

RIGHT
TO
CARRY
NOW

Protect Children
NOT GUNS

In the Wake of Newtown: Firearms and the Management of Investor Risk

Zachary Paris & Cristian Chis

February 2013

- *The December 14 shooting that killed 20 children and six teachers at Sandy Hook Elementary School in Newtown, CT re-ignited a major public policy debate about gun control in the U.S.*
- *Firearms manufactures and their investors face increasing risk exposure related specifically to the manufacture of assault-style weapons, the sale of such weapons to civilians and the political involvement of firearms manufacturers and their influence on proposed gun control legislation.*
- *Following the Newtown tragedy, there has been public and political pressure on institutional investors to divest their holdings in the firearms industry.*
- *For those investors concerned about their exposure to firearms manufacturers and retailers, they can employ engagement or screening and divestment methods to mitigate potential reputational, regulatory and financial risks.*

Photo credit: www.businessinsider.com

Introduction

With an estimated 270 million guns held by civilians, the highest gun ownership rate in the world (88.8 per 100 people) and over 11,000 annual gun-related homicides, the United States is both the largest gun market in the world and, compared to its developed market peers, the most afflicted by gun violence.¹ The recent mass shooting at Sandy Hook Elementary School in Newtown, CT, and the subsequent public outcry have spurred government officials and political leaders into a major policy debate. The scope of the debate has expanded beyond the manufacturers and retailers of firearms and ammunition to include major equity holders and providers of capital. The Public Advocate for the City of New York, Bill de Blasio, has gone so far as to publish a list of the city's 12 largest investors in the gun industry entitled "The Dirty Dozen," complete with recommendations to divest from gun stocks. The political debate is in many ways a reflection of the public debate following the Newtown tragedy, a public that through its 200 largest pension funds holds USD 4.5 trillion in assets. Growing concerns over the manufacture and retail sale of firearms pose significant reputational, regulatory and financial risks to both companies and investors and demand a proactive approach to risk management.

The Issue

The position of the U.S. as an outlier among developed countries with regard to gun violence has long been a focus of media reports as well as discussion among politicians and responsible investors. 2012

was a particularly high-profile year for gun violence, culminating in the tragic death of 26 elementary school students and teachers in Newtown and a renewed call for the nation to address the problem of gun violence. Recent debates and policy discussions concerning gun control have focused first and foremost on reinstating the 1994 Federal Assault Weapons Ban that expired in 2004. The updated version of the ban, proposed by Dianne Feinstein (D) California, would prohibit the manufacture and sale of 157 types of semi-automatic weapons as well as ammunition magazines in excess of 10 rounds.² The ban, if enacted, would be permanent and would impact both manufacturers and retailers of assault-style weapons and high-capacity magazines. The ban encompasses popular models like the AR-15 rifle, variations of which are produced by most gun manufacturers. Regulations concerning ammunition are particularly relevant as revenue from small arms ammunition is nearly equal to revenue from small arms sales (26 per cent and 27 per cent, respectively, of total industry revenue in 2012).³

Of concern beyond the manufacture and sale of assault-style weapons and high-capacity magazines is the impact that manufacturers and retailers have had on the public policy debate around gun control. The websites of both Smith & Wesson (NASDAQ:SWHC) and Sturm, Ruger & Co. (NYSE:RGR) prominently feature “Protect Your Rights” banners, which proclaim that gun rights are under attack and include a link to pre-written letters to send to one’s congressman. The letters argue against the passing of new gun regulations. Major gun manufacturers have also donated millions of dollars to organizations like the National Rifle Association (NRA), which in turn lobby aggressively against candidates and policies seeking to implement new restrictions on firearms. In May 2011, Sturm, Ruger & Co. launched a challenge to sell one million Ruger firearms by May 2012 with one dollar from each sale going to the NRA Institute for Legislative Action; the company exceeded its goal and donated over USD 1.2 million. The NRA, as a member of the American Legislative Exchange Council (ALEC), also works with legislators to craft “model” legislation concerning firearms. Previous efforts include working to expand “concealed carry” and “Stand Your Ground” laws⁴ as well as allowing guns to be carried on college campuses. The political influence of the NRA, built in part upon corporate support, remains a major impediment to the passing of any gun-control legislation. The organization has not lost a vote on gun control since 1999 and over the past three years 99 laws that reduce gun regulations have been passed across 37 states.⁵ The absence of adequate regulations has had a dramatic impact on communities suffering from gun violence across the country. Of the ten states with the strongest gun laws, seven also have the lowest rates of gun death, while 95.6 per cent of the states with gun death rates above the national average have gun laws that received grades of D or lower from the Law Center to Prevent Gun Violence.⁶

Of the ten states with the strongest gun laws, seven also have the lowest rates of gun death.

