holdings of the Royal Bank were its second-largest single investment.

Tens of millions of dollars of bank shares and bonds were also held by the other funds in the Ethical Funds portfolio (such as its bond and income funds). The competing Investors Summa fund was also heavily weighted in banks: its four top holdings as of May 1998 were major banks, together accounting for 18% of the total value of the fund.

The fantastic profitability of Canada's chartered banks during the 1990s, and the consequent rapid appreciation of their share prices, thus contributed to the relatively encouraging financial performance of the ethical mutual funds. For example, the Ethical Growth Fund's 1997 total rate of return was 17.4%, higher than the 15.0% total return on the TSE 300 stock market index that year. But, without its significant bank holdings, the fund's total return that year would have been just 11.7%—considerably *less* than the growth in the TSE index.

Now, it seems odd that an investment fund which bills itself as an alternative to the commercial, bottom-line-fixated financial establishment would focus so heavily on investing in the most powerful and entrenched representatives of that same financial establishment. What is it about Canada's major banks which justifies their designation as a leading ethical investment opportunity?

True, banks do not have smokestacks which pollute the atmosphere, and they do not produce military hardware. But the role played by banks in Canada's economy can hardly be described as "ethical." The banks have benefited mightily from—and hence have energetically lobbied for—exactly the same set of conservative economic policies that have so undermined growth and job-creation, and hobbled the ability of the state to moderate and regulate the character of that growth.

The banks have a huge vested interest in continuing Canada's tough anti-inflation policy, consistently high real interest rates, the wide-ranging deregulation of many economic sectors (most notably including finance itself), sharp cutbacks in government programs, and more recently the allocation of government surpluses to debt repayment and tax cuts rather than social reinvestment.

Even in their own employment and management practices, Canada's banks have revealed their self-interested and regressive character. They ruthlessly smashed repeated unionization attempts in the 1980s, and continue to pay their hourly clerical employees very low wages. Despite earning total profits in excess of $7 billion during 1997, the banking industry employed 35,000 hourly employees who earned an average of just $12 an hour (and only received 24 hours of work per week, on average).

Canada's best-paid banker that year—John Hunkin, head of the investment banking arm of CIBC, who pulled in total compensation of $10.4 million—single-handedly took home more income in 1997 than 680 of these average bank tellers.

In short, the banks epitomize what is wrong with Canada's paper economy, not how to make it more ethical. Moreover, the practice of investing in an independently-managed lending institution punches a huge hole in the ethical wall which supposedly oversees the investment decisions of the ethical mutual funds. For some reason, chartered banks are considered sufficiently ethical to pass the screens erected by the ethical fund industry. But those banks in turn have no screens governing their own lending and investment decisions: they invest in *any* venture, including those that might have been turned down by ethical mutual funds.

If the reasoning behind the ethical mutual fund industry is to "starve" unethical ventures of new financial capital, thus limiting their expansion opportunities (in fact, this reasoning is weak, as is discussed below), then investments in banks and other unscreened financial institutions clearly undermine the whole approach.

Another example of this contradiction is the Ethical Growth Fund's $20 million stake (as of end-1997) in another mutual fund company, Investors Group. [This is the same company, ironically, which sponsors the Summa ethical fund—the Ethical Growth Fund's leading competitor.] Apart from epitomizing the bizarre and wasteful practice of mutual fund companies investing in other mutual fund companies, this investment begs another question. The Investors Group manages $20 billion in assets, the vast majority of which (apart from the $600 million Summa fund) is not screened on ethical grounds. Why invest in a mutual fund company for ethical reasons, when that company in turn invests in *another* mutual fund company which does not impose screens on its investment decisions?[3] The whole process begins to resemble a shell game, in which the appearance of acting ethically becomes more important (for advertising purposes) than whether or not the money actually ends up supporting a "good cause."

Not surprisingly for an initiative which has proclaimed such lofty goals in its advertising, the rather modest and pragmatic reality of "ethical investing" has sparked considerable controversy. Critics have complained that too many ethical fund holdings are not nearly "ethical" enough, and bristle at the dominance of establishment blue-chip corporations in the funds' portfolios.

The extensive foreign holdings of the ethical funds also sparks concern; for example, as of 1997, the Ethical Funds company had invested some $225 million of its total assets outside of Canada (both through specialized "segregated" foreign funds, and through the 20% foreign content allowed within balanced mutual funds), in the stocks of such global ethical leaders as Disney Corp., IBM, Microsoft, and private U.S. health-care providers.

The ethical fund managers respond that it is better to do something, however imperfect, than to do nothing; they argue that it is better to reward corporations which are at least trying to modify the social or environmental impacts of certain of their operations, than to abstain entirely from making ethical choices in personal investing. This debate obviously needs to continue, and recent controversies regarding some of the holdings of the ethical funds will probably ensure that it does continue. Since many ethical funds are owned by credit unions, which themselves represent a rare bastion of democracy within the financial industry, there is considerable prospect for improving the ethical performance of the industry precisely through this public debate and pressure.

There are several other tough issues, however, quite unrelated to the problems of defining what constitutes an "ethical" investment, which must also be addressed by the advocates of ethical stock market investing.

For example, the link between buying or not buying the shares of a particular company, and actually influencing the *behaviour* of that company, is generally taken for granted in the ethical investing literature. It shouldn't be. When an ethical mutual fund claims that it will put money to work in "good" companies, and not in "bad" ones, it is accepting the proposition that there is a fairly direct link between the stock market (where shares are bought and sold) and the real investment and business activities of the companies listed there. Most of this entire book, however, has been dedicated to showing that this is not the case.

When ethical mutual funds (or any other mutual funds) buy shares, they are not "giving" that money to the company whose name appears on the shares, and they are not "putting their money to work" in the real economic operations of that company. Rather, they are giving the money to whatever investor owned the share previously. Unless the share is purchased through a new issue, and unless that new issue is raising new funds for a company (rather than buying out previous insider owners of the company, or reducing the firm's debt levels), the buying and selling of shares has nothing to do with raising money for real business activities.

As described in Chapter 3, well over 95% of stock market activity—which has been fuelled frenetically in recent years by the constant churning activity of pension and mutual funds—has no connection with financing real investments. So the notion that an investor is withholding capital from a company by virtue of not purchasing its shares is economically incredible.

Ethical fund advertising has promoted the misconception that buying a company's shares is equivalent to giving that company some money, because this

impression reinforces the emotional power of the desired message. For example, a powerful 1998 set of television ads for Ethical Funds featured a woman grieving for a relative lost to smoking-related cancer. After describing the woman's anger at the tobacco industry, the ads grimly report: "But every year she unknowingly sends them a donation," in the form of holding tobacco-related shares in her mutual fund. But how is purchasing a share equivalent to giving a company a donation? It is actually quite wrong to conclude that companies "get" the money that is spent on their shares. In reality, the buying and selling of mutual funds—including ethical mutual funds—has virtually no impact on the financial well-being or real business activity, good or bad, of the companies whose shares are traded like so many poker chips.

Ironically, then, this advertising theme refutes the supposed goal of investor education so espoused by the ethical money managers. As Ethical Funds president John Linthwaite puts it, "We believe that Canadians should know where their money goes." But, if this were genuinely the case, the ethical financiers should explain to clients that their money is actually going to whoever owned the shares of non-offending corporations prior to their purchase on the stock market—minus, of course, a generous 2% administration fee per year to pay for the services of the ethical money managers.

But surely, an ethically-minded personal investor might argue, selling a company's shares will have *some* negative impact on that company's real business. It is certainly true that the collapse of a company's share price is often a signal of some fundamental problem in the company's real business (although this is not always the case: see sidebar *What is Wealth?* in Chapter 2).

A company with a falling share price will face intense pressure—from its shareholders and from its lenders—to make fundamental changes in its business practices. This does not imply, however, that ethical funds could force a company to change its ways by exerting downward pressure on the price of its shares.

In the first place, ethical funds are not possibly large enough to affect share prices on Canada's stock markets: all the ethical funds together account for at most one-tenth of one percent of the total market capitalization of Canada's stock markets. Nor are they likely to ever become large enough to do so. Recall from Chapter 12 that the majority of financial wealth in Canada is concentrated in the hands of a small proportion of well-off families. These families are unlikely to start making many of their decisions on ethical grounds, rather than profit-maximizing grounds. [If they were, they might have given away some of their accumulated wealth!]

In this sense, ethical investing faces far greater barriers than other consumer activist campaigns. Consider the past effectiveness of consumer boycotts in changing the behaviour of certain companies—consumer pressure on the tuna industry to adopt dolphin-safe fishing practices, for example. The fact that billionaire Ken Thomson may not personally support this cause should not greatly affect its chances for success: it is unlikely that the Thomson family consumes any more tuna than the typical Canadian household (indeed, it probably consumes less). Hence Thomson's abstention or opposition is not significant to a campaign based on attracting support from a large number of tuna eaters.

The fact, however, that the Thomson family probably possesses as much stock market wealth as the bottom 50% of the Canadian population clearly *does* undermine the chances for success of the ethical investing movement. In a democratic realm, in which decisions are made one voter (or even one consumer) at a time, it is possible to imagine how powerful movements can be built one person at a time. But, as soon as we enter the realm of private finance, which operates according to the maxim of "one dollar, one vote" (not "one person, one vote"), then the concentrated power of the rich and the super-rich becomes a fundamental obstacle to change.

Even in the unlikely event that the ethical funds movement could mobilize enough support on the basis of "one dollar, one vote" politics to spark a significant sell-off of a particular company's shares, what would happen next? The ethical funds would then face the counteracting influence of investors who are *not* motivated by ethical consideration. They would rush to purchase the affected company's shares, which are now trading at a lower multiple to its expected future earnings than would otherwise be the case.

Remember that a pure ethically-inspired sell-off is not motivated by fear over a company's profits, but rather by ethical concerns.[4] Most investors are not motivated by ethical criteria: they are making decisions based on expectations of bottom-line returns, pure and simple (and this is likely to always be the dominant motivator for private investment decisions). Note that these investors do not have to be *anti-ethical* in order to frustrate the effects of the ethical funds movement; they merely have to be "agnostic." [An anti-ethical investor would be someone who purchased an unethical company's shares despite expectation of a *lower* return.] In other words, they merely have to be neutral on the issue of a company's ethical performance.

The ethically-inspired sell-off of a company's shares perversely *increases* the relative attractiveness of those shares according to traditional investment criteria, since the share price is now temporarily lower than would otherwise be justified, given the expected future profits and dividends of the company. Agnostic investors will snap up the shares, and the share price should return to its original level, with the only permanent effect being a one-time transfer of wealth from ethical investors (who sold low on ethical grounds) to agnostic investors (who purchased shares in a still-profitable company at an artificially low price).[5]

In short, the economic intuition underlying the notion that ethical investment decisions can impact corporate behaviour is incredibly muddled. This probably explains why this intuition is rarely, if ever, spelled out.

