

January 2012

Local authority pension funds and investments in the tobacco industry



Purpose of this briefing

This briefing is a position statement by Action on Smoking and Health and FairPensions which aims to inform stakeholders in local authority pensions, including councillors, pension fund members, local taxpayers and pension fund trustees.

Local authority pension funds in the UK have attracted public criticism for holding investments in the tobacco industry. There are three common responses to this criticism, each of which will be examined in this briefing:

1. Local authority pension funds have a legal duty to maximise financial return and cannot give consideration to ethical issues.
2. Pension fund trustees do not interfere with the day to day decisions of external investment fund managers.
3. Tobacco is a low risk, high return investment.

This briefing challenges the claim that local authorities are in effect 'duty bound' to invest in tobacco and:

1. clarifies the law regarding the legal duties of pension fund trustees and explains the options for trustees wishing to properly consider ethical concerns around investments in the tobacco industry;
2. counters common misconceptions about the fiduciary duties around investments; and
3. provides information on the financial risks facing the tobacco industry which raises doubts about its long-term investment viability.

Argument #1: 'We have a fiduciary duty to maximise return'

Trustees' legal obligations to pension fund members are known as fiduciary duties. Pension funds often justify tobacco investments by claiming that their fiduciary duty requires them to maximise returns and ignore ethical considerations. However, this conventional interpretation of the law is somewhat simplistic.

Response

Although local authority pension funds are governed by different laws to other types of pensions (see Box C), members of their pensions committees have similar fiduciary duties to pension fund trustees. The phrase 'duty to maximise return' does not appear in any UK statute or case law. Pension fund trustees have a fiduciary duty to invest "in the best interests of members and beneficiaries."¹ This is based on the common law duty of loyalty, which exists to ensure that trustees avoid conflicts of interest and do not abuse their position to further their own ends.² Trustees also have a duty to invest prudently.³

In the 1984 case of *Cowan v Scargill* (see Box A), the judge ruled that, in a pensions context, “*the best interests of the beneficiaries are normally their best financial interests.*”⁴ This is often quoted as evidence that pension fund trustees are prohibited from considering ethical issues. However, the judgement explicitly denies this interpretation, going on to say: “*I am not asserting that the benefit of the beneficiaries which a trustee must make his paramount concern inevitably and solely means their financial benefit.*”⁵

Box A: *Cowan v Scargill* 1984

This case concerned the mineworkers' pension scheme. The five trustees appointed by the National Union of Mineworkers (NUM), led by Arthur Scargill, refused to approve an investment plan for the trust unless it excluded *all* overseas investments and all investments in industries directly competing with coal (e.g. oil and gas). The court upheld the employer-nominated trustees' contention that this was a breach of fiduciary duty, as:

- The trustees were motivated by their personal views and by a desire to pursue union policy, and were not putting the beneficiaries first (a breach of the duty of loyalty)
- Many of the beneficiaries, such as widows and dependants, would not be directly affected by the health of the mining industry, but would suffer any negative impacts from the likely sacrifice of return (a breach of the duty of impartiality)
- In any case, the social benefits of the policy were too speculative and remote: the pension fund's assets were not large enough to have any material impact on the prosperity of the mining industry or the national economy.

It is worth bearing in mind that, contrary to popular belief, the policy was not rejected on the grounds that it is unlawful for trustees to consider non-financial issues (see above). Rather, it was rejected on grounds specific to the facts of the case, including the trustees' decision-making process.

