

## **Social Investing: Pension Plans Should Just Say "No"**

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Prepared for Conference on  
Costs and Benefits: "Socially Responsible" Investing and Pension Funds  
The American Enterprise Institute  
Washington, DC  
June 7, 2004

\*The authors would like to thank James Lee and Kristen Richards for excellent research assistance.

This conference explores the impact of “socially responsible” investing on private and public pension funds and Social Security. Social investing takes three primary forms – screening (either excluding “bad” companies or including “good” companies”), shareholder advocacy, and community investing. By far the most prevalent form is screening – generally negative screens whereby the sponsor excludes firms involved with tobacco, alcohol, or some other undesirable activity. After decades of avoiding social investing, public pension funds are increasingly considering one or more of these approaches. This paper argues that current social investing initiatives are generally not effective and, even if they were, public plans should not engage in any form of social investing, and while private plans have more leeway, they should not be sacrificing returns for social considerations.

More specifically, the paper makes the following points. First, negative social screens to rid portfolios of “sin” stocks probably accomplish nothing in terms of their impact on the targeted firm, as long as the marginal investor is available to purchase the stock. Second, if done perfectly – full diversification and no politics – social investing is probably close to costless in terms of returns to shareholders. Some analysts argue that losses may arise under some types of investment models, and others argue that social investing actually produces higher returns. But for discussion purposes, careful social screening probably costs zero. Third, with zero benefits and zero costs, social investing is probably fine in situations where the stakeholder and the decision maker are the same, and no politics are involved. That is, if wealthy individuals want to screen out tobacco companies, that is fine. But public pensions are institutions where the decision makers and the stakeholders are very different. Public plans have also in the past made striking errors when integrating social considerations into their investment decisions. In the case of private plans, the stakeholders and decision makers may be the same, suggesting that negative social screens, which are generally costless, are probably fine. But private plans should not engage in investments that sacrifice returns for social considerations.

## **I. What Is Social Investing and How Much Is Going On?**

Today's social investing movement began with efforts to screen out "sin" stocks – tobacco, alcohol, and gambling. Avoidance screening was extended in the early 1970s when Pax World Fund created a mutual fund that excluded weapons contractors as a way for investors to signal opposition to the Vietnam War and militarism in general. Social investing took off in the early 1980s, in the wake of a major campaign to encourage pension funds and others to divest investments in corporations doing business in apartheid South Africa. Positive screens for firms with good records on labor relations, employment policies, or the environment are a more recent development. Shareholder advocacy also has more recent roots and involves communication between the investor and the company – either directly or through proxy voting – on social and corporate governance issues. Community investment was an early form of social investing but one that has not grown significantly. It involves channelling capital to entities that are perceived to be underserved, such as local housing markets, small businesses, employers of union labor, or community agencies.

The size and importance of the social investment movement depends on how the phenomenon is defined. The Social Investment Forum (SIF), a trade group of social investors, reports that at the end of 2003, mutual funds with social screens held \$151 billion. Table 1 presents the individual funds that are available to the public – that is, excluding union and other client-restricted institutions – by the various sponsoring organizations.<sup>1</sup> The largest of these organizations was American Funds with \$55 billion, consisting of Washington Investors Mutual Fund with \$46 billion and American Funds Mutual Fund. The website description says that these funds "may not invest in

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<sup>1</sup> The largest funds omitted from Table 1 are as follows: 1) The Boilermakers' Co-Generation and Infrastructure Fund: Project Finance (\$6.8 billion), which co-invests in the construction of power generation plants that are then leased or sold to independent power producers, industrial companies, or the government. The Boilermakers & Blacksmiths National Pension Trust is the sole investor in the Fund. 2) The Longview Collective Investment Fund (\$5.4 billion), which is sponsored by the Amalgamated Bank, an institution that provides trust, investment advisory, custodial, and benefits remittance services for Taft-Hartley and public sector employee benefit plans. 3) The Multi-Employer Property Trust Fund, which is an open-end equity real estate fund comprised of 241 multi-employer and public employee pension plans that invests in high-quality, income producing office buildings, warehouses, flex/R&D facilities, retail centers, hotels, and apartments. 4) The AFL-CIO Housing Investment Trust Fund (\$3.4 billion), which is a pooled pension fund that invests in affordable housing developments throughout the U.S..

companies that derive their primary revenues from alcohol or tobacco.” The other large funds shown in Table 1 also tend to screen for alcohol and tobacco.