For institutional investors holding companies involved in firearms, three key factors determine exposure to reputational risk:

The manufacture of assault weapons

- These weapons include semi-automatic firearms that can hold a magazine in excess of 10 rounds and/or contain at least one military feature such as a forward grip or a folding stock. They differ from hunting rifles and other recreational firearms in their ability to inflict mass casualties by quickly firing a large number of rounds without the need to reload. The attention of regulatory authorities and the general public is currently focused on this class of firearms.



The sale of assault weapons to the general public

- Public concern regarding the sale of firearms is focused on retailers who sell assault weapons to the civilian market, as opposed to military or law enforcement agencies.

The political involvement of firearms manufacturers

- The public policy positions, political donations and lobbying by gun manufacturers have impeded efforts to pass legislation intended to reduce gun violence. Such political involvement is now under increased scrutiny as President Obama, with majority public support, looks to pass comprehensive gun reforms to curb gun violence.

The Players

Manufacturers

Select list of firearms manufacturers whose product lines include assault weapons.

Company	Market Cap Pre-Sandy Hook (USD)	Market Cap Current (USD)	Sales to Civilians as % of Total
Smith & Wesson Holding Co. (NASDAQ:SWHC)	632M	608M	89.1%
Sturm, Ruger & Co. (NYSE:RGR)	914.5M	1.04B	Est. >50%
Olin Corp. (NYSE:OLN)	1.71B	1.86B	Est. <29%
The Freedom Group (Private)	N/A	N/A	85.9%
Beretta Holding SpA (Private)	N/A	N/A	Not Available
Colt Manufacturing Co. (Private)	N/A	N/A	100%

Retailers

Select list of firearms retailers in the U.S.

Retailer	Market Cap (USD)	Firearms as % of Revenue
Wal-Mart (NYSE:WMT)	239.28B	Est. <5%
Dick's Sporting Goods Inc. (NYSE:DKS)	6.04B	Est. <5%
Cabela's Inc. (NYSE:CAB)	3.50B	Est. 10-25%
Sears Holding Corp. (NASDAQ:SHLD)	5.11B	Est. <5%
Sports Authority (Private)	N/A	Not Available

Risks to Investors

Reputational

Companies and investment funds should remain aware of their current and target investor base and the potential impact of unmanaged reputational risk with regard to investments in firearms.

Public perception of firearms varies by region, but recent polls show nationwide majority support for a ban on assault weapons and high-capacity magazines as well as an expansion of mandatory background checks.⁷ Asset managers and retailers are exposed to varying levels of reputational risk depending upon their investor and customer base. Pension funds and university endowments with beneficiary/donor bases in regions of the country strongly in favor of gun control (New England, Mid-Atlantic, Pacific) are exposed to much greater levels of reputational risk than funds with beneficiary/donor bases located in areas of the country strongly in favor of protecting gun rights (Mid-West, South Central, Mountain).⁸ Retailers with a large presence in pro-gun control areas are exposed to similar reputational risks.

Investment funds should remain aware of their current and target investor base and the potential impact of unmanaged reputational risk with regard to investments in firearms. Many European institutional investors as well as many institutional investors in pro-gun control areas of the U.S. have placed firearms manufacturers on exclusion lists and/or have announced plans to divest from such holdings. Many of these investors also apply revenue threshold screens to retailers such that if a retailer obtains, for example, more than 5 or 10 per cent of its revenue from the sale of firearms, it will be placed on an exclusion list. However, significant public attention on a retailer's involvement in the sale of firearms could lead some investors to place the company on an exclusion list regardless of the revenue threshold.

Regulatory

Regulatory risks are primarily limited to the manufacturers and retailers of firearms and ammunition. While there is a national majority in favor of the proposals included in the updated Assault Weapons Ban, it faces staunch opposition from Republicans in both the House and Senate who are responsive to the demands of their constituents and donors. Only 44 per cent of polled Republican voters support a ban on assault weapons and high-capacity magazines. Of even more concern for some politicians is the fact that "pro-gun" voters tend to be much more politically engaged. Of respondents who say that protecting gun rights is more important than gun control, approximately 25 per cent have contributed to a gun-rights group, while only five per cent of respondents who believe gun control to be more important have made contributions to gun-control groups.⁹ Many political leaders, including the Senate Minority Leader Mitch McConnell, are facing re-election in the 2014 mid-terms, an election cycle in which engaged groups historically have had an outsized influence.

