



# **Socially Responsible Investing**

**Alberta Teachers' Retirement Fund Board  
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# Alberta Teachers' Retirement Fund Board

## SOCIALLY RESPONSIBLE INVESTING

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# **SOCIALLY RESPONSIBLE INVESTING**

## **Executive Summary**

The ATA has requested ATRF to provide a paper on the implications of applying an ethical filter to all the investments contained in the investment portfolio of ATRF for information of their Provincial Executive Council and the 2003 Annual Representative Assembly.

Socially responsible investing (SRI) is the integration of social, political, economic or environmental parameters into the traditional investment decision-making process. Investment screening is only one of a number of potential strategies that could be used to address SRI. There are three broad SRI strategies that are used in the investment industry:

- shareholder activism,
- investment screening, and
- economically targeted investments.

Typically, the proponents of SRI include religious orders, foundations and individual investors. SRI is easily applied by individuals and a smaller group of like-minded individuals to reflect their individual or collective religious, social, economic or political beliefs or priorities.

Implementing SRI for an institutional investor representing thousands of beneficiaries with a wide cross-section of personal beliefs can be extremely difficult. Consequently, only about 1% of institutional and retail assets under management in Canada are invested using SRI screens. The vast majority of Canadian pension plans that have SRI strategies employ shareholder activism.

## **Fiduciary Duty**

The key legal issue arising from SRI for pension plan trustees is whether SRI is inconsistent with their fiduciary duties to the plan beneficiaries with respect to the investment of trust assets. While individual investors are free to select where and how to invest, pension plan trustees are not. Legislation and common law frame the investment parameters and options for pension plan trustees. Pension plan trustees are entrusted with investing fund assets on behalf of all plan members. These members are unlikely to share the same social, political or moral objectives as each other, or as the trustees who are making the investment decisions. The ultimate goal is to provide these members with their secured pension promise.

The preponderance of authority suggests that trustees cannot sacrifice financial benefits for their beneficiaries based on social or ethical beliefs held by the trustees, unless this is mandated by the trust documents themselves. Fiduciaries that are willing to accept potentially reduced rates of return or greater risk are likely to violate their fiduciary obligations.

## Investment Screening

Investment screening can take three possible forms:

- qualitative screening,
- exclusionary screening, and
- best of sector approach.

SRI screening strategies require that companies and governments be judged on issues other than the return on the investment. It demands that factors of social, moral and political behavior be monitored, measured and evaluated. The range of issues or concerns encompassing social investing covers practically anything that anyone might be concerned about.

The key impacts in considering SRI screening strategies are:

### 1. Performance

Investment performance may be affected by underperformance as compared to the broader investment market.

### 2. Risk

Screening reduces potential diversification and may increase overall portfolio risk by screening out significant sectors of the economy.

### 3. Benchmark

The challenge is to create a customized benchmark that fairly represents the investable market for the asset class being considered for the SRI screened strategy. The concern is that over the longer term, this customized benchmark may underperform the broader benchmark for the asset class. This would detract from otherwise possible overall financial benefits.

### 4. Costs

Investment management costs are higher for SRI screened strategies for the following reasons:

- The inability to participate in passive index pooled funds results in additional active investment management that increases investment management fees significantly.
- The inability to utilize pooled funds that are managed actively results in more costly segregated fund management structures.
- External investment management firms may charge higher fees to manage SRI screened strategies.
- Resources are required to determine screening criteria.
- Internal and external monitoring costs of the more complex structure are higher.

## ATRF Situation

The Alberta Teachers' Retirement Fund Board (ATRF) is the trustee and administrator of the Teachers' Pension Plan and the Private School Teachers' Pension Plan, and the custodian of the assets of the plans. The plans cover about 62,000 teachers, pensioners, former teachers, surviving spouses and beneficiaries.

The benefit and funding interests of all plan members are of prime consideration for the ATRF Board, which is charged with the investment of the assets of the pension plans. ATRF investment policies follow the principles of trust and common law. They are structured to preserve capital, optimize return on investments and achieve the rate of return required to minimize the risk of having to increase total plan contributions.

Under the law, ATRF is required to meet very high standards of responsible investment behavior. ATRF is compelled to follow an investment policy that maximizes the asset values of the plans within acceptable risk levels for all members of the plan. To do less would be a breach of trust.