Many ethical investors point to the pressure that can be brought to bear on corporate executives through actions launched by concerned shareholders: legal suits, publicity campaigns, the raising of controversial issues at shareholders' meetings, approaching other shareholders to express their concerns, and so on. To be sure, these forms of pressure and lobbying can be quite successful in modifying some of the worst practices of private businesses, especially when combined with pressure levied against the firm from outside the shareholders' community (from workers, communities, or governments). Shareholder activism has played an important role in many important social change initiatives in Canada; it was particularly notable in the successful efforts to force Canadian banks to divest some of their holdings in apartheid South Africa, Pinochet's Chile, and other notorious jurisdictions. But it has been the *activism* of shareholders in these instances, not their ownership of shares, which has been influential in changing corporate behaviour. Indeed, many or most of the activists in Canadian corporate responsibility campaigns (many of which were launched by religious organizations) had purchased just a single token share of the offending company—so as to gain admittance to shareholders' meetings and position themselves as "insiders" in the debate. It was the loudness of their voices and the persistence of their organizing, not the market value of their portfolios, which made these activists so effective.

Incredibly, however, the ethical money managers have betrayed this legacy of shareholder activism with their explicit decision to remain purely *passive* players in the companies represented in their portfolios. Far from using its shareholdings to pressure companies to improve their practices, the ethical funds movement has explicitly limited its role strictly to buying or not buying a company's shares. As Ethical Funds president John Linthwaite puts it, "It is not within our mandate to take an activist stance on specific issues." This will come as a surprising disappointment to many whose hopes were raised precisely by the prospect of using their money to promote activist goals. Even when an ethical fund takes the rare step of dumping its holdings in an offending company, it does so quietly and without fanfare (usually for legal reasons, and to avoid burning bridges within the tightly-knit community of private financiers), rather than making a high-profile statement of protest which might reinforce the efforts of non-shareholding parties to enforce a higher standard of accountability on the offending business.

Sadly, in some cases the ethical funds have even helped to defeat these expressions of genuine shareholder activism. For example, the Ethical Growth fund cast its proxy votes with management in defeating a motion to limit CEO compensation to no more than 20 times the salary of an average bank employee, introduced by activist shareholders at the 1997 annual meeting of the Royal Bank. President John Linthwaite, justifying the fund's stand on this issue, said: "This ... was very much a corporate governance issue, where we normally adopt a policy of voting in favour of anything that enhances shareholder value." [6]

In general, the statements and actions of the ethical mutual fund industry might be characterized as well-intentioned but overstated. The industry's effective advertizing has raised the expectations of ethically-minded individual investors far higher than is justifiable given both the very cautious, pragmatic nature of the funds' actual screening processes, and the industry's refusal to become an active insider in the struggle for more socially responsible corporate behaviour. In this context, the funds can be rightly criticized for not doing as much "good" as they imply with their advertizing, but surely they are at least moving in the right direction.

In some respects, however, the ethical funds' promotion campaigns may actually undermine the longer-role goal of reforming and regulating the financial industry. Nowhere is this more the case than with the ethical funds' oft-repeated claim that there is no contradiction between earning a high rate of profit and being true to one's principles. "Performance without compromise," crows the Ethical Funds prospectus. "At Ethical Funds, we believe that in order to achieve superior financial returns, you don't have to sacrifice your principles," explains another brochure. "Time and time again, we've found that progressive, ethically-managed companies are more profitable that their less conscientious counterparts." The ethical funds industry has gone to great lengths to make the point that its clients need not forego *any* profit in order to make a social statement with their mutual fund investments. And this case seems to have been proven by the relatively good financial performance of the major ethical funds.

But this whole approach can lead to some strange and worrisome political conclusions. First, if a private financial investor can earn a high rate of return from an ethical mutual fund, does this not seem to imply that the profits earned by those lucky Canadians who own significant quantities of financial wealth are somehow fundamentally "ethical"? We have seen that most financial wealth in Canada is owned by a small elite of society. Is there not some ethical problem with the very fact that someone receives large amounts of new money by sole virtue of the fact that they owned large amounts of money in the first place? Apparently not, in the world of ethical investing.

The Ethical North American Equity fund earned a one-year return of 42 percent in 1997. An investor with, say, $100,000 in that fund ended the year with

$42,000 more than they started, in return for doing nothing more strenuous than writing a cheque and reading quarterly statements. In comparison, the average Canadian worker earned just $31,000 in 1997 as compensation for an entire year's labour. One doesn't have to agree with Shakespeare ("Neither a borrower nor a lender be!") to wonder if this is really an ethical state of affairs. Yet by so aggressively promoting the supposed ethical value of personal investment decisions, and leading us to the conclusion that—yes—financiers can be ethical, too, the ethical mutual funds may leave Canadians less inclined to question the fundamental ethics of private finance, not more.

The ubiquitous claim that ethics and profits can indeed go hand-in-hand also promotes a naive, Pollyanna view of the workings of the real economy. Well-managed companies are both ethical and profitable, the argument goes, and hence by screening companies on social grounds the ethical funds coincidentally pick out the most profitable ones.

In some superficial sense, this may be true. Managers who regularize and standardize operating procedures and are generally respectful of their legal and regulatory responsibilities will be managers who tend to avoid certain ethical problems (such as mine disasters, workplace safety problems, or other potentially litigious quagmires) while simultaneously running productive and profitable operations. Moreover, profitable companies tend to be precisely the ones with discretionary resources to dedicate to goals such as charitable donations, affirmative action hiring practices, or even (to some extent) better employee compensation. In this sense, it is higher profits which "cause" better ethics, not the other way around.

Canada's banks, which have relatively good reputations on many "corporate citizenship" subjects (such as charitable donations), exemplify this reverse direction of causation. Companies which are highly profitable typically strive doubly hard to act (or at least appear to act) ethically, as a matter of good public relations, if for nothing else. But none of this implies that ethics and profits are indeed consistent, or even mutually supportive. And in the real-world environment in which they must constantly try to survive, companies face regular and very fundamental trade-offs between profitability and any significant conception of responsibility to their employees, the communities in which they operate, or the natural environment. By aggressively promoting its claim that good ethics and healthy profits are fully consistent, the ethical mutual fund industry is obscuring these fundamental economic and social trade-offs.

For example, any business in Canada faces a central incentive to minimize the amount of labour which it hires to perform needed tasks, and to minimize what it pays for that labour. This is a fundamental feature of an economic system in which the bottom-line profits of a business are siphoned off to the private owners of that business: the more costs can be reduced (including the costs of human resources), the greater are the profits left at the end of the day. An owner need not be merely greedy in order to be motivated in this manner. More often than not, they are forced into relentless cost-cutting by competitive pressure from companies which are more aggressively economizing on all inputs (including labour) and hence reducing costs more quickly.

What has been the collective result of all of these corporate-level efforts to reduce costs and maximize profits? Combined with conservative, pro-business economic policies on the macro level (such as high interest rates to restrain growth), the outcome has been endless corporate downsizing in the context of a generally lacklustre labour market. Unemployment and underemployment have remained high, while wages have stagnated—even as the productivity of those lucky enough to keep their jobs has grown. The number of "good" jobs with profitable, productive corporations declines steadily, while displaced workers are forced into marginal employment or self-employment to support themselves.

There is a fundamental ethical dimension to every one of these corporate downsizing decisions. In each case, the interests of the firm's owners for profits results in the displacement, unemployment, and reduced economic prospects of those who earn their living from work instead of from the ownership of financial wealth. The life prospects of many displaced workers are literally shattered.

Minimizing employment, ruthlessly shedding surplus workers, and cutting compensation to the minimum level necessary in the light of general labour market conditions: these are the imperatives of doing business successfully in modern capitalism, and they raise fundamental issues about the ethical structure of our society. Virtually any company which refused to follow the cost-cutting mantra would eventually be driven out of business. This makes it very difficult for an ethical mutual fund to select companies which might genuinely put "people before profit," because those companies are not likely to be around for long. So it is not surprising that the ethical funds quite happily invest in companies which have ruthlessly downsized their way to success (like Canadian National Railway, Bell Canada, and Northern Telecom).[7]

To boycott companies which laid off workers or paid lousy wages would hardly constitute a recipe for financial success in the nitty-gritty arena of late-20th-century corporate capitalism. It is to be expected that ethical investment funds will need to make some strategic compromises in their specific portfolio decisions. But to do this while stridently denying any trade-off between ethics and profits, when virtually all of the firms in their universe are forced by the rules of the game they are playing to act in fundamentally unethical ways, is to obscure the nature of the system itself in a grotesque manner.

Always Look on the Bright Side

The managers of ethical mutual funds certainly know a good business opportunity when they see one. And the stock-marketization of Canada's social programs is generating an endless stream of new business arenas in which the tried-and-true promotional themes of the ethical investing industry can be applied over and over again.

For example, Ethical Funds Inc. was fast out of the blocks with Canada's first-ever ethical Registered Education Savings Plan (RESP). The RESP system is very similar to Canada's RRSP system: investors can shelter money in an RESP account from taxes on interest or capital gains, until such time as the funds are withdrawn to pay education expenses for the investor or for his or her children or grandchildren.

RESPs were supposedly introduced to help Canadians cover the skyrocketing cost of higher education. Tuition fees at Canadian universities tripled between 1988 and 1998, thanks to relentless government cutbacks in education budgets. Students and their families have found it increasingly difficult to pay for a university education, even as they were being lectured *ad nauseum* that getting a good education is a prerequisite to success in the brave new job market.

Unfortunately, RESPs won't do much to change this state of affairs. Like RRSPs, they deliver juicy taxpayer subsidies to those lucky Canadians who have extra money for personal investments. Adding insult to injury, the federal government announced in 1998 that it would pay a 20% cash credit (up to $400 per child per year) to RESP investors, most of whom are well-off to start with: more Robin Hood in reverse.

But, spotting a lucrative new market, Ethical Funds leaped into the fray, promising to donate a share of its RESP sales to education initiatives for children in developing countries. As the brochure stated stirringly, "We believe that education is the right of every child." Well, if that's true, Ethical Funds' managers should look long and hard at Canada's RESP program, which will subsidize higher education for families with significant investment portfolios, while simultaneously pricing public education out of reach for the rest of society.

Ethical Funds is obviously not endorsing government budget cutbacks by participating in the RESP program. And, if someone is going to invest in an RESP, it is probably better to invest with a company which donates a share of its profits to the Third World than with one which doesn't. But, by so aggressively and uncritically touting RESP investments as a tool of ethical behaviour, the Ethical Funds program adds momentum to a fundamentally regressive shift in Canada's education policies which progressive Canadians should still be fighting to reverse.