Table 1. *Institutions with Socially Screened Mutual Funds Totaling More than \$1 Billion, December 2003*  
(Billions)

<i>Institution</i>	<i>Assets</i>
American Funds	\$55.1
AARP	11.4
Pioneer Investments	9.3
TIAA-CREF	4.5
KDL Research and Analytics, Inc	4.5
Scudder Investments	4.4
Baron Funds	4.0
Thrivent Financial Management, Inc	3.0
Ariel Corporation	2.7
Third Avenue Management, LLC	2.4
Calvert Group	1.9
New Covenant Funds	1.6
Pax World Funds	1.3
Domini Social Investments	1.2
PIMCO	1.0
Total	108.1
Share of all socially screened mutual funds	71.6%

Source: Social Investment Forum, *Report on Socially Responsible Investing Trends in the United States*, 2003.

Note: Union and other client-restricted institutions not included.

Taking the SIF numbers at face value, the total number of mutual funds with social screens account for 3 percent of the non-money market mutual fund industry.<sup>2</sup> But we have some concerns about the numbers reported. For example, one of the union funds we discuss later in the paper, the Boilermakers’ Co-Generation and Infrastructure Fund : Project Finance, is reported by SIF to hold \$6.8 billion. But, in fact, the Project Finance Fund amounts to only \$300 million, and the rest of the \$6.8 billion is not invested with

<sup>2</sup> The Federal Reserve’s Flow of Funds reports that mutual fund assets, excluding money market mutual funds, totaled \$4.9 trillion in the fourth quarter of 2003.

any social screens.<sup>3</sup> Hence, the SIF numbers appear to overstate the importance of social investing in the mutual fund industry, and the total is likely less than 3 percent.

The other way that SIF measures social investing is a list of so-called “separate accounts,” which includes those institutions that take social considerations into account when making their investment decisions. Specifically, it is supposed to include all assets that are “screened, involved in shareholder advocacy, or are directed to community investing.” We looked closely at two Boston entities on the list – Boston College and State Street Global Advisers.

Boston College, which has an endowment of about \$1 billion, does not screen for anything. The university has a one-page directive, prepared in 1981, that says it will look at moral as well as financial aspects of its investment decisions. Boston College did participate in the 1980s and early 1990s in the boycott of firms doing business in South Africa, but it has not screened a single industry, divested a single stock, or voted a single proxy in the last 10 years. Boston College officials suspect that they are on the list because they subscribe to the services of the Investor Responsibility Research Center (IRRC). Boston College has a small portfolio, however, so any overstatement may not be serious. The treatment of State Street Global Advisers, which has \$1.1 trillion under management and screens \$90 billion, seems appropriate.<sup>4</sup> Conceptually SIF includes only the \$90 billion, and in fact reduces the total to avoid double counting funds reported elsewhere. When SIF adds up all the assets of the religious organizations, universities, hospitals, foundations, and public pension plans on the list, it reports \$2.0 trillion in socially invested separate accounts –10.4 percent of the \$19.2 trillion in assets under financial management (Table 2).

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<sup>3</sup>Alisa Gravitz from the Social Investment Forum maintains that the reporting error for the Boilermakers’ investments is simply one of labeling—claiming that, in fact, the entire Boilermakers’ National Trust Fund is socially invested. However, conversations with Mario Rodriguez, the Chief Investment Officer of the Boilermakers’ Pension funds, contradict the SIF claim. When asked about SIF’s claim that the entire fund is socially invested, Mario Rodriguez responded, “The SIF info is incorrect.”

<sup>4</sup>SSGA has socially screened portfolios in nearly every asset class including passive and active funds, U.S. and non-U.S. portfolios, small cap equity, fixed income and cash portfolios. Although most of this money is screened for tobacco, SSGA has many accounts with a wider variety of screens. One actively managed fund with about \$300 million screens on a broad array of social concerns, including alcohol, tobacco, gaming, and weapons. It also has an environmental and human rights screen, and separate proxy voting.

Table 2. Socially Invested Portfolios, 2003  
(Billions)

Year	Mutual Funds	Separate Accounts	Total
1999	\$154	\$1,343	\$1,497
2001	136	1,870	2,006
2003	151	1,992	2,143

Source: Social Investment Forum. 2003. 2003 Report on Socially Responsible Investing Trends in the United States.

Our view is that such a percentage overstates the amount invested socially, because it categorizes the full assets of a fund or institution that screens for a single product as social investing. Such an approach may be appropriate in terms of marketing social investing products. That is, if an institution screens for, say, tobacco, it is clearly open to the notion of screening for other products or perhaps investing in a screened mutual fund. But in terms of its impact on financial markets, including the entire portfolio seems excessive. If an entity with a \$10 billion portfolio screens for only, say, tobacco, which accounts for about 1 percent of the capitalization of the Standard and Poor's 500 (Table 3), one could argue that only \$0.1 billion is being re-directed because of social considerations. On the other hand, the full \$300 million of the Boilermakers' Co-Generation and Infrastructure Fund: Project Finance should probably be included. This fund supports union employment, and therefore falls into the "community investing" component of social investing, by co-investing in the construction of power generation plants that are then leased or sold to independent power producers, industrial companies, or the government. The measurement problem arises because social investing is treated as a dichotomous activity for classification purposes, and generally it is not. In terms of its impact on financial markets, social investing therefore involves significantly less than the 10 percent figure reported by the SIF.