The legislation and trust governing ATRF and the pension plans gives no mandate to ATRF to pre-select or exclude investments based on social, moral and political issues, and provides no protection to the Board from potentially sacrificing financial benefits for plan members based on social and political beliefs held by the Board or plan beneficiaries. Any changes to the legislation and the trust must be agreed to between the Alberta Government and The Alberta Teachers' Association and enacted into legislation.

ATRF believes that, in the long run, the economic performance and financial results of any corporation will suffer if it is not responsive to public concerns. Therefore, corporations must carefully assess public attitudes and values, and operate accordingly or place optimal financial performance at risk.

Financial performance is one of several criteria that are assessed as part of ATRF's investment decision processes. The evaluation of any particular investment may include consideration of a number of social factors such as labour stability and environmental performance, where the portfolio manager believes, based on reliable advice and information, that such factors should be properly considered in assessing the investment's likely risk and performance.

It is the directors of corporations that are responsible to shareholders for maximizing long-term growth of shareholder value. Directors must work with management to implement best possible corporate governance practices covering all significant matters related to the corporation, including socially responsibility.

ATRF's SRI strategy seeks to promote corporate responsibility through shareholder advocacy. It is aimed at promoting corporate governance practices that will maximize long-term growth of shareholder value. ATRF employs three methods in its shareholder advocacy SRI strategy:

- corporate dialogue,
- communication with other shareholders, and
- proxy voting.

# **Alberta Teachers' Retirement Fund Board**

## **SOCIALLY RESPONSIBLE INVESTING**

### **A. Introduction**

At its 2002 meeting, delegates to the Annual Representative Assembly (ARA) of The Alberta Teachers' Association (ATA) passed the following Resolution 139/02:

BE IT RESOLVED, that the Alberta Teachers' Retirement Fund (ATRF) Board of Administrators be requested to study and report to the 2003 Annual Representative Assembly on the implications of an ethical filter to all investments contained in the investment portfolio of ATRF.

The ATA has requested ATRF to provide a paper on the issue raised in this resolution for information of their Provincial Executive Council and the 2003 ARA.

Investment screening is only one of a number of potential strategies that could be used to address socially responsible investing (SRI) in corporations and countries. This paper provides a brief overview of SRI strategies and related issues. It also provides details on investment screening approaches and impacts. The paper concludes with an overview of ATRF's SRI practices.

## **B. Socially Responsible Investing (SRI)**

### **1. What Constitutes SRI?**

SRI is referred to by various terms including

- socially responsible investing,
- economically targeted investing,
- ethical investing, and
- sustainable development investing.

Broadly speaking SRI is the integration of social, political, economic or environmental parameters into the traditional investment decision-making process. It is the application by fiduciaries of non-financial selection criteria to investing assets of beneficiaries held in trust, where such criteria relate to specific social, moral or ethical objectives.

### **2. Potential SRI Strategies**

#### **(a) Shareholder Activism**

This strategy seeks to promote corporate responsibility through shareholder advocacy. It is aimed at effecting change in the corporate governance practices of corporations to maximize long-term growth of shareholder value. There are generally three methods in which investors use their ownership to create change within a corporation.

##### **(i) Corporate Dialogue**

Investors take opportunity to discuss specific corporate governance practices with management and boards of directors.

##### **(ii) Communication with Other Shareholders**

Investors discuss issues with other shareholders to determine whether they should jointly leverage their ability to affect change.

##### **(iii) Proxy Voting**

The proxy vote is an important asset of a pension plan. Ownership and voting rights are used to support ethical conduct and good corporate governance practices.

Recent changes to the Canada Business Corporations Act have enhanced the ability for shareholder activism. Corporations will find it harder to prevent shareholder proposals from being raised and voted at shareholder meetings. Shareholders will be able to communicate freely among themselves without triggering restrictions on proxy solicitation. Should shareholders launch a formal proxy battle, they will be able to promote their position on the Internet or through media advertising.

(b) Investment Screening

Under this strategy, corporations and countries are screened based on specific issues to select the "best-of-sector" investments, or to screen out certain corporations or countries.