At a bare minimum, one would hope an ethical RESP brochure might say a few critical words about the nature of the RESP program and its social and economic effects, or even include a mail-in postcard with which ethical Canadians could protest the whole boondoggle. But then, that might undermine the carefully calculated feel-good emotions which seem to be the primary purpose of the ethical investment movement.

Worse yet, this ethical contortionist act undermines the efforts of those who are actually fighting to moderate corporate abuses. Think of the workers at CN Rail, fighting to save their jobs after yet another downsizing announcement (CN reduced its workforce by almost 10,000 between 1995 and 1999, even as its stock market value tripled). Along comes an ethical money manager, arguing that CN's actions are ethical enough for the company to be included in the Ethical Funds portfolio. Hence the incredible profits which CN shareholders (including the mutual fund) have enjoyed as a direct result of those layoffs must also in some genuine way be ethical.

"We have to invest in *something*," the ethical fund manager would cry. Yes, all money managers must make their choices—but the ethical funds do the entire social justice movement in Canada a disservice when they try to deny that the whole process has a seedy, ugly, and fundamentally unethical underside.

The ethical mutual fund industry was largely initiated by Canada's credit union movement. Credit unions (like other deposit-taking institutions) have been challenged by the explosion of mutual funds and the rise of personal investing. Few depositors keep much cash in simple savings accounts any more, and this has forced credit unions to change their services if they want to maintain their share of the personal banking business. [In fact, credit unions have been fighting a losing battle in this regard, with their share of total financial assets in Canada falling fairly steadily since the era of high interest rates and high finance began in 1980.]

Still, given the political and social roots of credit unions, it is not surprising that the decision to offer "crass" financial services (like mutual fund investments) might prove to be a difficult one. Thus ethical mutual funds provided credit unions with a politically correct solution to their dilemma: they could join in the paper boom that was boosting the fortunes of other financial institutions, yet still be seen to be promoting the original goals of social accountability and financial democracy which motivated the formation of credit unions in the first place.

Many individual investors probably also felt squeamish about investing personally in the stock market, even as they despaired at the historically low rates they were earning on standard savings accounts. This may have been especially true for many of the baby-boom Canadians whose RRSP accounts have powered the mutual fund industry to new heights: many no doubt experienced pangs of guilt as they invested in the same corporations they once protested against in the 1960s and 1970s.

Guilt is rarely a healthy motivator in interpersonal relationships, and the same is likely true of economic and financial ones. Individuals fortunate enough

I Like What I See

"A lost job can put a smile on any shareholder's face."
—Eric Reguly, *Globe and Mail* business columnist
October 24, 1998

to have some spare cash to invest—and this remains a lucky minority—should probably just go ahead and invest in a mutual fund. And credit unions should probably just sell them. Investing in the stock market may seem uncomfortable to those with a social conscience, and probably for good reason. It would have been better to recognize that discomfort and accept it as an inevitable consequence of the way Canada's economy has been structured in the 1990s. But instead the founders of the ethical funds set their sights higher, trying to put an ethical stamp on an activity—private personal investing—which is inherently selfish and in many ways economically destructive.

The true motivation for most of the incredible growth of ethical mutual funds may be inadvertently captured in one of the Ethical Funds advertising slogans: "Feel good about your finances." Allowing a certain constituency of the investing public to sleep better at night is quite a different outcome from using your money to change the world. As suggested more delicately by Moira Hutchinson, former coordinator of the Task Force on the Churches and Corporate Responsibility and a pioneer of shareholder activism, "There is a danger of emphasizing too much the idea of ethical investment as a means to a clean conscience." The ethical fund industry's advertising has suggested a high calling, but its actions in practice seem to have been motivated more by a desire to foster a feel-good sentiment among its burgeoning clientele than to effect real social change.

Ethical mutual funds, especially those run by credit unions, will likely get better over time at designing and imposing stronger screens on their financial investments and clarifying their role in political campaigns focused on corporate misbehaviour. But their fundamental nature as agents for individual, private financial investors inherently limits their potential to change a world in which the concentrated ownership and destructive behaviour of financial wealth is a big part of the problem.

Labour-Sponsored Investment Funds

If ethical investment strikes some social activists as an apparent contradiction in terms, then the labour-sponsored venture capital industry must qualify as a positively Orwellian distortion of the English language. Labour-sponsored funds (LSFs) are mutual funds which specialize in investing in small and medium-sized companies. Private investors receive a range of generous tax breaks to subsidize their LSF holdings (in addition to the usual RRSP subsidies). In turn, the funds are supposed to finance the start-up and growth of job-creating small businesses. In reality, however, the LSF industry keeps about one-half of its total assets in low-risk government bonds and other "non-venture" investments.

Management costs in the LSF industry are huge, averaging close to 5% of total assets each year, yet the industry's venture investment portfolio has demonstrated average rates of return that are near-zero, or even negative. Clearly it is the generous tax subsidies—which reduce the net after-tax cost of an LSF investment for many investors to virtually zero—which drive the whole strange industry. Even the connection of the LSF industry to the labour movement whose name it carries is fuzzy and uncertain.

As of 1997, the LSF industry represented a total of over $4 billion in invested assets.[8] About half of this total is represented by concrete investments in real small and medium-sized businesses. The other half represents investments in government bonds, T-bills, and other "paper" investments. Relative to Canada's overall financial industry, the LSF industry remains a bit player. Total LSF assets represent just over 1% of total mutual fund assets in Canada, and are equivalent to about 0.2% of the total market capitalization of Canada's major stock markets. New investments in businesses by LSFs (perhaps $350 million annually in recent years) equal about 0.25% of total business investment in Canada. LSF investments in small and medium-sized businesses account for about 0.15% of the total assets of Canada's non-financial business sector.

However, within the specialized venture capital business (which provides equity and other long-term financing to small and medium-sized businesses), the LSFs have quickly become important players. LSFs now account for over one-half of all venture capital in Canada, and have helped to deliver important sums of new financing for particular small businesses. This is not to say that these businesses could not have obtained financing elsewhere; other types of investment (bank loans, issues of new shares, or private financing) still remain the most important sources of new capital for small business. The venture capital industry in general, and the LSFs in particular, have given small businesses an additional source of finance which they typically prefer (partly because LSF investments are publicly subsidized and hence cheaper, and partly because venture capital providers may be less demanding than some other sources of capital in terms of information disclosure, constraints on management independence, and other factors). But it would be wrong to conclude that each dollar of LSF investing represents financing that otherwise could not be obtained through conventional financial channels.

Canada's LSF industry can be broken down into three general categories, as summarized in Table 15-1. Quebec's Solidarity Fund is Canada's oldest and largest LSF. It was founded in 1983 by the Parti Quebecois provincial government, and is sponsored by the Quebec Federation of Labour. An important feature of the Solidarity Fund is its connection to the ultimate goal of Quebec independence, a goal which is supported by most unions and social groups in Quebec. A key justification for the fund is its effort to strengthen the domestic private sector in Quebec, reducing its reliance on financial and management inputs from outside of Quebec; this is considered important in laying the economic basis for Quebec independence.

Table 15-1
Three Categories of LSFs

Fund Category	*Number of Funds*	*Total Assets (year-end 97)*
Solidarity Fund, Quebec	1	$2.2 billion
"Rent-a-Union" Funds, Ontario	15	$1.8 billion
"True" Labour Funds, English Canada	5	$265 million

Source: Annual Reports of the funds.

The Solidarity Fund has also demonstrated the most explicit and interventionist social mission of all LSFs in Canada. The Solidarity Fund's prospectus document speaks stirringly about the struggle for full employment and positions the Fund's mandate within that context. The Fund has established several subsidiaries which are charged with investing directly in less developed regions of the provincial economy. The Solidarity Fund also has by far the best record of investing in unionized companies: 20% of its 365 investments at the end of 1997 were in firms whose workers were at least partially represented by unions. That is a small proportion, but far higher than LSFs in English Canada (which have invested almost exclusively in non-union enterprises).

A second category of LSF includes about 15 funds established in Ontario, accounting for about $1.8 billion in assets—just under half of all LSF assets in Canada, and close to 90% of all LSF assets in English Canada. One of the strangest legacies of the former NDP government in Ontario is the unique provincial legislation creating LSFs in that province. In Ontario (unlike elsewhere in Canada), the right to establish an LSF was not limited to a major labour federation. Instead, any individual union—no matter how small or obscure—can establish a fund. The result has been the emergence of a bizarre "rent-a-union" LSF industry. Few investors in the Ontario funds have any connection to the labour movement whatsoever. Private financial consultants simply arrange for official sponsorship from some obscure union, in return for an endorsement fee that by Bay Street standards barely qualifies as petty cash. The funds can then be marketed with a union "seal of approval"—mostly to high-income investors who likely oppose the operation of unions in every other facet of the economy.

Unions involved in this industry include such prominent voices of labour as the CFL Players' Association, the Canadian Police Association, and the Professional Association of Foreign Service Officers. In many cases, private financial professionals have been explicit about their intention to use the LSF legislation to create a lucrative tax-loophole for their private clients. The result has been a flood of incoming money from private investors, so that the rent-a-union industry quickly came to rival (in aggregate) the Solidarity Fund.

A good example of the bizarre practices that occur in Ontario's LSFs (the fastest growing segment of the LSF industry in Canada) is provided by an LSF called SportFund. This fund was started by Joel Albin, a former vice-president of the Bank of Montreal. He was quite explicit about his goal, which was to generate maximum tax breaks for his wealthy clients (see sidebar). SportFund boasts a panel of "expert" investment advisors, including such notable financial professionals as Darryl Sittler (former Toronto Maple Leaf), Brad Park (former Boston Bruin), Ernie Whitt (former Toronto Blue Jay), and Franco Harris (former Pittsburgh Steeler).

The union which nominally sponsors SportFund, in return for an endorsement fee, is (who else?) the CFL Players' Association. The sorts of important social projects funded by the subsidized capital accumulated in SportFund include a sports bar, an indoor adult playground, and Don Cherry's junior hockey franchise. Ironically, SportFund boasted a higher return in 1997 than any other LSF in Canada: an impressive 17%. Several other LSFs in Ontario were also started by financial professionals who left well-paying jobs with established institutions to take advantage of the lucrative tax loopholes created by the LSF legislation.

Outside of Quebec, five LSFs enjoy official support from segments of the genuine labour movement. In B.C., Manitoba, and New Brunswick, the funds are sponsored by the provincial labour federations. In Ontario, where the Ontario Federation of Labour has refused to support the LSF concept, two funds—the First Ontario Fund and the Canadian Venture Opportunities Fund, with combined assets of about $30 million as of 1997—were started by respective coalitions of several of the more conservative private sector unions. Together, these five "true" LSFs make up the smallest part of the overall LSF industry; combined, they account for about $250 million in assets, or some 5% of all LSF assets in Canada.