Many states may pre-emptively pass legislation similar to the proposed Assault Weapons Ban.

These political dynamics will have a significant impact on the progress of the current legislation as well as the potential revisiting of past legislation such as the Protection of Lawful Commerce and Arms Act (PLCAA), which protects firearms manufacturers and retailers from liability lawsuits. However, many states may pre-emptively pass legislation similar to the proposed Assault Weapons Ban. California already has such a ban in place, while the State of New York passed a series of gun-control measures in January 2013, including an assault weapons ban and a prohibition on magazines in excess of seven rounds.



Financial

The Obama Administration's public campaign to enact tougher gun control measures has done little to impact the share performance of the major gun manufacturers and retailers. Instead, fear among gun enthusiasts that certain weapons may eventually become unavailable has fueled enormous gains for listed gun manufacturers. In 2012 the share prices of Smith & Wesson and Sturm, Ruger & Co. increased 94 per cent and 33 per cent respectively. While the shares of both companies dipped following the shooting in Newtown, they continue to post gains in 2013.

There is little risk that any proposed divestment campaign will have a significant financial impact on the USD 11.7 billion firearms industry.¹⁰ Only three firearms manufacturers are publicly listed and, of these three, only Olin Corp. has more than eight per cent of its outstanding shares owned by a single institutional investor. Furthermore, the client base of major equity holders is sufficiently diverse that a client-requested sell-off is unlikely. However, the outcome of the political debate may have serious financial implications for the industry. Should there be a repeal of legislation like the PLCAA, firearms manufacturers, retailers and investors would become exposed to much greater financial risk as a result of a potential flood of liability lawsuits.

The Call for Divestment

Following the Newtown tragedy, the U.S. entered a period of national mourning and reflection. Major firearms retailer Dick's Sporting Goods immediately suspended firearm sales and public officials across the country called on public pension funds to review their holdings. In January 2013, as part of his campaign

“We cannot support or invest in companies that profit from the proliferation of assault weapons and the violence these guns bring to our communities.”

- Rahm Emanuel, Mayor of Chicago

to have the city's pension funds divest from firearms manufacturers, the Mayor of Chicago, Rahm Emanuel, stated that, “We cannot support or invest in companies that profit from the proliferation of assault weapons and the violence these guns bring to our communities.”¹¹ Emanuel also sent formal letters to the CEOs of two prominent banks, each of which provides a credit line to a firearms manufacturer, calling on them to stop providing financial services to the companies as long as they remain opposed to stricter regulations on

assault weapons. Philadelphia's Mayor, Michael A. Nutter, crafted the “Sandy Hook Principles,” which have been adopted by the city's pension board and endorsed by the United States Conference of Mayors. The Principles require that firearms manufacturers and retailers comply with a number of gun safety measures or they will be ineligible for investment by the city of Philadelphia's pension funds. The California State Treasurer, Bill Lockyer, who sits on the boards of both CalSTRS and CalPERS, introduced a motion for CalSTRS to divest its firearms holdings as “assault weapons clearly fall into the category of being a product detrimental to public health and safety.” The motion was unanimously adopted, with Harry Keiley, the chairman of the fund's investment committee, adding that “This latest incident, which occurred at a school and involved fellow educators and the children we cherish, is a tipping point for CalSTRS.”¹²

In many cases, firearms account for a very small percentage of fund assets. New York City's five pension funds have investments in firearms manufacturers valued at approximately USD 18 million, far less than

“Assault weapons clearly fall into the category of being a product detrimental to public health and safety.”

- CalSTRS



0.1 per cent of the USD 127.8 billion portfolio. Similarly, CalSTRS' USD 154 billion portfolio contains approximately USD 12 million in firearm investments.¹³ However, many pension funds simply do not want to be associated with the firearms industry in any way, which has led to an institutional sell-off in areas of the country where there is strong support for gun control. The USD 46.6 billion New York City Teachers' Pension Fund has divested its USD 13.5 million in firearms investments.¹⁴ The USD 9.5 billion Chicago Teachers' Pension Fund is also divesting its USD 146,000 of firearms investments, while the city's Municipal Employees Annuity and Benefit Fund (MEABF) announced it would sell its firearms holdings valued at approximately USD 1 million. Other city agencies, including the Chicago Transit Authority, the Chicago Housing Authority, and the Chicago Park District, are conducting similar reviews of their portfolios. Pension officials in the states of Connecticut, Rhode Island, and Massachusetts are also reviewing their portfolios. In addition, institutional pressure led the private equity firm Cerberus Capital Management to announce that it would sell the Freedom Group, the largest gun manufacturer in the country, whose product line includes the Bushmaster AR-15, the gun used in the Newtown tragedy.