Indeed, it has been noted that the policy at issue bore little resemblance to a modern responsible or ethical investment policy. A landmark 2005 report by law firm Freshfields Bruckhaus Derringer concluded that “*No court today would treat Cowan v Scargill as good authority for a binding rule that trustees must seek the maximum rate of return possible with every individual investment and ignore other considerations.*”¹

¹ UNEP-FI, 2005, 'A legal framework for the integration of environmental, social and governance issues into institutional investment'

Similarly, in the case of *Martin v City of Edinburgh District Council* (see Box B), the judge said, “*I cannot conceive that trustees have an unqualified duty... simply to invest trust funds in the most profitable investment available.*”⁶

Indeed, local authority pension schemes (in line with other occupational pension schemes) are required to say in their Statement of Investment Principles “*the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments*”.⁷ This provision was intended as a ‘light-touch’ intervention to clarify that it is indeed legitimate for pension funds to take ethical issues into account.⁸

Case law does indicate that it would be difficult for trustees to justify an ethical restriction which significantly damaged financial returns, largely because of their duty to act impartially: it would not be fair if the ethical preferences of one group of beneficiaries hurt the retirement

prospects of another group who did not share their views.⁹ However, this is not the same as a bar on considering ethical issues. In particular, it leaves open two scenarios in which trustees might be able to exclude certain investments: firstly, if it would make no material difference to investment returns (the ‘**ethical tie-break**’), and secondly, if they have reason to believe it would actually enhance performance over the long run (the ‘**responsible investment approach**’).

Box B: Martin v City of Edinburgh 1995

In the case of *Martin v City of Edinburgh District Council*, a Conservative councillor sued his Labour colleagues for implementing a policy of disinvestment from apartheid-era South Africa. The judge ruled that the councillors had failed in their fiduciary duty because they had not undergone due process and taken proper advice. But he stressed that had they done so, the policy could have been legitimate: indeed, the fund's performance actually improved after the policy was implemented.

Moreover, the judge explicitly rejected the plaintiff's claim that *Cowan v Scargill* required trustees “*merely to rubber-stamp the professional advice of financial advisors.*” On the contrary, he said:

“I cannot conceive that trustees have an unqualified duty... simply to invest trust funds in the most profitable investment available. To accept that without qualification would, in my view, involve substituting the discretion of financial advisers for the discretion of trustees.”

The ethical tie-break

In *Cowan v Scargill*, the union trustees were insisting on a blanket exclusion of all overseas investments, and of any industries in competition with coal. In a subsequent paper the judge speculated that a more nuanced policy – for example, of excluding certain investments ‘all other things being equal’ – might have been permissible.¹⁰ More broadly, he suggested that an investment policy which accommodated the ethical concerns of some members without compromising the financial interests of others would be in the best interests of the beneficiaries as a whole. In other words, ethical criteria could be used to choose between two investment options that are equally attractive financially. This ‘tie-break’ principle has been restated several times in UK and US law and guidance.¹¹

Of course, trustees cannot be expected to predict actual investment performance. For this reason, the test of whether two options were ‘equivalent’ is not outcome but process: did the trustees take appropriate advice, and, based on the information available at the time, was their decision reasonable? It is very possible to imagine that a decision to exclude tobacco could pass this test. Indeed, many funds with much broader ethical exclusions (for example, the Norwegian State Pension Fund which excludes investments in tobacco producers among other things¹²) have consistently matched or outperformed the market.

The responsible investment approach

Trustees may also decide that excluding a particular investment would have a positive impact on the fund's long-term performance. It is now widely accepted that environmental, social and governance (ESG) issues can affect company performance. In a landmark 2005 report, the law firm Freshfields Bruckhaus Derringer concluded that considering these factors is well within the scope of investors' fiduciary duties: indeed, “***it may be a breach of fiduciary duties to fail to take account of ESG considerations that are relevant and to give them appropriate weight.***”¹³

On this basis, there are various reasons why trustees might conclude that tobacco is a risky long-term investment and these reasons are explored below (see Argument #3). Indeed, the London Borough of Newham currently excludes tobacco on this basis, saying in its Statement of Investment Principles:

“Fund managers are instructed not to invest segregated elements of their portfolio in companies that generate over half of their income from tobacco products, due to the risk that tobacco companies may face large liabilities from outstanding court actions.”¹⁴

Where does this leave fiduciary duty?

All of this suggests that the law does not oblige pension funds to dismiss the ethical concerns of their members out of hand. Rather, the appropriate response is to analyse whether those concerns could be accommodated without compromising the performance of the fund. Moreover, non-financial issues which could affect the performance of the fund should be considered by funds as part of their normal investment analysis.