The operation of the rent-a-union funds which dominate the LSF industry in English Canada has become a huge embarrassment to the LSF "true believers."

Putting Money to Work

"When I saw what the labour-sponsored vehicle offered with the tax breaks, I thought, 'Geez, if I can structure it in a way that I could get my investors those tax breaks, then why not?' It would be sort of negligent not to as a corporate finance person... [But] to qualify, I needed a union."

—Joel Albin, President and CEO, SportFund Inc.
January 23, 1995

In Name Only

"The current generation of labour-sponsored venture capital funds still stands out as the most powerful tax avoidance tool available in Canada... The labour "sponsor" receives a fee for adding its name to the enterprise, but generally plays no further role."

—Dunnery Best, Senior Vice-President,
Merrill Lynch Canada Inc.
February 13, 1999

To some extent, therefore, the sponsors of the "true" funds have tried to differentiate themselves from the rent-a-union industry; four of the five "true" funds in English Canada, for example, have formed a Labour Sponsored Investment Funds Alliance (together with the Solidarity Fund) which has adopted its own (non-binding) statement of principles on how a "true" LSF should behave. [The Canadian Venture Opportunities Fund is not a member of this Alliance.] The sponsors of the "true" LSFs will only go so far, however, in attempting to distinguish themselves from rent-a-union funds. Notably, they will not publicly criticize other funds, and have not demanded that the federal and provincial governments withhold subsidies from funds which do not meet their own criteria for constituting an LSF.

And, while Ontario's rent-a-union funds typify the worst abuses of the LSF industry, and reveal how this subsidized industry can so easily be manipulated for cynical private gain, the general weaknesses of the LSF concept are not limited to those Ontario funds. Even "true" LSFs reflect most of the weaknesses of this general approach—a reliance on individual private investors, an emphasis on tax reduction over job-creation, huge and wasteful administrative expense, poor job-creation records, and dubious political implications for unions. Some of these issues are considered below.

Subsidy and Reality

The LSF industry would not exist without massive subsidies from the federal and provincial governments. These subsidies come in many forms. The first and most direct is the LSF credit itself. The federal government will cover 15% of the cost of any LSF investment, up to an annual individual maximum of $5,000. Most provincial governments will match this subsidy, for a total credit of 30%. Individual investors have to keep their LSF shares for eight years, or they must pay back the subsidy. After eight years they can sell their shares, buy new ones (even shares in the same LSF), and claim the 30% credit all over again. Since 1992, the federal and provincial governments have spent a combined total of about $1.5 billion on the LSF credits alone. With the 1999 expansion of the maximum subsidized investment, the LSF credit will cost both levels of government up to

$300 million per year.

The effective subsidy rate for LSF contributions is enhanced by virtue of the fact that they qualify for inclusion in an individual's RRSP account. For high-income earners, this translates into an additional subsidy of about 50% (depending on the specific high-income tax rates prevailing in each province). High income earners thus get a total of 80% back from government for their investments in an LSF: 30% from the LSF credit, and 50% from the RRSP. Ironically, because of the regressive way in which the RRSP credit is designed, the effective subsidy rate for the typical Canadian worker contributing to a labour fund is actually *lower* than the subsidy paid to a high-income earner investing in exactly the same fund. [See Chapter 12 for an explanation of this feature of the RRSP system.]

There is another lesser-known but incredible additional source of subsidy for the LSF industry. LSF contributions qualify, for federal tax purposes, as a "small business" investment. Most Canadians are only allowed to invest up to 20% of their total RRSP accounts in foreign countries. As discussed in Chapter 14, the rationale for this restriction is obvious: since RRSPs are heavily subsidized by Canadian taxpayers, these funds should be invested within Canada to boost domestic growth and job-creation. But investors in "small businesses" (including owners of LSF shares) are allowed to divert more of their *other* RRSP investments to foreign countries. In general, an investor is allowed to invest three extra RRSP dollars abroad (above and beyond the normal 20% ceiling) for every RRSP dollar invested in a small business in Canada (including the LSFs).

What is this subsidy worth? The financial industry has been lobbying hard for the federal government to eliminate the 20% cap on foreign RRSP investments. They point to studies showing that the typical foreign investment earns a higher rate of return than investments within Canada—at least 0.75 percentage points of extra profit per year for each dollar invested abroad.[9] By allowing an investor to attain extra foreign profit on $3.00 of subsidized RRSP investments for each dollar contributed to an LSF, this translates into a subsidy of 2.25% per year (3 times 0.75 points), or a compounded total of about 19.5% over the eight-year period during which LSF investors are required to keep their investments in the labour fund.

Incredibly, then, for a high-income investor, this third subsidy reduces the true cost of an LSF investment almost to zero: 30% for the LSF credit, 50% for the RRSP deduction, and 19.5% for the allowable extra foreign content. This equals a total subsidy rate of 99.5%. In other words, for each $100 contributed to an LSF, a high-income investor actually pays just 50 cents.

The foreign content rule creates some uncomfortable problems for advocates of the LSF concept. Tax-savvy investors are allowed to move $3.00 of subsidized investments out of Canada for each dollar they contribute to an LSF. The net impact on investment within Canada is thus *minus* $2.00! Can these investments thus really be seen as a contribution to business investment in Canada?

Even some of the "true" LSFs have placed special emphasis on this loophole in their public advertising. For example, a promotional leaflet for B.C. Working Opportunities Fund highlighted the fund's ability to help investors avoid the statutory limit on foreign investment of RRSPs. Incredibly, the same leaflet also argued that "keeping your money in B.C." was a key reason why investors should contribute to the fund.

The accumulated cost of all of the federal and provincial subsidies to the LSF industry up to the end of 1998 is well in excess of $3 billion.[10] This represents about three-quarters of all of the assets held at that time by Canada's LSFs. And it considerably exceeds the value of the total investments by LSFs in actual small and medium-sized businesses (since LSFs invest only about one-half of their funds in small businesses, with the rest being held in low-risk government bonds).

One recent study estimated that it costs government $1.35 for each dollar that LSFs invest in actual businesses.[11] Wouldn't it be more efficient for government to simply make direct public investments in deserving ventures, dispensing with the expensive charade of private money managers and private investors?

The problem with any investment strategy that exists primarily on the basis of tax subsidies offered to private individuals or companies is that all sorts of grotesque and unintended consequences are produced, thanks to the creative efforts of these same individuals and companies to avoid income taxes. This difficulty has been illustrated vividly by past failed Canadian investment policies that were similarly structured. For example, the huge subsidies offered to frontier oil exploration and Canadian TV and film production in the 1980s motivated the creation of entire industries whose existence was predicated solely on assisting individuals and companies to maximize the value of these tax breaks—quite apart from whether any oil was discovered or any film of cultural or economic value was actually produced.

The lesson of these fiascoes is that, to be efficient, investment subsidies to private agents must be tied to concrete results: actual investments in real endeavours with real social benefits. Canada's LSF policy is repeating this same error. Like the exploration grants of the National Energy Policy or the failed TV and movie subsidies, the appeal of the LSF industry to its investors and managers has everything to do with tax breaks and little to do with real productivity and economic growth.

Subsidized T-Bills

Another disturbing aspect of the LSF industry is the small proportion of total assets that is actually invested in small and medium-sized businesses in Canada. Federal law requires only that 60% of an established LSF (one that has been in existence for five years or more) be invested in actual venture stakes in real businesses. Most LSFs do not meet this target, either because they have not yet operated for five years, or because they are simply in outright violation of the rule.

For example, the large Working Ventures fund, nominally sponsored by the now-defunct Canadian Federation of Labour, held just one-third of its $828 million total capital at the end of 1997 in actual venture investments, even though the fund was created in 1986. Other funds had attained venture investing shares ranging between 35% and 55% by the end of 1997. Established funds which consistently break the 60% rule can be fined; however, these fines are refundable if the LSF subsequently meets the venture vesting target, and the degree of enforcement of the 60% rule has so far been questionable.

Even the nature of the subsequent punishment can be quite bizarre. For example, to avoid being fined for its low venture investment activity, in 1996 the Working Ventures fund committed $15 million to an Ontario government fund (the Community Small Business Fund) which provides risk capital to small businesses. By so doing, the fund avoided a $30 million fine it was supposed to have paid because of its poor record of venture investing.

The whole justification for the private-sector approach to investment embodied in the LSF industry is that private financiers are somehow supposed to be more efficient than government in allocating capital and supervising investment projects. Yet, when the second-largest LSF in Canada fails to meet the 60% investment target, it avoids major fines by paying into an alternative provincial government investment agency. Millions of dollars of taxpayers' money would be saved if the huge subsidies were simply given directly to a public investment bank (like the one in Ontario, or similar funds operating in other provinces), dispensing altogether with the hungry middlemen who run the LSF industry.

The LSF industry was initially given the right to invest in low-risk money-market instruments because it was felt that private funds could not be fully invested in actual business ventures without creating unacceptable difficulties of risk and illiquidity for the individuals who invest in the fund. A fund with all its money invested in real businesses might face temporary cash-flow difficulties, or be too vulnerable to poor performance in a few of its supported business ventures. Therefore, the government allowed these funds to keep a large share of their subsidized capital in low-risk non-business assets, as a necessary condition of making these funds (despite the high subsidy rate) acceptable to private investors.

The astonishing fact that the federal and provincial governments are subsidizing over $2 billion in low-risk investments in Treasury bills and other bonds is a direct result, therefore, of the choice of private, competitive financial firms as the delivery vehicle for this subsidized venture capital. If, instead of establishing an elaborate network of private funds, supported by private investors, and staffed by private money managers, government had established a genuine public investment bank, there would be no need to keep a huge supply of subsidized T-bills on hand.

Management Expenses

The LSF industry as a whole spends at least $75 million per year on deadweight administrative costs—a large amount for an industry which has invested at most $2 billion in real business projects. LSFs typically have higher management fees (measured as a proportion of their assets) than other types of mutual funds. Whereas bond-based mutual funds report typical expense ratios of about 1% of assets per year, and equity-based funds about 2% of assets per year, many LSFs report management expenses equal to 5% of assets per year, or even more.

Again, it was expected that LSFs would have higher administration costs than other investment funds, in theory because of the inherent costs involved in brokering and supervising investments with numerous small companies. Nevertheless, it is worth noting that over the eight years for which investors are required to hold their LSF shares in order to keep the 30% credit, even just a 3.3% annual management fee compounds to a full 30% of the initial investment. In other words, the high overhead cost of running a typical LSF eats up the full value of the 30% LSF credit.