(i) Qualitative screens

Qualitative screening is an extension of conventional investment analysis.

Where a portfolio manager is faced with a decision of deciding between two companies with similar financial prospects, other factors such as environment, employee relations, human rights, etc. are used to select the company with the best prospect for maximizing shareholder value.

(ii) Exclusionary screens

Corporations are screened in order to avoid investing in corporations and countries that are involved in, or that derive a certain level of their revenue, from a set of pre-determined criteria. Possible criteria include:

- tobacco
- environment
- alcohol
- military
- employee relations
- human rights
- nuclear power
- gambling
- animal rights

(iii) Best-of-Sector Approach

Companies are measured on a quantitative and qualitative basis against sector counterparts to select potential investments. This increases fund diversification as it provides for some participation in industries that would otherwise not be included. This approach may also provide an incentive for improvement of corporate governance practices as corporations may take steps to ensure they are competitively positioned against sector counterparts.

(c) Economically Targeted Investments

This strategy includes the investment of money into community development or micro-enterprise initiatives that contribute to the growth and well being of particular communities. Community investment is a means to raise new capital for the development of local business. Community investors generally place money in community loan funds providing capital to local entrepreneurs, co-operative or community-oriented enterprises such as worker or consumer co-ops, regional development bonds, not-for-profit enterprises or community loan funds. A critical factor in community investment funds is the use of volunteer and public resources to establish funds, identify borrowers, manage risk and raise capital. These low-cost resources enable community investment funds to provide capital that cannot be offered by banks and other for-profit financial institutions.

### 3. Industry Practice

Typically, the proponents of SRI include religious orders, foundations and individual investors. SRI is easily applied by individuals and a smaller group of like-minded individuals to reflect their individual or collective religious, social, economic or political beliefs or priorities.

Implementing SRI for an institutional investor representing thousands of beneficiaries with a wide cross-section of personal beliefs can be extremely difficult. Consequently, only about 1% of institutional and retail assets under management in Canada are invested using SRI screens.

The majority of Canadian pension plans use shareholder activism as their SRI strategy. The biggest Canadian pension plans (e.g., Caisse de depot et placement, Ontario Teachers' Pension Plan, Ontario Municipal Employees Retirement System, Canada Pension Plan and Hospitals of Ontario Pension Plan) do not use SRI screening strategies. Rather, they rely on shareholder activism, principally proxy voting, for their SRI strategy.

The Canada Pension Plan stated the following on its website as of March 12, 2003:

". . . we will not accept or reject investments based on non-investment criteria. However, we will generally support corporate policies and practices and shareholder resolutions that would result in the disclosure of information that could enable investors to evaluate whether a corporation's behavior will enhance or hinder long-term investment returns. As a rule, we believe that companies that respect the environment, human rights, fair employee practices, community relations and otherwise act in an ethical manner tend to perform better over the long term."

The City Council of The City of Edmonton replaced its exclusionary investment screening SRI strategy in 2002 with one relying on proxy voting. The following points were provided for its consideration in making this change:

- Among social change agents, there is a debate as to the effectiveness of a social and political investment restriction in furthering social and political agendas. Over the past few years, other forms of social action have been much more effective, particularly by government bodies and environmental organizations. Dissident shareholders have also been found to have more effect than non-shareholders.
- Costs of investment screening were high and investment results lower. In addition, participation in passive investing and pooled funds was very difficult and more costly.
- The investment industry is now much more aware of social and environmental issues. If an analyst does not receive the right assurances from company management, an increase in perceived environmental risk, or other similar risks, can affect the analyst's decision to buy or continue to hold the company's stock. Markets are now doing a better job of monitoring social and political risks.

## C. **Fiduciary Duty**

The key legal issue arising from SRI for pension plan trustees is whether SRI is inconsistent with their fiduciary duties to the plan beneficiaries with respect to the investment of trust assets.

While individual investors are free to select where and how to invest, pension plan trustees are not. Legislation and common law frame the investment parameters and options for pension plan trustees. Pension plan trustees are entrusted with investing fund assets on behalf of all plan members. These members are unlikely to share the same social, political or moral objectives as each other, or as the trustees who are making the investment decisions. The ultimate goal is to provide these members with their secured pension promise.