Argument #2: “It is not our policy to interfere with our fund managers’ discretion”

Response:

It is common practice for pension funds to delegate day-to-day investment decision-making to external fund managers. However, this does not prevent them from instructing their fund managers in particular matters (as in the Newham example above). Indeed, the law is quite clear that, although trustees may delegate their investment functions, they cannot delegate their fiduciary responsibilities.

Final responsibility for investment decision-making rests with the trustees themselves. The judge in *Martin v City of Edinburgh* (see Box B above) stressed that trustees must “*appl[y] their minds separately and specifically to the question whether [the decision at hand] would be in the best interests of the beneficiaries.*”¹⁵ Moreover, in order to fulfil their fiduciary duties, the law requires trustees to monitor their fund managers on an ongoing basis.¹⁶ In other words, as FairPensions’ recent report concluded, “*It is a vital principle of fiduciary obligation that fiduciaries cannot outsource their obligation to think.*”¹⁷

Box C: Local authority pensions – a special case?

Local authority pension funds are governed by different *statutory* rules to other occupational pension schemes.¹ There is no statutory requirement for assets to be invested in the best interests of beneficiaries, and schemes must take account of the interests of local taxpayers.² In our view this does not amount to a significant difference in the underlying legal principles governing scheme investment. Common law fiduciary duties – to which the above analysis refers – still apply. However, given their duty to taxpayers, it is arguably also relevant for local authority pension schemes to consider the cost to the taxpayer both of measures to prevent smoking and of dealing with the public health impacts of smoking when evaluating their tobacco investments.

1 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093)

2 The Myners Principles, <http://www.thepensionsregulator.gov.uk/docs/igg-myners-principles-update.pdf>

Argument #3: The tobacco industry is a low risk, high profit investment

Response:

Tobacco shares have traditionally been a low-risk, high profit investment. However, there are a number of factors indicating that investments may be a risk in the medium and long term and there is a strong business case for reviewing investments in the short term.

There is a risk that some tobacco investments may currently be overvalued. In November 2011 Goldman Sachs downgraded Imperial Tobacco to “sell” from “neutral”, having previously downgraded the stock from “buy” to “neutral” in September 2011^{18,19} and an article by ‘Smart Investor’ on City Wire in August 2011 suggested that British American Tobacco shares may be overvalued.²⁰

Is the tobacco industry in terminal decline?

Analyst Adam Spielman has argued that tobacco could virtually disappear in 30 to 50 years. In the Financial Times, Spielman argues that “*The percentage of smokers is declining across the developed world ... If these trends continue, then by 2050 many important tobacco markets will have gone to zero smoking.*”²¹

The UK, European and American markets

Sales in the UK and Europe have been in long-term decline and are predicted to decline further. In the UK adult smoking rates have fallen from 27% in 2000 to 21% in 2009²² and since 1990 there has been a decline in smoking rates in almost all EU states.²³

The European Commission is currently revising the Tobacco Products Directive, which is likely to include proposals to make pictorial warnings mandatory and larger (80% of the pack) and to introduce plain packaging of tobacco products.²⁴ The UK government has set out its ambition to reduce adult smoking prevalence in England from 21% to 18% by 2015,²⁵ resulting in 210,000 fewer smokers every year. The Welsh Government plans to reduce adult smoking rates from 23% to 16% by 2020.²⁶

The American market is also in long term decline, with cigarette sales falling steadily from 640 billion in 1981 to 380 billion in 2006.²⁷

Imperial Tobacco is still highly dependent on its EU and American markets with 55% of net revenue coming from the declining EU market,²⁸ having sought to diminish dependence on the UK and expand sales through acquisitions in America and Europe, acquiring brands including Fortuna, Gauloises and Gitanes in 2008. However, the risk of this dependency on the European and American markets was demonstrated in 2010 when net revenue in the Americas decreased by 9 per cent to £780 million and adjusted operating profit declined by 15 per cent to £244 million following substantial increases in federal excise tax.²⁹

Developing world markets

Tobacco companies have sought to manage the risk posed by declining EU volumes through investing in new, profitable markets, such as investments in Africa and China. However, excluding China where the transnational tobacco companies have little market share, global tobacco consumption is already declining^{30,31,32} and with increased regulation these markets can no longer be relied on to provide the growth tobacco companies need to balance declining EU sales.