In fact, the true cost of administering the LSFs is actually much greater than the stated management expense ratios, again because of the fact that these funds maintain one-half of their assets in low-risk Treasury-bills and other bonds. It is not expensive to manage a simple portfolio of bonds. In fact, two of the "true" LSFs—the First Ontario Fund and New Brunswick's Workers Investment Fund—have outsourced management of their non-venture assets to private investment agencies, in both cases for an annual fee equal to 0.2% of those assets.

So, if we deduct a share of total LSF management costs equal to 0.2% of their bond holdings, the remaining management expenses can be considered a fair estimate of the "pure" overhead cost of running the actual venture capital business. The results are startling. After controlling for the fact that LSFs maintain one-half their capital in low-risk, relatively low-cost bonds and Treasury-bills, the true management expense ratios for the pure small business portion of their assets soar by anywhere between 75% and 400% from the apparent expense ratios reported by the funds.

Many funds—even some of the "true" LSFs (such as Manitoba's Crocus Fund and the First Ontario Fund)—are collecting expenses on their actual venture investments in excess of 10% or more per year of the total value of their small business investments. No wonder it is so difficult for these venture investments to show any positive return whatsoever, when the whole process is dragged down by such an expensive administrative superstructure.

These huge management costs drag down the financial performance of the funds. On average, LSFs generated negative bottom-line returns during 1998, and average returns of only about 3% per year during the booming 1990s as a whole—despite the sure profits which the funds earn on their large holdings of low-risk bonds. Without their public subsidies, most private investors would never tolerate such high management expenses, or such low bottom-line returns. Now, in principle, there is nothing wrong with a public investment program which generates a small or even zero return on its assets—so long as those investments are socially mandated and meet clearly specified and measured social goals. But, if Canadian taxpayers are going to subsidize an investment program with zero or negative returns, it would be far better to support public or social projects with explicit social goals—low-cost housing, non-profit community development projects, public infrastructure—rather than paying for an elaborate and costly network of private financiers and accepting the notion that private companies motivated by private profit are the best agents to organize economic growth and job-creation.

Venture Investment Criteria

As with the ethical mutual fund industry, controversies have also erupted over the criteria on which LSF assets are invested in the private companies which are supposed to be the ultimate beneficiaries of this strange investment system. Even though the LSF industry is often advanced as a form of "social" investment, there are actually no binding social, ethical, or labour criteria on which the funds are allocated to recipient companies.

The only restriction is that these companies have less than 500 employees and less than $50 million in total assets. Beyond that, the LSFs are legally free to invest in any company that they wish. Since most funds (including the "true" funds in English Canada) are committed explicitly and legally to maximizing the value of shareholder assets, this means selecting companies on the basis of high expected profitability and low expected risk. This, in and of itself, is rather strange for a subsidized investment system ostensibly designed to serve social goals.

Some of the results of this virtually unconstrained approach to venture investment are quite bizarre. For example, many LSFs invest in small businesses by purchasing a portion of new shares that these companies issue through an initial public offering (IPO) or other conventional equity offering. This constitutes a blatant abuse of the stated purpose of the LSF industry. The subsidies to this industry are justified on grounds that unconventional sources of finance are required by small businesses which simply cannot access conventional stock markets. So why are the funds permitted to place subsidized capital in vehicles (such as IPOs) which are readily snapped up by non-subsidized investors?

Other issues are raised by the types of companies that benefit from LSF placements. One would think that a "labour-sponsored" industry would be sensitive to the labour relations practices of the companies in which it invests. Yet, the question of whether a company is unionized, and whether it treats its workers fairly, are not normally relevant to the investment decisions of LSFs. The vast majority of LSF-supported companies (including those financed by the "true" LSFs) are non-union firms.

Indeed, many of the companies which have benefited from the subsidized capital offered by the LSF industry are some of the worst violators of the principles which the labour movement otherwise promotes. For example, the Working Ventures fund has invested heavily in an Alberta-based "short-line" railway. Short-line railways take advantage of a deliberate labour loophole in most provinces, under which union representation is annulled when ownership is transferred from a unionized national railway (governed by federal jurisdiction) to a provincially-chartered short-line. The economic *raison d'être* of these companies is that this loophole allows them to sidestep a union and thus pay drastically lower wages.

The growth of short-line railways represents a direct attack on the jobs and working conditions of union members in the railway industry. Yet a major LSF, in the name of "labour," is actually financing this attack.

Other questionable LSF investments:

- The Canadian Medical Discoveries Fund invested in a company trying to develop Canada's first private hospital in Calgary.
- Numerous funds (including several of the "true" funds) have investments in private hotels, restaurants, tour companies, and other hospitality industries. Some of these "small businesses" are actually franchises of established international chains.
- Working Ventures invested in a company which operates a network of video lottery terminals in Atlantic Canada.

- One of the largest LSF placements ever was a \$7 million investment by Working Ventures in an elite golf and country club near Saskatoon, Sask.

In these and other cases, it is extremely hard to consider the company in question as holding sufficient social value to justify injections of publicly subsidized capital.

One particular example illustrates vividly the potential ironies of using public funds to subsidize private investments without attaching binding performance criteria to those investments. Working Ventures has invested several million dollars in Indigo Books, a firm competing in the new mega-bookstore market. Indigo is the creation of Heather Reisman, a well-connected Toronto executive, formerly a senior manager at Cott Corp. Ms. Reisman is married to Gerry Schwartz, CEO and majority owner of Onex Corp., a leveraged buy-out firm with assets of about \$6 billion. Schwartz was the second-best paid CEO in Canada in 1997, with total compensation (including exercised stock options) of just under \$19 million.

Indigo's flagship store in Toronto was the site of a special 1998 birthday party for Ms. Reisman. The aisles of books were rearranged to make room for a glamorous soirée attended by luminaries such as Conrad Black and Brian Mulroney. Reisman recently managed to defeat a union organizing drive launched by the Union of Needle, Industrial and Textile Employees (UNITE—which ironically co-sponsors a competing LSF, the Canadian Venture Opportunities Fund). In the wake of employees being fired for having a bad attitude and other forms of arbitrary treatment, enough workers signed cards to force a certification vote. After typical management pressure leading up to the vote, UNITE lost by six votes.[12]

The notion that this well-heeled, well-connected, anti-union book retailer located in a tony Toronto neighbourhood should be the recipient of millions of dollars of publicly subsidized capital at all—let alone that this capital should be advanced in the name of "labour"—surely constitutes one of the most outrageous chapters in the strange saga of Canadian LSFs.

Embarrassed by the strange and counterproductive nature of some LSF investments, the "true" LSFs claim to adhere to a social code in their investment decisions. But the wording of these commitments is deliberately vague, and no binding ethical or social screens are actually imposed. For example, the charter of the Labour Sponsored Investment Funds Alliance calls for "ethical employment practices and cooperative labour relations." Yet the vast majority of companies supported by the funds are non-union.

How do the labour unions sponsoring these funds expect that labour relations will be "ethical" and "cooperative" if workers remain unorganized? Indeed, if labour relations in non-union companies can be sufficiently "ethical" and "co-operative" to justify investments of the "workers' money," why do workers need unions in the first place? B.C.'s Working Opportunity Fund actually stresses in its promotional literature that "whether a company is unionized or not does not enter into consideration when making investment decisions." Similarly, the prospectus document of Manitoba's Crocus Fund states explicitly that "the fund's investments are not to be influenced by whether the business is non-unionized or unionized."

All LSFs in English Canada (including the "true" funds) commit to maximizing long-run returns as their dominant investment objective, and none list social or ethical criteria as among the top factors guiding investment decisions. In short, despite some overtures to the contrary, there is no fundamental difference between the criteria governing LSF investments—namely, high profits and low risk—and those governing the decision-making of any other private investment agency.

LSFs and Job-Creation

The LSF industry claims to have "created or maintained" a total of 100,000 jobs in Canada, or about 1% of all private-sector paid employment. This claim is not credible, however, and rests on a single and highly implausible assumption. To arrive at this job total, LSF managers simply add up all of the workers on the payroll of all of the companies which have received financing from one or more of the LSFs. Underlying this approach is the assumption that every one of those companies would have become completely and permanently bankrupt, with no jobs retained in any successor firm, were it not for the infusion of capital from an LSF.

Since virtually all LSF placements take the form of minority holdings in sponsored companies, it is hardly fair for the LSFs to claim credit for all of the employees on the payroll.[13] Moreover, while the LSF industry has probably generated some genuinely new funds for small business ventures, much of the financing channeled through LSFs would have occurred even without the labour funds (obtained through banks, equity markets, or traditional unsubsidized venture capital funds).

In other words, many of the investments made by LSFs would have occurred through alternative vehicles in past years. Thanks to generous tax subsidies, however, the LSF vehicle has become a preferred choice for both private investors and the supported companies. A large share of the demand for LSF financing, therefore, has simply been *diverted* from other investment sources, and cannot be considered to be creating net new jobs.

Obviously, some jobs have been created or maintained as a result of LSF investments, and the workers in those companies are understandably grateful.

What is a fairer estimate of the total employment impact of the LSF industry? It might be assumed that the LSFs' share of total business job-creation is proportional to their share of total business investment, or of the total business capital stock. In this case, the LSF industry might account for between 0.15% and 0.25% of total private sector paid employment in Canada—or between 15,000 and 25,000 jobs in total. Even 15,000-25,000 jobs is nothing to scoff at, of course, in the context of a chronically depressed labour market, but nevertheless this is not an impressive job-creation record in light of the total public subsidies exceeding $3 billion that have been received by the industry.

A Profile of LSF Investors

The sponsors of LSFs like to claim that they are vehicles for directing the savings of average union members and other working people toward more socially useful projects. This claim is one of the justifications for the involvement of certain unions and labour federations in the industry. After all, it is not entirely clear why unions were chosen to oversee the LSF vehicle in the first place, since the LSF industry exists to funnel the subsidized investments of private individuals into placements with private, usually non-union companies. Why were unions given the responsibility for (at least nominally) overseeing the industry in the first place? The idea that these funds somehow represent "labour's capital" is hence one of the political justifications for the involvement of unions. In reality, however, the clear majority of LSF investors have no connection whatsoever to unions—even those who have invested in the "true" LSFs.

The typical LSF investor is very similar to the typical RRSP investor. As discussed in detail in Chapter 12, most Canadian households simply do not have disposable income to devote to personal financial investments, no matter how generous are the public subsidies to those investments. And hence LSF investments, like all other personal investments, are disproportionately concentrated in high-income households, most of whom probably oppose the operation of unions in other spheres of the economy, but who happily participate in "labour's" investment scheme because of the generous tax subsidies involved.