Reputational risk has been the primary driver behind the institutional sell-off as pressure from asset owners and the general public has led many pension funds to divest as a means of disassociating themselves from the industry. The reputational risk associated with firearms investments has also had unforeseen consequences for major equity holders. As Cerberus looks to sell the Freedom Group, a number of investment banks including JPMorgan, Goldman Sachs, Deutsche Bank, Barclays, and Credit Suisse have reportedly declined to advise or represent potential buyers for the Freedom Group and/or Cerberus following recommendations from their the reputational risk committees,¹⁵ highlighting the financial (liquidity) risk of significant equity stakes in firearms manufacturers.

Conclusion and Implications for Investors

The tragedy at Newtown has reinvigorated the national debate over gun control and has heightened investor awareness of the risks of investing in firearms. Investor reflection on the risks and ethics of investing in firearms has fueled a major divestment campaign, while major legislation looms large over the industry.

Parallels have been drawn between similar divestment campaigns, most notably the campaign surrounding South African apartheid in the 1980s and tobacco companies in the 1990s. However, important differences exist between the current firearms debate and the divestment campaigns of the past, not the least of which is that the right to bear arms is constitutionally enshrined via the Second Amendment. Also unlike the tobacco industry in the 1990s, firearms manufacturers and retailers are currently protected from liability lawsuits through the PLCAA. While a number of public pension funds have announced plans to divest from firearms, others in states like Idaho and Texas, where public opinion favors protecting gun rights over gun control, do not consider investments in firearms an issue. Differing public opinion across regions and uncertainty concerning regulatory outcomes present varying levels of reputational, regulatory and financial risk for investors. Taking into account such variation, investors may consider responding to the issue of firearms by pursuing strategies that include elements of engagement and/or screening and divestment.

Important differences exist between the current firearms debate and the divestment campaigns of the past.

Engagement

Engagement may be an appropriate course of action for investors who do not regard the manufacturing



and/or retail sale of firearms as inherently problematic, but are concerned with factors such as the types of firearms that a company manufactures or the public policy positions that it advocates. Engagement is likely to be appropriate for investors and asset managers with relatively low reputational risk exposure and/or client concern.

In implementing an effective engagement strategy investors can establish formal standards concerning issues such as product lines or political involvement. Examples of formal standards can be found within the Sandy Hook Principles, which require gun manufacturers to support and promote the implementation of a universal federal background check system and to reevaluate their involvement in the sale and production of assault weapons for use by civilians. Investors should clearly communicate such standards to the relevant companies through a formal engagement process and request that the companies establish timelines for implementation and compliance.

Screening and Divestment

For investors and asset managers with moderate-to-high reputational risk exposure and/or moderate-to-high client concern, a screening and divestment strategy may be an appropriate course of action. Screening criteria may incorporate various dimensions of a company's involvement:

Type of Involvement: As discussed above, the firearms products that have generated the greatest concern and risk are assault weapons manufactured for the civilian market and ammunition for such weapons. Screening criteria may be general or may focus on the manufacturers of specific products of concern. Criteria may also distinguish between the manufacturing and retailing of firearms. For example, an investor could decide to place all companies with direct involvement in manufacture of firearms on an exclusion list but allow investment in firearms retailers.

Level of Involvement: The percentage of annual revenues that a company derives from an activity of concern can also be incorporated into screening criteria. For example, a revenue threshold screen could stipulate that a company involved in the manufacture of firearms must not obtain more than 5 per cent of its revenue from such activities, or that a retailer of firearms must not earn more than 10 per cent of its revenue from such activity.

Political Advocacy: Screening criteria can also incorporate a company's political involvement, such as efforts to influence the passing of legislation to ensure universal background checks.

At the very least, investors should be aware of any holdings that they have in companies involved in the manufacture or retail sale of firearms and be prepared to respond to client or stakeholder concerns that may pose reputational risk.