Regulatory Risk

Framework Convention on Tobacco Control

The World Health Organization's Framework Convention on Tobacco Control (FCTC)³³ aims to restrict smoking prevalence in the very countries where the industry has achieved its growth in recent years. More than 170 countries are now party to the FCTC. The FCTC covers price and tax measures to reduce the demand for tobacco products (Article 6), non-price measures to reduce demand (Article 7) product regulation (Article 9) packaging and labelling (Article 11), reducing advertising promotion and sponsorship (Article 13) and measures to reduce supply (Articles 15-17).

Countries across the globe are introducing measures to meet their FCTC requirements, including widespread legislation for smokefree workplaces and advertising bans. For example China, which accounts for over 40% of the total global tobacco market, introduced a range of measures to tackle tobacco in May 2011, including a ban on smoking in all public places.³⁴

In Russia, the world's fifth biggest market, health warnings were introduced in 2010 and the national parliament is mandated to pass legislation to bring Russia into full alignment with the FCTC, which will mean smokefree indoor public places and public transport and a complete ban on all advertising, promotion and sponsorship by 2015.³⁵

Uruguay has introduced a range of measures, including an increase in tobacco tax, graphic health warnings taking up 80% of the packet and a ban on all tobacco advertising.³⁶

Tax increases

Several countries have introduced substantial increases in tobacco taxation. During 2010 Spain introduced a 28% increase in tobacco duty as part of a package to tackle the budget deficit,³⁷ Japan introduced a 33% increase³⁸ and in Australia tax was increased by 25%.³⁹ The Indonesian government announced a 15% increase in tobacco excise from January 2012.⁴⁰

These abrupt, high level tax increases are likely to have a greater impact on tobacco industry profits. There is a significant risk that similar tobacco tax increases will become increasingly attractive to governments seeking to tackle budget deficits.

Plain packaging

Australia is set to become the first country in the world to require tobacco products to be sold in plain, standardised packaging with promotional features removed, from 1 December 2012.⁴¹

In the UK, the Government has committed to consult on options to reduce the promotional impact of tobacco packaging, including the introduction of plain packaging.⁴² In addition to Australia and the UK, other countries are also examining the option of introducing plain packaging, including Turkey, New Zealand and Canada. According to the Financial Times: *"If the Australian proposals are implemented, similar laws will emerge elsewhere, with damaging effects on profits."*⁴³



Front cover of the tobacco industry journal warning of the business risk from plain packaging (2008)

In 2008 the industry journal Tobacco Journal International reported on proposals to require plain packaging for tobacco products, stating: “*standardisation of cigarette packaging [would] drive down pricing and put an end to the appeal of premium cigarettes which carry higher profit margins*”. Although the article concluded the 2008 proposal had little chance of success at that time, the author observed “*how much industry regulation has come to pass, namely once it has been put on the table it never really goes away until one country becomes bold enough to implement it and then others soon follow suit.*”⁴⁴

A report produced for Philip Morris by Jorge Padilla⁴⁵ argues that plain packaging will lead to substantial price reductions, by removing the brand loyalty that enables tobacco companies to charge premium prices. The report also argues that plain packaging will make market entry by new suppliers of super-low price “no-name” products easier. Although Padilla’s claims have been challenged by a leading economist,⁴⁶ shareholders should be aware of the risk implied by the industry’s own analysis.