Data on the income levels of LSF investors are available from Revenue Canada, which oversees the payout of the federal tax credit to these investors (*see Table 15-2*). About 375,000 Canadians contributed to an LSF in the 1995 tax year, or just 1.8% of all Canadians who filed tax returns. Among those who earned over $50,000 (and accounted for just over 10% of all tax-filers that year), about 7% of tax-filers invested in an LSF.

Average contribution rates, not surprisingly, also grow with income. LSF contributors who earned less than $50,000 put, on average, about $3,350 into their LSF accounts. The average LSF contribution for investors earning between

Table 15-2
LSF Contributions by Income Category
1995 Tax Returns

Income level	Under $50,000	$50,000 - $100,000	Over $100,000
Share of all taxfilers	88.3%	10.2%	1.5%
Proportion who contributed to an LSF	1.2%	6.9%	6.3%
Share of all LSF contributors	56%	39%	5%
Average LSF contribution	$3,350	$4,585	$7,550
Share of total LSF contributions	46%	44%	10%

Source: Author's calculations from Revenue Canada, *Tax Statistics on Individuals*, 1995 Tax Year, and unpublished Revenue Canada data.

$50,000 and $100,000 rose to $4,585, while those earning over $100,000 contributed an average of over $7,500. In total, tax-filers who earned less than $50,000 in 1995 (almost 90% of tax-filers that year) contributed just 46% of total LSF investments. On the other hand, those earning over $50,000 (about 11% of all tax-filers) accounted for 54% of LSF investments.

LSF contributions are thus slightly *more* concentrated among high-income investors than are tax-subsidized RRSP contributions in general. Recall from Chapter 12 that those earning under $50,000 accounted for 49% of all RRSP contributions in 1995, compared with 46% of all LSF contributions.

Implications for the Labour Movement

Perhaps the biggest difficulty with the LSF industry for the unions that nominally gave it birth cannot be described with economic statistics. By positioning themselves as investors in small businesses (most of which are not unionized), participating unions compromise their activity and credibility as *unions* in a number of worrisome ways.

For example, the LSF industry is premised on the claim that small business is the main engine of growth and job-creation in Canada's economy. But, as was described in detail in Chapter 5, the net job creation of Canada's small business sector is vastly overstated in misleading statistics which ignore the rapid rate of job destruction and turnover in this same sector. The real driving forces behind economic expansion, for the most part, are larger companies (which account for the bulk of investment and export demand) and government. Generally, the small business sector is dependent on the investment decisions of these more dominant economic players.

Moreover, small business is perhaps the most conservative political sector in Canadian society today with respect to most of the legal and political issues confronted by unions. Small business lobbyists regularly call for smaller government, lower taxes, further cutbacks in unemployment insurance, and weaker health and safety laws. Small businesses, on average, pay lower wages, offer fewer employment benefits, are more resistant to unionization, are less productive, and invest less in real capital than larger businesses.

Not all small businesses share these views and reflect these bad practices, of course, but most do, driven to desperation as they are by their efforts to stay afloat in their fiercely competitive, marginally viable industries. How do unions oppose the counterproductive views and practices of the small business sector, while at the same time holding up small business as not only the engine of economic growth, but as a worthy recipient of publicly subsidized capital?

Similarly, the LSF industry, whether deliberately or inadvertently, has clearly helped to promote the ideology of "people's capitalism" that is so effectively propagated by the financial industry. In reality, as was discussed in detail in Chapter 12, financial wealth in Canada is incredibly concentrated in the hands of a tiny elite. Yet the financial industry has always tried to position itself as somehow representative of society as a whole. The advertising and lobbying claims of the LSF industry serve to further reinforce the false notion that workers are important investors.

Moreover, virtually any union initiative that involves the solicitation and management of private investment contributions from individuals creates a huge potential internal conflict over those issues for which the interests of workers and the interests of investors diverge. There are many real-world instances in which this potential conflict of interest could become politically debilitating.

For example, as described above, many LSFs aggressively promote their investments as a convenient means of avoiding the federal government's 20% ceiling on foreign investment of tax-subsidized pension funds. This positions "labour's capital" on exactly the opposite side of the fence from the labour movement itself, which has called energetically for the maintenance, and even the tightening, of the 20% rule.

This is not to suggest that the labour movement should not be concerned with investment. Quite the contrary. Unions need to understand and challenge the power of private finance and private investors if they are ever to effectively redirect economic policy. But this challenge is not likely to occur through the positioning of union members as important private investors in and of their own right, especially in the context of an investment vehicle that is as individualistic and profit-oriented as are the labour-sponsored funds.

Pension Fund Activism

A third focus for efforts aimed at reforming the nature of private financial decisions has been the huge pools of capital represented by workplace pension funds. These funds represent some of the largest single financial pools in Canada.

Trusteed workplace pension plans held total assets at the end of 1997 of close to $400 billion, representing about 7.5% of all financial wealth in Canada. Corporate shares account for close to one-third of the funds' assets; the rest are held in government bonds and other investments. Pension funds thus control about 12% of all equity ownership.

It is likely that the relative importance of these pension funds will gradually decline in coming years, as a result of the falling proportion of Canada's workforce which enjoys workplace pension coverage. More Canadian workers are employed in smaller businesses which do not provide pension benefits; a growing number of others are self-employed. Employees in unionized workplaces are 2.5 times more likely than their non-union counterparts to enjoy workplace pension benefits; union members thus make up the clear majority of Canadians with workplace pension coverage, even though they account for just one-third of all Canadians workers. The slight erosion of unionization rates during the 1990s has therefore clearly limited the growth of trusteed pension funds.

Even where pension benefits are provided, there is a shift toward individual RRSP-style pension coverage, under which the employer contributes a fixed sum each month to each worker's RRSP account. Those workers are then usually free to invest those funds as they see fit. These "defined-contribution" pension plans have the advantage of lower administration costs than traditional "defined-benefit" plans (which specify the value of monthly pensions that must be paid when a worker retires). Their drawback, however, is that the pension a retired worker ultimately receives depends on numerous unknowns, such as the performance of the stock market and each individual worker's investment decisions. From the standpoint of the activist investment movement, the growing popularity of defined-contribution plans will further limit the financial power represented by workplace pension funds.

Indeed, the importance of these pension funds is often exaggerated. It is often claimed that modern capitalism is moving toward a form of collective ownership, in which workers own their companies through their pension funds. Futurist Peter Drucker even titled his 1975 book on this subject, *The Unseen Revolution: Pension Fund Socialism in America*. This implies a revolutionary potential for pension fund activism that is clearly not justified. Despite the importance of particular large funds, pension funds in general account for only a small share of total financial wealth in Canada, and that share is likely to decline somewhat in coming years.

Nevertheless, the concentrated power and high profile of particular pension funds make them very important players in Canada's overall financial landscape. The largest workplace pension fund, the Ontario Teachers Pension Plan, held some $55 billion in assets at year-end 1997. This makes it the largest single financial investor in Canada, larger even than the Canada Pension Plan (which at present maintains only a relatively small "reserve" fund of about $40 billion).[14]

The Ontario teachers' fund also symbolizes the ethical and political dilemmas raised by the decision-making power and investing activities of large pension funds. Prior to 1990, the fund was only permitted to invest in low-interest government bonds—a source of great outrage among Ontario teachers. Legal changes that year allowed the fund to invest more freely and aggressively in order to generate higher returns. The teachers' fund has since become one of the most "activist" of institutional investors in Canada, shaking up the cozy atmosphere of Canadian corporate boardrooms with demands for greater corporate accountability (and greater profitability).

The fund's investment strategy has included taking large minority positions in real estate developments and other non-traditional investments. Its relentless search for higher returns has certainly paid off in financial terms: it is one of the few institutional pools of capital in Canada whose returns have consistently exceeded the performance of the overall stock market. But it has also raised eyebrows among those, including many Ontario teachers, who believe the financial power of the fund should be put to work in the interests of better social outcomes, not just bottom-line returns.

For example, the teachers' fund owns about one-quarter of Maple Leaf Foods, majority ownership of which was purchased in 1995 by the McCain food empire. In 1998, Maple Leaf declared war against its unionized workers (most of whom belong to the United Food and Commercial Workers' union, the UFCW), demanding huge wage concessions backed up by the threat of plant closures. Maple Leaf actually shut its Edmonton factory after workers there went on strike against the wage rollbacks. Other UFCW units eventually accepted the wage cuts, but at huge cost to both the standard of living of their members and the credibility of their union.

In Winnipeg, for example, UFCW members burned their collective agreements and shouted down their union leaders after reluctantly accepting an incredible seven-year contract in September 1998 that contained huge wage rollbacks. One 13-year employee of the plant saw his wages fall from $17.50 to just $9.25 an hour, a cut of almost 50%. It is safe to say that Maple Leaf could not have undertaken such an aggressive and wrenching shift in its labour relations without the passive support of its largest minority shareholder. And hence many teachers, along with others in the union movement, were appalled at the link between the teachers' pension fund and this significant attack on the wages and working conditions of Maple Leaf employees.

Large pension funds wield economic influence in other ways, too, beyond their specific investment decisions. For example, many pension fund managers

have been vocal in lobbying for looser rules governing pension investments, most specifically calling for the relaxation of federal restrictions on the foreign investment of tax-subsidized pension monies. Once again it seems the "workers' money" is being used *against* workers, instead of for them: the managers of workplace pension funds travel to Ottawa espousing exactly the opposite position to that advanced by union leaders. We can probably guess which set of lobbyists is listened to more carefully.

So the interest of many workers and union activists in attempting to influence the behaviour of workplace pension funds is understandable. And in one important respect, this form of financial activism has a clear advantage over both ethical mutual funds and labour-sponsored investment funds. Workplace pension funds are an inherently *collective* investment vehicle, in that the capital is pooled and invested on behalf of all of the members of the pension plan, rather than being held in individual accounts. Pension funds are thus one form of financial investment in which the traditional rules of democratic decision-making (one person, one vote) might hold sway, in contrast to the one dollar, one vote "democracy" of the paper economy.

Pension fund activism would seem to hold greater potential for reforming financial behaviour in a way that breaks fundamentally with the individualistic structure of other investment vehicles. At a bare minimum, it would be hoped that workers and unions could prevent at least some of the most glaring instances of the financial power of pension funds being used in direct contradiction to the broader interests of working people. At the same time, however, attempts to gain greater say in how workplace pension funds are invested raise several complex economic and strategic issues which must be carefully considered before too many eggs are placed in this basket.[15]

In the first place, it is not at all self-evident—legally, economically, or politically—that the money in a pension fund is indeed the "workers' money," let alone any particular *union's* money. A pension fund exists to ensure that an employer meets its contractual commitment to pay retirement pensions to its employees at some point in the future. Pension law requires firms to set aside adequate funds to meet those future obligations, on the basis of certain assumptions regarding life expectancy, future earnings, investment returns, inflation, and numerous other factors. Without these accumulating accounts, there could be little guarantee that an employer's promise to pay future retirement pensions would in fact be fulfilled.