Pension plans are funded by investment returns and contributions by plan members and employers. Trustees of pension plans are fiduciaries that must be prudent and diligent in their management of the assets of the pension plan to produce cost-effective investment returns required in order to provide benefits to all plan members.

In addition to ensuring that long-term investment performance meets the requirements for providing plan benefits, pension plan investment policies must also ensure that long-term contribution rates are at supportable levels. Investment activities that may negatively affect the achievement of maximum cost-effective long-term investment performance are incompatible with the fiduciary responsibilities of pension plan trustees.

### **1. Legislation and Jurisprudence**

There are no statutory or regulatory guidelines, or prohibitions, regarding the implementation of SRI. However, regulators generally require that SRI policies must be stated in the plan's statement of investment policies and guidelines and that plan members be notified of this position.

Regulators generally accept the modern portfolio approach, which makes it clear that a particular investment will not be judged in isolation, but rather in the context of the fund's investments as a whole. Consequently, trustees are unlikely to be exposed to fiduciary liability if one investment in the entire portfolio does not perform well, provided the investment forms part of an overall prudent portfolio.

Given the absence of specific Canadian statutory or regulatory standards, trustees must consider common law principles to assess the legal implications of SRI. The common law obligation imposed on all trustees is to act prudently and in the exclusive interest of the plan beneficiaries (the duty of loyalty) in carrying out the purposes of the trust for which they are responsible. Unfortunately, trustees have no available Canadian judicial guidance on this issue, as there are no binding Canadian judicial authorities that directly deal with whether SRI infringes on a trustee's fiduciary duty.

## **2. Legal Commentary**

The preponderance of authority suggests that trustees cannot sacrifice financial benefits for their beneficiaries based on social or ethical beliefs held by the trustees, unless this is mandated by the trust documents themselves. Fiduciaries that are willing to accept potentially reduced rates of return or greater risk are likely to violate their fiduciary obligations.

Trustees may formulate investment preferences based on SRI, where investment options are comparable based on traditional investment considerations. SRI investments have to be prudent on traditional financial standards. A prudent financial evaluation of any particular investment may include, and may require, consideration of many non-financial factors such as labour stability, environmental practice, and other social or ethical values.

Given that the majority view is that financial benefits cannot be sacrificed for non-financial or collateral benefits, trustees must also ensure that the cost of implementing SRI is acceptable and does not detract from otherwise possible overall financial benefits.

In addition to having a SRI mandate in the trust documents and to normal procedural prudence mechanisms applicable to all investment decisions, fiduciary liability risks may be further reduced through disclosure mechanisms. It would be prudent for fiduciaries that adopt SRI policy to specifically incorporate the policy in the statement of investment policy and guidelines for the fund, specifically setting out the criteria to be met for investments under the SRI policy. Disclosure of the SRI policy to plan beneficiaries may provide further liability protection. Another approach could be to mandate the SRI policy in the trust documents and allow the trust sponsors to input on the criteria to be incorporated in the SRI policy.

## **D. Investment Screening**

As noted in section B.2.(b) on page 4, investment screening can take three possible forms:

- Qualitative screening,
- Exclusionary screening, and
- Best of sector approach.

SRI screening strategies require that companies and governments be judged on issues other than the return on the investment. It demands that factors of social, moral and political behavior be monitored, measured and evaluated. The range of issues or concerns encompassing social investing covers practically anything that anyone might be concerned about.

There is no accurate or equitable way to measure and interpret social factors. The end result is a subjective judgement call driven by ideology. Decisions based on ideology may frustrate the primary purpose of the pension plans – to optimize investment returns in order to provide pensions.

This section provides an overview of investment screening techniques, issues and impacts.

### **1. Screening Techniques**

Third-party agencies can be hired in most developed market jurisdictions to perform screening services. Depending on the complexity of the screening strategy, pension plans can hire staff and allocate resources to perform the screening internally, or may secure a SRI consulting service. In the Canadian market, SRI consultants include EthicScan, Michael Jantzi Research Associates and the Social Investment Organization.

The issue is more complex for plans that have externally managed portfolios. Few external investment management firms may have an investment structure that matches the plan's SRI screening policy. This means that the trustees will have a very small universe from which to select a potentially successful manager. In addition, trustees may not be able to find any appropriate external investment managers in some markets or asset classes.