Endnotes

- ¹ "United States Gun Facts, Figures and the Law," Gunpolicy.org, accessed 30 January 2013, <http://www.gunpolicy.org/firearms/region/united-states>.
- ² Dianne Feinstein, "Assault Weapons Ban of 2013," Gunpolicy.org, accessed 30 January 2013, <http://www.feinstein.senate.gov/public/index.cfm/assault-weapons-ban-summary>.
- ³ Brad Plumer, "How the U.S. Gun Industry Became so Lucrative," The Washington Post, 19 December 2012, accessed 30 January 2013, <http://www.washingtonpost.com/blogs/wonkblog/wp/2012/12/19/seven-facts-about-the-u-s-gun-industry>.
- ⁴ Concealed carry laws allow for a permit to be obtained to carry a weapon in public in a concealed manner. Stand Your Ground laws enable the use of deadly force in self-defense. The laws have been criticized as "Shoot First" laws which allow for the use of deadly force and provide immunity for a shooter who claims that he/she felt threatened.
- ⁵ Mark Follman, "More Guns, More Mass Shootings," Mother Jones, 15 December 2012, accessed 30 January 2013, <http://www.motherjones.com/politics/2012/09/mass-shootings-investigation>.
- ⁶ "Understanding the Link Between Weak Gun Laws and Gun Violence," Law Center to Prevent Gun Violence, 14 November 2012, accessed 30 January 2013, <http://smartgunlaws.org/gun-laws-matter-2012-understanding-the-link-between-weak-laws-and-gun-violence>.
- ⁷ "U.S. Public Support for Proposals Aimed at Preventing School Shootings," Gallup Poll, 19-20 January 2013, accessed 30 January 2013, <http://www.gallup.com/poll/160085/americans-back-obama-proposals-address-gun-violence.aspx>.
- ⁸ "Gun Rights and Gun Control," Pew Research Poll, September 2010, accessed 30 January 2013, <http://www.pewresearch.org/files/old-assets/pdf/gun-control-2011.pdf>.
- ⁹ Mark Sappenfield, "Why Republicans Defy Public Opinion in Gun Control Fight," The Christian Science Monitor, 20 January 2013, accessed 30 January 2013, <http://www.csmonitor.com/USA/DC-Decoder/Decoder-Wire/2013/0120/Why-Republicans-defy-public-opinion-in-gun-control-fight>.
- ¹⁰ Brad Plumer, "How the U.S. Gun Industry."
- ¹¹ Paul Barrett, "The Big Cities' Financial War on Guns May Backfire," Bloomberg BusinessWeek, 28 January 2013, accessed 30 January 2013, <http://www.businessweek.com/articles/2013-01-28/the-big-cities-financial-war-on-guns-may-backfire>.
- ¹² Michael Cooper and Mary Williams Walsh, "Big Teachers' Fund to Sell its Gun Shares," The New York Times, 9 January 2013, accessed 30 January 2013, <http://www.nytimes.com/2013/01/10/business/california-teachers-fund-to-divest-of-gun-stock.html>.
- ¹³ Michael Cooper, "Big Teachers' Fund."
- ¹⁴ David Chen, "Teachers' Pension Fund Divests Gun Holdings," The New York Times, 15 February 2013, accessed 18 February 2013, <http://www.nytimes.com/2013/02/16/nyregion/new-york-city-teachers-pension-fund-gets-rid-of-gun-holdings.html?src=recg>.
- ¹⁵ David Welch and Cristina Alesci, "Cerberus Said to Have Struggled to Find Advisers for Gun Sale," Bloomberg, 19 January 2013, accessed 30 January 2013, <http://www.bloomberg.com/news/2013-01-18/cerberus-said-to-have-struggled-to-find-advisers-for-gun-sale.html>.

Contact Information

For more information on any of the contents of this report please feel free to contact the authors. For more information about Sustainalytics' products and services please email contact@sustainalytics.com or visit our website www.sustainalytics.com.



Zachary Paris
Client Relations Adviser
zachary.paris@sustainalytics.com



Cristian Chis
Researcher
cristian.chis@sustainalytics.com



Copyright ©2013 Sustainalytics.

All rights reserved. No part of this report may be reproduced in any manner without the expressed written consent of Sustainalytics.

This report was drafted in accordance with the agreed work to be performed and reflects the situation as on the date of the report. The information on which this report is based has – fully or partially – been derived from third parties and is therefore subject to continuous modification. Sustainalytics observes the greatest possible care in using information and drafting reports but cannot guarantee that the report is accurate and/or complete. Sustainalytics will not accept any liability for damage arising from the use of this report, other than liability for direct damage in cases of an intentional act or omission or gross negligence on the part of Sustainalytics.

Sustainalytics will not accept any form of liability for the substance of the reports, notifications or communications drafted by Sustainalytics vis-à-vis any legal entities and/or natural persons other than its direct principal who have taken cognisance of such reports, notifications or communications in any way.

Sustainalytics

www.sustainalytics.com

For general enquiries:

contact@sustainalytics.com



Amsterdam | Bogotá | Boston | Brussels | Bucharest | Copenhagen | Frankfurt | London | Paris | San Francisco | Singapore | Timisoara | Toronto