Pension funds are thus the actuarial equivalent to the show-business slogan: "Show me the money!" They are supposed to be an up-front guarantee that workers' future pensions are reasonably secure, regardless of the financial fortunes of the company in question. From the narrow perspective of ensuring the integrity of those future pensions, it is quite legitimate for workers and unions to conclude that what occurs to pension funds in the interim—between the time they are set aside and the time the pensions are paid out—is not really their direct concern. Pensions are envisioned not as the outcome of an *investment*, but rather as the deferred payment of *wages* by an employer who has been forced (through collective bargaining, legislation, and/or moral suasion) into recognizing that its responsibility to the well-being of its employees extends beyond their tenure as employed, productive workers.

The act of "investing" only enters the equation because it provides a convenient and more affordable way for the employer to arrange for the payment of those future pensions. Moreover, the risk associated with those investments is borne by the employer which sponsors the plan; this is fundamentally different from individualistic RRSP-style plans, which shift that risk entirely to the individual worker.

By engaging in the co-management of pension funds, workers and unions start to muddy this division of responsibility implicit in the traditional understanding of occupational pensions, and in so doing open up a Pandora's Box of potential trade-offs and quandaries. For example, if workers and their unions are going to share in the decision-making authority over pension fund investments, it seems reasonable to expect that they will have to shoulder some of the responsibility—in the form of reduced pensions—if those investments should happen to bomb. At present, this is not the case: it is the employer's responsibility to ensure that its promise of future pensions is fulfilled, regardless of successes or failures on the stock market. How can workers demand that their employer pay a predetermined pension benefit, come hell or high water, if they are simultaneously going to tell employers how pension contributions should be invested in the intervening period?

The response of many pension fund activists to this potential quandary is to borrow a page from the ethical mutual funds hymn book, claiming that there is no contradiction between high financial returns and ethical or socially responsible behaviour. Hence, pension funds can be channeled into socially beneficial undertakings without in any way undermining the viability of those future pensions. The argument that profits and ethics can go hand-in-hand was considered above and found to be superficial and unconvincing. An obvious question is begged: why do companies and investors engage in seemingly destructive or regressive forms of economic behaviour, if not to enhance their returns? Was there some motive other than higher profits—perhaps a simple, irrational hatred of organized labour—which inspired Maple Leaf Foods to launch its 1998 attack on its unions? And was there some similarly non-pecuniary motive which elicited the (at least passive) support of the Ontario teachers' fund in that conflict?

The Maple Leaf battle typifies the fundamental trade-off between profitability and social well-being that is inherent in a system of unregulated competition between private firms and private investors. For every example of a profitable firm which demonstrates its social responsibility in relatively trivial ways—perhaps a bank which scores high on the ethical scorecards because of its generous charitable donations—there is another company whose profit-seeking actions undermine the economic and social well-being of its employees and their communities in far more fundamental ways. And, if good corporate behaviour is indeed so profitable, then it should be enough to highlight this information for the benefit of existing fund managers whose mandate is limited to maximizing financial returns: their own profit-maximizing impulse should then kick into gear, without requiring an added "push" from socially-concerned pension fund activists.

Indeed, it is not clear why the stock market would not recognize and appropriately reward successful efforts by a company to implement business strategies that are simultaneously socially responsible and profit-enhancing. Many advocates of socially-responsible investing argue that good corporate behaviour (a better commitment to workers, communities, and the environment) pays off in higher long-run profits. If this were true, why wouldn't the stock market (and hence purely bottom-line-focused money managers) reward those companies accordingly?

Financial investors may be many things, but they generally aren't stupid or (at an individual level) irrational. If a company can indeed become more profitable by valuing its other "stakeholders" (workers, communities, the environment) and building longer-term relationships with them, then the talented analysts who are paid big money to identify prospects for future profits would be sure to seize upon that firm's longer-run potential. The notion that the stock market is too impatient to wait for the longer-run payoffs that are supposedly produced by these kinder, gentler strategies is not believable. More likely, the stock market has come to a different and more realistic conclusion: namely, companies which go "softer" on their workers and other "stakeholders" are likely to be *less* profitable than their competitors, not more, given the intensely competitive markets in which most of them operate.

For that reason, it would be more honest for the advocates of pension fund activism to acknowledge the existence of a trade-off (or at least a potential trade-off) between profitability and social responsibility. By then demanding that their pension fund managers put more priority on the social responsibility part of the equation, these advocates are putting their money where their mouths are, instead of pretending that they can have their financial cake and eat it ethically, too.

Pension funds obviously need to generate adequate and positive returns in order to fulfill their obligation to current and future retirees. But pension fund activists can make a convincing case that the financial solvency of a pension fund need not be undermined by investments which generate an *adequate* return, as opposed to the *maximum* returns sought in a socially-unconstrained investment approach.[16] In other words, socially-responsible investments can be pursued which allow for the financial viability of the plan in question, while forgoing the higher returns that would be earned by an unconstrained investment mandate.

Once this trade-off is explicitly acknowledged, however, other challenging but tractable problems emerge. In the first place, the goal of socially responsible investing is constrained by existing legal requirements imposed on pension fund trustees—namely, that they fulfill a "fiduciary responsibility" to future pensioners by investing the entrusted funds solely according to the criteria of maximum return. This provision allows no diversion of pension monies to good but less profitable causes. It also helps to prevent against outright pension fund corruption of the type associated with the U.S. Teamsters and other unions in previous decades.

To some extent, this conflict between the social and financial objectives of pension fund managers can be "finessed" through the careful design of alternative investment projects. [Greystone Properties Ltd., discussed further below, provides one example of how this can occur.] As long as a pension fund investment can be expected to earn adequate returns, in light of actuarial assumptions, to guarantee the payment of the proscribed future pensions of plan members, then managers should be able to win some ethical and social leeway in making their investment decisions.

U.S. experience has shown that the requirement of fiduciary responsibility on pension trustees can still allow a fair degree of leeway for trustees to support socially-mandated projects. Efforts to obtain legal and legislative clarity on this issue in Canada should be pursued.

The notion of investing pension monies on grounds other than bottom-line profitability will also cause obvious controversy within the ranks of the workers whose pensions depend on those investments. Hence the overall strategy presupposes an ongoing grassroots education and political campaign to convince rank-and-file plan members that adequate (albeit not maximum) returns can be earned while utilizing pension monies in more constructive (or at least less destructive) ways. And the outcome of that ongoing debate is by no means clear. It may very well turn out that greater control by union members over the investment of pension funds produces a *greater*, not lesser, focus on maximizing financial returns.

For most of these individuals, their per capita share of an accumulated pension fund represents by far the largest sum of money they will ever "own." To inform them that their union is trying to win more control over that money in order to invest it for the social good will be fiercely controversial. It was suggested in Chapter 12 that merely allowing more Canadians to "play the markets" is no guarantee that the priorities and outcomes of those markets will somehow become more socially beneficial. Similarly, if the outcome of greater worker control over pension fund investments is the accidental creation of a whole new constituency of profit-seeking, individualistic investors, then the effort will clearly have done more harm than good.

Indeed, it is no coincidence that the most independent and aggressive union pension funds—such as the Ontario teachers' fund in Canada, or the California public employees' fund (CALPERS) in the U.S., with total assets of $130 billion (U.S.) at the end of 1997—have been precisely the institutional investors most intent and most successful in forcing a more explicit bottom-line focus by company managers on the maximization of shareholder values, regardless of the consequences for the employees of those companies and their communities.

The most notable outcomes to date of the more "activist" approach on the part of pension plan managers have nothing to do with "social" goals. They have been, rather, the success of these managers in limiting the use of "poison pill" provisions and other cozy management practices which protect the interests of company executives at the possible expense of share values. CALPERS and other major U.S. pension funds have been expanding their "activism" more recently to address some ethical and social issues. But there is little doubt that the dominant effect so far of their more interventionist approach to investing has been to *enhance* the extent to which companies are subject to the bottom-line discipline of the stock market, not to moderate it.

There is a final cautionary note that must be considered by the pension fund activists. Pension funds have attracted attention from the socially responsible investment constituency because of their large individual size and their rare status as institutions of collective (rather than individual) financial decision-making. We have already noted that the aggregate economic importance of pension funds should not be exaggerated: despite the huge size of particular funds, pension funds are small in the context of the overall paper economy. Equally important, the funds' status as large pools of capital potentially subject to some degree of democratic oversight should not single them out for particular performance requirements that are not imposed on other financial investors. Pension funds own about 12% of all Canadian equities. It is politically and strategically risky to require them to adhere to a higher ethical and social standard (which, if we are honest, implies some sacrifice in terms of financial returns), when the other 88% of the stock market is allowed to run roughshod over the social and economic landscape. Apart from the fact that this proposed "solution" to the failings of the financial system actually misses 88% of the problem, this strategy could have the unintended result of undermining support among workers for collective defined-benefit pension plans in the first place. Individualistic, unconstrained RRSP-style plans may start to look quite appealing to those who hunger for a piece of the paper boom.

So, for both economic and strategic reasons, it is problematic to single out workplace pension funds for regulatory or performance burdens which are not—at least eventually—intended to be imposed on *all* financial investors. In this context, an analogy can be made to the history of union efforts to negotiate important non-wage benefits (including pension benefits!) for their members. Progressive unions have always phrased those bargaining demands as being a first step toward winning better social protections for all members of society, not just unionized workers. Benefit programs which were first negotiated in a few key industries could then be proposed as publicly-run benefit or insurance programs (such as extended health care, pharmacare, or dental insurance) available to everyone.

The same should be true of efforts to impose social conditions on pension fund investments. These efforts must always be positioned as part of a much broader effort to impose higher standards of social accountability on the financial system as a whole, through regulations and policies of the sort described in Chapters 14 and 16.

With all of these caveats in mind, then, it is quite right that Canadian unions are carefully beginning to explore the possibilities of imposing certain conditions on the investment of workplace pension funds (through negotiation with employers or through outright co-management of the funds). There are many examples of initiatives in this area, and their experimentation and experience over the coming years will help to fill in some of the questions regarding the extent to which pension fund activism can indeed be a fruitful avenue for financial reform.