The process for SRI screens includes:

- Information gathering, starting from sources of corporate information including trade journals, mass media, government data, annual reports, etc.
- Data is then categorized by specific criteria reflecting the appropriate framework.
- Company reviews the data, and has an opportunity to refute, correct or expand.
- Transparency of process may provide an indication of commitment.

Investable companies may be assessed depending on the degree to which they:

- Have a commitment to social, moral or ethical responsibility as defined by specified criteria
- Have established performance measures
- Have implemented these measures
- Offered a transparent process

## **2. Issues and Impacts**

### **(a) Performance**

The SRI screening strategy may result in the selection of companies or countries that are ahead of the curve in terms of social or moral practices and, therefore, may outperform in ways that enhance shareholder value through innovation, new market opportunities, financing, etc.

A number of SRI screened funds outperformed the market during the technology bubble, as they tended to be overexposed to the technology sector that has been regarded as SRI "friendly". These same funds then underperformed the market as the technology sector dropped significantly.

Some SRI screened funds reduce potential diversification and may increase overall portfolio risk by screening out significant sectors of the economy, such as oil and gas or forest products. Over the years, some SRI screened funds have eliminated the following Canadian stocks, with significant implications for performance and/or diversification:

- Bombardier (defense)
- Nortel (Burma holding)
- Seagram (alcohol)
- Imasco (tobacco)
- Talisman (Sudan)

In addition, SRI screens will often eliminate stocks in oil and gas, metals and minerals, and forest products and will overweight technology and financial services. While episodic in nature, the elimination of commodity stocks can significantly impact portfolio performance.

A recent study of SRI screened mutual funds published in the Canadian Investment Review suggests that SRI screening does not impair returns for investment mandates established for investments in large capitalized Canadian stocks. Outside of Canada, some SRI screened mutual funds have underperformed their broader industry benchmark, while others have outperformed. Performance information is limited as SRI screened strategies do not have a long history and are generally limited to large capitalization equity mandates in the world's more developed markets.

(b) Benchmark Issues

SRI indices are not readily available and some have short histories. Dow Jones has created the DJ Sustainability Index, which represents a list of 300 possible global companies that integrate economic, environmental and social factors into their strategies and operations. A common index used in the United States is the Domini Social Index. In Canada, Michael Jantzi Research Associates launched the Jantzi Social Index of 60 Canadian stocks as a broad benchmark in January 2000.

Depending on the screening constraints, customized benchmarks may be required to accurately reflect the limitations placed on the manager. The first challenge is to create a customized benchmark that fairly represents the investable market for the asset class being considered for the SRI screened strategy. The concern is that over the longer term, this customized benchmark may underperform the broader benchmark for the asset class. This would detract from otherwise possible overall financial benefits.

(c) Costs

Investment management costs are higher for SRI screened strategies for the following reasons:

- The inability to participate in passive index pooled funds results in additional active investment management that increases investment management fees significantly.
- The inability to utilize pooled funds that are managed actively results in more costly segregated fund management structures.
- External investment management firms may charge higher fees to manage SRI screened strategies.
- Resources are required to determine screening criteria:
  - priority time allocation and resources from plan sponsors and ATRF Board, including related committees
  - additional internal ATRF staff
  - external consultant support
  - initial and ongoing software and systems support
- Internal and external monitoring costs of the more complex structure are higher.

## **E. ATRF Situation**

The Alberta Teachers' Retirement Fund Board (ATRF) is the trustee and administrator of the Teachers' Pension Plan and the Private School Teachers' Pension Plan, and the custodian of the assets of the plans. The plans cover about 62,000 teachers, pensioners, former teachers, surviving spouses and beneficiaries.

The benefit and funding interests of all plan members are of prime consideration for the ATRF Board, which is charged with the investment of the assets of the pension plans. ATRF investment policies follow the principles of trust and common law. They are structured to preserve capital, optimize return on investments and achieve the rate of return required to minimize the risk of having to increase total plan contributions so that:

- benefits for current service from September 1, 1992 under the Teachers' Pension Plan and all benefits under the Private School Teachers' Pension Plan are fully funded,
- the unfunded liability for pensionable service before September 1992 under the Teachers' Pension Plan is funded by the year 2060, and
- the new deficiency for pensionable service after August 1992 under the Teachers' Pension plan is funded by 2017.