Analyst Adam Spielman has also highlighted the risk to the industry’s profitability posed by reduced brand equity likely to result from plain packaging. “*The industry is so profitable only because consumers are willing to pay a premium of £1.50 for certain brands.*”⁴⁷ “*If the proposal is carried out, it would reduce the brand equity of cigarettes massively... Anything that weakens this will dramatically reduce profitability.*”⁴⁸

Litigation – from Nunavut to Nigeria

In 1998, 46 US states settled their Medicaid lawsuits against the tobacco industry for recovery of tobacco-related health care costs and were awarded \$206 billion in compensation. The deal, known as the Master Settlement Agreement, was in addition to \$36.8 billion awarded to the states of Mississippi, Florida, Texas, and Minnesota.⁴⁹

The industry now faces a new threat from other governments around the world that are suing tobacco companies for the cost of providing healthcare. In recent years Argentina, Israel, Italy, Turkey, France, Poland India, Nigeria, Canadian provinces and Sri Lanka have all brought suits against tobacco companies relating to the healthcare costs arising from smoking. The EU took action in the US courts against tobacco manufacturers for colluding in tobacco smuggling under the Racketeering Influenced Corrupt Organisations Act.⁵⁰ In 2011, the Australian government announced that it was considering legal action to seek compensation from tobacco companies for the health care costs of smoking.⁵¹

Tobacco industry profits have suffered from over £250 billion paid out in litigation costs and if recent law suits are successful this is likely to open the door to encourage similar cases elsewhere.

The damage to the tobacco industry from litigation is not limited to the cost of settlements alone. “*There is also a risk that, regardless of the outcome of the litigation, negative publicity from the litigation and other factors might make smoking less acceptable to the public, enhance public restrictions on smoking, induce many similar lawsuits against JT and its subsidiaries, forcing them to deal with and bear the costs of such lawsuits, and so on.*” Japan Tobacco Inc., 2007⁵²

Box D: Tobacco – an industry with a disappearing future

- 170 countries are parties to the Framework Convention on Tobacco Control, and committed to introduce price and tax measures to reduce the demand for tobacco products
- UK government plans to cut the number of smokers by 210,000 every year
- Plain packaging “*will dramatically reduce profitability.*”

The questions that stakeholders should be asking

- Has the pension fund asked its fund managers for their view on the long-term financial viability of tobacco, in light of declining markets and regulatory or litigation risks?
- Has the pension fund asked its fund managers to undertake an analysis of the long-term impact of excluding tobacco from their portfolio, taking into account any measures that could be taken to compensate for the exclusion (for example, increasing weightings of other defensive stocks)?
- If not, will pension fund trustees:
 - commission these analyses;
 - make the results available to members; and
 - review their tobacco holdings, taking into account these findings as well as the ethical concerns of members?
- Will the pension fund develop and publish a statement of policy in relation to investments in tobacco companies?