Several public-sector unions, including the Canadian Union of Public Employees, have recently won formal representation on public-sector pension boards in several provinces, and these union representatives are now exploring ways of effectively influencing pension fund investments. Pension funds in several private-sector industries (such as construction) have long allowed for joint union-management trusteeship, and union-side trustees are beginning to expand the criteria on which their investment decisions are made. A recent B.C.-based initiative to enlist the power of union pension funds in pressing department stores and other companies to crack down on the sale of products made

with child labour is an encouraging example of the potential for coordinating pension fund activism with broader social and political campaigns.

The Canadian Auto Workers (CAW) negotiated an agreement with the major auto-makers in 1993 to dedicate a certain proportion of pension premiums to the construction of non-profit housing in auto-dependent communities. This provision, unfortunately, was struck down by Ontario regulators, but future refinements to contract language could conceivably solve this difficulty. At any rate, the CAW approach provides an example of how certain conditions can be imposed on the investment of pension monies through the collective bargaining process, without the union taking on explicit joint responsibility for co-management of the pension fund (a move which opens up the Pandora's Box of issues discussed above).

Progressive teachers in Ontario are also organizing and lobbying for the imposition of clear social criteria governing the investment decisions of the mightiest of pension funds, the Ontario teachers' fund.

These varied initiatives should carry on cautiously but ambitiously. At a bare minimum, all unions must be concerned at the current extent to which the economic power of the capital pooled in these funds—a power which exists solely because of union successes in winning pension benefits for their members in the first place—is used to undermine the broader economic interests of those workers and their unions.

One particularly interesting initiative could provide a model for future progress in this area. Greystone Properties Inc. is a non-profit real-estate development company based in Vancouver, which was funded through investments made by several pension funds which were co-managed by unions. The company has specialized in the construction of low-cost non-profit housing in the tight Vancouver housing market. It requires all of its projects to be undertaken by unionized contractors. Greystone thus goes far beyond being simply a passive owner and investor of financial capital, to intervene in influencing the way in which that money is actually put into motion in the real economy. In other words, Greystone steps outside of the realm of financial investment decisions, to become actively involved in the real investment process.

Both the end-product of those investments (low-cost housing) and the method by which they are carried out (creating unionized construction jobs) result in explicit and beneficial social impacts. Greystone's early experience suggests that pension fund investments with the company have generated returns at least as attractive as those produced by other placements, thus avoiding (for now) the difficult profits-versus-ethics debate. Whether this will remain the case even in the wake of Vancouver's economic slump (and the consequent cooling of the housing market there) is an important issue. So, too, is the question of whether the Greystone approach is transferable to other economic sectors which may have less economic space for non-profit, union-wage suppliers of goods and services.[17] Nevertheless, the Greystone initiative is a very important one, and demonstrates the potential for democratically-controlled capital to make a real difference in the real economy.

Conclusion: Investors or Citizens?

Perhaps there is a single, common difficulty encountered by all of the preceding efforts to channel financial investment in more socially constructive directions. Each attempts to exert some degree of social control over financial investments from within a general system of private and very unequal ownership of capital. In this context, the "basis to claim" of the partisans in each initiative is their legal ownership of the capital in question—whether as individual investors in a mutual fund or labour-sponsored investment fund, or as members of a workplace which is collectively covered by a particular pension fund. It is their status as investors, in other words, rather than their status as citizens, which constitutes the platform from which their call for greater social accountability is issued.

The Ethical IMF

Any "activist investor" strategy can entrap well-meaning investors in dilemmas which trade-off their interests as *investors* against their interests as workers, union members, neighbours, and citizens. A telling example of this risk was provided by the corporate response of the Ethical Funds company to the 1997-98 financial meltdown in Asia and elsewhere.

In the wake of that global chaos, the Ethical Pacific Rim Fund lost almost 40% of its value in 1997. [One might wonder why it is considered "ethical" in the first place to invest tax-subsidized money in places like Singapore and Indonesia—but that is another story.]

Following this catastrophic loss, Ethical Funds managers moved quickly to reassure investors. This is standard operating procedure for mutual fund managers during times of market turbulence. Instead of asking why financial markets are so turbulent, and questioning whether these paragons of instability should really be entrusted with such economic importance, the key goal of mutual fund managers during market "corrections" is to stop their clients from withdrawing their money. Ethical Funds responded like any other mutual fund provider in this context. Think about the long-term, its brochures urged soothingly. Stay the course. Slow and steady wins the race. Panic only makes things worse.

But the real surprise was the Ethical Funds' endorsement of the ultra-conservative policy response to the Asian crisis that was designed and imposed by the International Monetary Fund (IMF). To try to staunch the flood of financial capital that was catastrophically fleeing the Asian economies, the IMF imposed harsh and contractionary measures, including sharp increases in interest rates (to 50% or higher) and dramatic cutbacks in government spending. The provision of short-term IMF credits, essential if the complete collapse of the Asian financial system was to be avoided, was tied to these measures.

Led by American officials, the IMF also seized on the crisis as an opportune moment to demand Western-style "reforms" to the previously tightly-regulated Asian financial system, demanding less control over international capital flows, and more powerful and free-wheeling stock markets.

A growing chorus of economists has denounced the IMF measures as disastrous. They clearly contributed to the catastrophic collapse of output and employment in Asia, and hence will exacerbate and prolong the financial crisis. Far better would have been measures to limit capital flows directly (as were adopted by the Malaysian government), combined with expansionary interest rate and budgetary policies to offset the destruction of private credit and maintain output and employment levels.

What was the official Ethical Funds view on this crucial subject? President John Linthwaite wrote diplomatically in the 1997 annual report, "We are encouraged by the prompt response of the IMF to stabilize Asian economies and the receptiveness of Asian countries to proposed economic reforms." In a choice between policies that keep people at work and policies which protect the market valuations of financial assets, even the ethical mutual funds come down on the side of investors. This irony is especially bitter in light of the fact that British Columbia—home of the Ethical Funds head office—experienced more economic fall-out from the Asian crisis than any other province, with thousands of jobs lost in forestry, mining, and other industries which depend heavily on Asian markets. The bitter IMF policies probably contributed to the unemployment of thousands of B.C. workers, to say nothing of the mass human hardship experienced throughout Asia. But as long as they help to restore all-important levels of investor confidence, they win the ethical funds' stamp of approval.

In these bleak economic times, of course, activists must take advantage of every platform they can clamber onto. And so it is quite natural that, where progressive-minded citizens also happen to be investors, they should want to use that status to reinforce their overall demands for greater social equality and prosperity.

But this attempt to reform the investment process from within should come stamped with a prominent warning label: *Use with extreme caution!* In attempting to fashion a social change movement within a generally tight and self-interested community of financial investors, these activist investment initiatives risk endorsing and reinforcing the same structures they are opposing. They introduce a variety of potential conflicts of interest between the non-investment concerns and priorities of sponsoring organizations (such as credit unions or trade unions) and their bottom-line interest in the financial profitability of their own investments. They tend to underestimate the degree to which control over financial capital is concentrated in the hands of a small private elite which is quite insulated from any of the ethical or social imperatives which the activist investor movement attempts to propagate. And, worst of all, they may inadvertently contribute to the dangerous notion that the ultimate decision-making power over what is done with capital should indeed rest with the owners of that capital (be they individual or institutional).

The flip side of this coin is that, if you're not an investor, then what happens with investment is none of your business. Yet the broader goal of democratizing and regulating finance is premised precisely on the notion that investors must be held accountable to the entire communities in which they accumulate and reinvest their capital. In other words, a truly democratic financial system is one in which all citizens have a voice, not just those who own capital.

Credit unions constitute one remaining outpost within the broader financial industry which still respects this now-radical notion that democracy works according to "one person, one vote," rather than "one dollar, one vote." Indeed, the most ethical thing about ethical mutual funds and some of the labour-sponsored investment funds may very well be the fact that they are sold through credit unions. These vehicles thus channel a small share of financial business (the commissions paid on mutual fund and LSF sales) through institutions that genuinely challenge many of the structures and assumptions of private finance.

Any business that can be conducted through credit unions instead of commercial financial institutions definitely makes a small contribution to the preservation and perhaps the expansion of true financial democracy. For that small segment of the Canadian population which happens to possess both disposable cash and a social conscience, the clearest stand they can take is to deal with a credit union instead of a bank. Even better would be to become actively involved in the collective and democratic management of that credit union, thus helping to ensure that it remains both effectively administered and true to the progressive founding principles of the credit union movement.

Beyond the clear choice of dealing with and getting involved in a credit union, conscientious individuals concerned with the ethical and social implications of their personal financial choices will face continuing and difficult personal dilemmas—and this is probably a good thing.

The crucial problems in the financial system are rooted in the structures of concentrated private ownership and the fundamental dynamics of self-interested financial markets, rather than in the choices made by individual investors. To attempt to focus the attention of progressive-minded Canadians on that small proportion of investment decisions which may be amenable to popular suasion—union pension fund investments and the mutual fund holdings of sympathetic individuals—would be to divert attention from the real problem. The financial industry will be reformed not through appeals to the hearts and minds of financial investors themselves, but through social and political pressure which imposes a greater degree of accountability and oversight over the realm of finance, in the name of society at large.

In the meantime, of course, concerned individual investors will want their own investments to somehow be part of the solution (or at least not so much a part of the problem). They can consider various options. Ethical mutual funds and labour-sponsored investment funds have been reviewed and found wanting, but many concerned investors will still support them as imperfect steps in the right direction. Investors can also support numerous community or social investment funds which have been established by credit unions, religious organizations, and other groups. These funds explicitly offer a lower rate of return than commercial financial instruments (thus raising the spectre of a profits versus ethics trade-off that is so feared by the ethical mutual fund industry), but they channel the funds directly into worthy community development projects, both in Canada and in developing countries.[18]

Finally, a socially-concerned personal investor who still hungered for the seductive returns of stock markets and other mainstream financial instruments might even adopt the following strategy. First, accept the fact that personal investment choices alone can make no measurable difference to the behaviour and outcomes of the economy. Invest, if desired, in a no-fee index-based mutual fund which will mirror the financial performance of the overall stock market, but without paying the inflated salaries of well-off money managers who oversee active mutual funds (including the well-off money-managers who run the ethical mutual funds).[19] Make this investment through a credit union, where possible. Finally, take an amount equal to roughly 2% of the total sum invested (representing the management fees that *would* have been paid on any actively-managed mutual fund) and donate it to social change and political action projects (including those, like the Canadian Centre for Policy Alternatives, the Council of Canadians or the Canadian Coalition for Community Reinvestment, all based in Ottawa, which are fighting for progressive reforms to the financial system).

This investor will end up with a financial return roughly equal to those who invested in actively managed mutual funds (since history shows that most mutual funds don't match overall market returns, despite their expensive management fees). But they will have supported social change activism with their 2% "tithes," instead of the unproductive market-churning of overpaid financial professionals. And that is definitely a reason to sleep well at night.