The Teachers' Pension Plan has a very high total contribution rate level of 24.03% of teacher salaries effective September 1, 2003 due to the funding requirements related to the unfunded liability for pensionable service before September 1992 and for the new deficiency for pensionable service after August 1992. The unfunded liability was \$5.342 billion and the new deficiency was \$407 million as at August 31, 2002.

ATRF diversifies its investment structure to achieve the best possible return available from various asset classes and various securities.

### **1. Fiduciary Duty**

Under the law, ATRF is required to meet very high standards of responsible investment behavior. ATRF is compelled to follow an investment policy that maximizes the asset values of the plans within acceptable risk levels for all members of the plan. To do less would be a breach of trust.

The legislation and trust governing ATRF and the pension plans gives no mandate to ATRF to pre-select or exclude investments based on social, moral and political issues, and provides no protection to the Board from potentially sacrificing financial benefits for plan members based on social and political beliefs held by the Board or plan beneficiaries. Any changes to the legislation and the trust must be agreed to between the Alberta Government and The Alberta Teachers' Association and enacted into legislation.

ATRF must be prudent and diligent in its management of the assets of the plans to produce the investment returns required to provide benefits to all plan members. This is a very different situation from that which relates to private persons investing on their own behalf or a small group of individuals who share clearly defined beliefs.

## **2. Socially Responsible Investing Strategy**

ATRF believes that, in the long run, the economic performance and financial results of any corporation will suffer if it is not responsive to public concerns. Therefore, corporations must carefully assess public attitudes and values, and operate accordingly or place optimal financial performance at risk.

Financial performance is one of several criteria that are assessed as part of ATRF's investment decision processes. The evaluation of any particular investment may include consideration of a number of social factors such as labour stability and environmental performance, where the portfolio manager believes, based on reliable advice and information, that such factors should be properly considered in assessing the investment's likely risk and performance.

It is the directors of corporations that are responsible to shareholders for maximizing long-term growth of shareholder value. Directors must work with management to implement best possible corporate governance practices covering all significant matters related to the corporation, including socially responsibility.

ATRF's SRI strategy seeks to promote corporate responsibility through shareholder advocacy. It is aimed at promoting corporate governance practices that will maximize long-term growth of shareholder value. ATRF employs three methods in its shareholder advocacy SRI strategy:

### **(a) Corporate Dialogue**

In certain circumstances, ATRF discusses specific corporate governance practices with management and boards of directors of companies. This action may occur for both companies whose shares ATRF owns and for companies that are being considered as investment opportunities.

### **(b) Communication with Other Shareholders**

ATRF also discusses certain issues with other shareholders to determine whether we should jointly leverage our ability to affect change. ATRF is a member of the Canadian Coalition for Good Governance. The primary objective of the Canadian Coalition for Good Governance is to improve the performance of corporations through the promotion of good governance practices across Canada. Members of this Coalition include major Canadian pension plans and institutional investment firms.

(c) Proxy Voting

ATRF believes that the opportunity to vote its shares at a company's meeting is an important responsibility and has developed proxy voting guidelines that have been provided to the fund's investment managers. The portfolio managers report to ATRF on how they voted the fund's shares and on their overall compliance with ATRF's proxy voting guidelines. The guidelines are based on four main principles for corporate governance adopted by the Pension Investment Association of Canada:

- Fund assets should be invested to realize long-term value and to support the financial interests of all beneficial owners.
- Management staff of a corporation is responsible to a board of directors, that in turn is responsible for maximizing long-term growth of shareholder value. The board reports to the shareholders. The board should reinforce these concepts in making its appointments and by appropriately defining the separate roles of board members and management.
- All shareholders have a right to receive proper notice of corporate actions and to vote on issues that have a material impact upon their investments. Minority shareholders should not be treated differently from controlling shareholders.
- The proxy vote is an important asset of the fund. Ownership and voting rights should be used to support ethical conduct but not any particular external social or political agenda at the expense of long-term returns. Trustees are obligated to exercise their ownership rights in order to optimize the long-term value of their investments.