References

- 1 The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005/3378), Regulation 4(2).
- 2 Bristol and West Building Society v Mothew [1996] 4 All ER 698
- 3 Re Whiteley [1886] LR 33 Ch D 347
- 4 Cowan v Scargil [1984] All ER 750; [1985] Ch 270. Page 760.
- 5 Cowan v Scargill, Ibid, Page 761
- 6 Martin v City of Edinburgh District Council [1988] SLT 329, [1988] SCLR 90
- 7 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (SI 2009/3093), Regulation 12(2)
- 8 See for example Stephen Timms, 10 Nov 2009, Speech for National Ethical Investment Week.
- 9 Breach of the duty of impartiality was a key reason for the judgement in Cowan v Scargill.
- 10 Megarry, 'Investing Pension Funds: The Mineworkers Case', Youdan (ed.), 1989, 'Equity, Fiduciaries and Trust'. Toronto: Carswell
- 11 E.g. in Bishop of Oxford v Church Commissioners [1993]; in guidance from The Pensions Regulator, which is no longer operational but which we understand still reflects their position; and in the US, in the 'ETI' Interpretive Bulletin, October 2008 (29 CFR 2509.08-1)
- 12 [Tobacco producers excluded from government pension fund](#), Ministry of Finance press release, 19 January 2010.
- 13 UNEP-FI, 2005, 'A legal framework for the integration of environmental, social and governance issues into institutional investment'
- 14 London Borough of Newham Pension Fund, [Statement of Investment Principles 2010/11](#) (pdf)
- 15 [1988] SLT 329, 1988 SCLR 90 (The wording quoted is from the headnote to the case report)
- 16 Pensions Act 1995, Section 34(4)
- 17 FairPensions, 2011, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation', p24
- 18 [Goldman Sachs downgrades Imperial Tobacco from neutral to sell](#), StockMarketWire.com, 17 November 2011
- 19 [Goldman Sachs downgrades Imperial Tobacco from buy to neutral](#), StockMarketWire.com, 7 September 2011
- 20 [British American Tobacco and illogical markets](#), Smart Investor, City Wire.co.uk, 31 August 2011
- 21 [Cigarettes bad for wealth, but there's life in tobacco yet](#), Financial Times, 14 January 2011
- 22 General Lifestyle Survey 2009 (Formerly General Household Survey)
- 23 World Health Organization Tobacco Control Database. <http://data.euro.who.int/tobacco>.
- 24 [Public consultation on the tobacco products](#) Directive and consultation response.
- 25 Healthy lives healthy people: a tobacco control plan for England, Department of Health, March 2011
- 26 [Good news for public health in Wales](#). ASH Wales press release, December 2011.
- 27 Tobacco Outlook, Economic Research Service, 1995-2007
- 28 [Imperial Tobacco Annual Report 2010](#)
- 29 [Imperial Tobacco Annual Report 2010](#)
- 30 Stevens B. [Deutsche Bank Global Retail and Consumer Conference](#). Paris 12th June 2007. Paris: British American Tobacco 2007. (pdf - accessed 13 September).
- 31 Morgan Stanley. Tobacco - Late to the Party. Morgan Stanley Research Europe. London. 30 January 2007
- 32 Euromonitor. The Future of tobacco. Euromonitor International. September 2011
- 33 [WHO Framework Convention on Tobacco Control](#), World Health Organization 2003
- 34 [China ban on smoking in public places comes into force](#), BBC online, 1 May 2011.
- 35 [Russia](#), TobaccoControlLaw.org
- 36 [Philip Morris close plant in Uruguay amid lawsuit](#), Reuters, 21 October 2011.
- 37 [Spain passes tobacco tax increase](#), BBC Online, 3 December 2012,
- 38 [Japanese yen for smoking tested by 33% cigarette price rise](#), The Guardian, 06 October 2010
- 39 [Cigarette tax to increase by 25% from midnight](#), ABC News, 29 April 2010,
- 40 [Indonesia to increase excise tax by 15%](#), MENAFN, 24 November 2011,
- 41 [Senate passes world for plain packaging of tobacco legislation](#), Department for Health and Ageing, 10 November 2011
- 42 Healthy Lives, Healthy People, op cit.
- 43 [Tobacco industry's smokescreen in plain packaging debate](#), Financial Times, 6 September 2011
- 44 Tobacco Journal International, April 2008
- 45 Padilla, J. The impact of plain packaging of cigarettes in the UK: a simulation exercise, a report for Philip Morris International, November 2010.
- 46 Reed, H. Analysis and review of J. Padilla, 'The impact of plain packaging of cigarettes in the UK: a simulation exercise', Action on Smoking and Health, September 2011
- 47 [Plain packaging a threat to brands](#), Financial Times, 6 June 2008,
- 48 [Little hope in appealing to natural justice](#). Interview with Adam Spielman. Tobacco Journal International, September 2008

- 49 Henderson, James A. Jr. and Twerski, Aaron. Reaching Equilibrium in Tobacco Litigation. Cornell Law Faculty Publications. Paper 175, 2010.
- 50 ASH briefing [Racketeering legal action \(RICO\) against tobacco companies for smuggling](#) Nov. 2002
- 51 [Governments eye court action to make cigarette companies pay](#), Herald Sun, 12 December 2011
- 52 The Tobacco Atlas, 3rd Edition. American Cancer Society, 2010