Table 3. “Sin” Stocks as a Share of the Standard & Poor’s 500, year end 2003  
(Billions)

Company	Market Capitalization	Percent of S&P
Defense Contractor	\$142.1	1.38
Tobacco	126.7	1.23
Alcohol	50.4	0.49
Casinos/Gaming	17.8	0.17
Total S&P 500	\$10,285.5	

Source: Appendix Table A-1.

Although the SIF data probably exaggerate the extent of social investing, they provide a unique source of information on the typical approach to incorporating social considerations into investment decisions. As shown in Table 4, in terms of assets under management, screening is by far the most prevalent approach. Only about one fifth of that amount is involved in shareholder advocacy, and community investing activity is tiny.

Table 4. Social Investing in the U.S. by Type of Strategy, 2003  
(Billions)

Strategy	Amount
Screening	\$2,143
Shareholder advocacy	448
(Both screening and advocacy) <sup>a</sup>	(441)
Community investing	14
Total	2,164

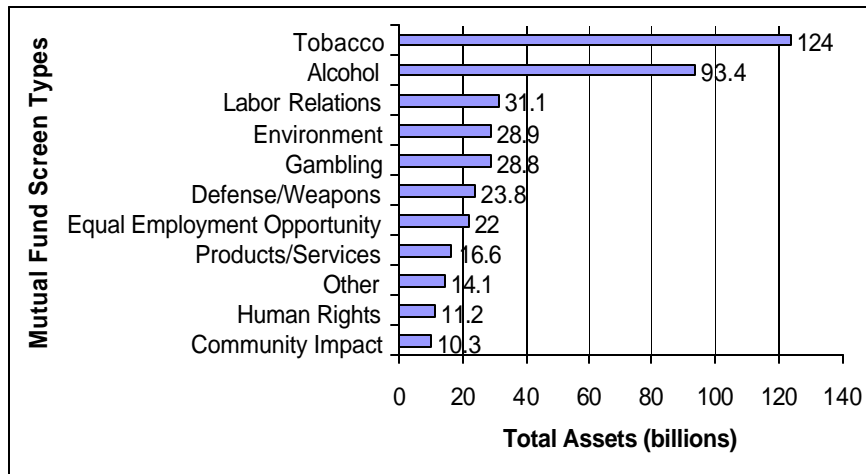
Source: Social Investment Forum. 2003 Report on Socially Responsible Investing Trends in the United States [http://www.ici.org/stats/latest/trends\\_12\\_03.html#TopOfPage](http://www.ici.org/stats/latest/trends_12_03.html#TopOfPage)

a. Some social investing involves both screening and shareholder advocacy, and these amounts are subtracted to avoid double counting.

In terms of the type of social screens applied, SIF provides information only for mutual funds; no comparable data are provided for separate accounts. By far the most popular mutual fund approach to social investing is a negative screen for tobacco; alcohol comes in second (Figure 1). The majority of funds (64 percent) use a single screen; the

remainder are equally divided between those with 2 to 4 screens (18 percent) and those with 5 or more screens (18 percent).<sup>5</sup>

Figure 1. *Mutual Fund Screen Types, 2003*



Source: Social Investment Forum. 2003 Report on Socially Responsible Investing Trends in the United States.

Having a clear idea of the extent of social investing activity is important to the subsequent analysis, because the nature of the social investing and the magnitudes matter. The thrust of the following argument is that negative social screens – the most prevalent form of social investing – most likely have zero financial impact on the targeted firms. At the same time, they probably cost investors little in terms of lower returns. The zero impact-zero cost conclusion rests on the assumption that socially invested assets are a relatively small share of the market, which appears to be true.

## II. How Does Social Investing Affect Companies?

Is the goal of social investing simply to make a statement against, say, tobacco or for, say, the environment? Or do socially conscious investors think that they are going to affect the financial fate of the targeted firm? The SIF Report suggests that social investing will have a financial impact; social investors are putting their money to work in ways that will build “a better, more just, and sustainable economy.” The textbooks suggest the opposite; boycotting a stock is unlikely to have any impact on its price, because the demand for a company’s stock is almost perfectly elastic. A couple of

<sup>5</sup> Social Investment Forum (2003).

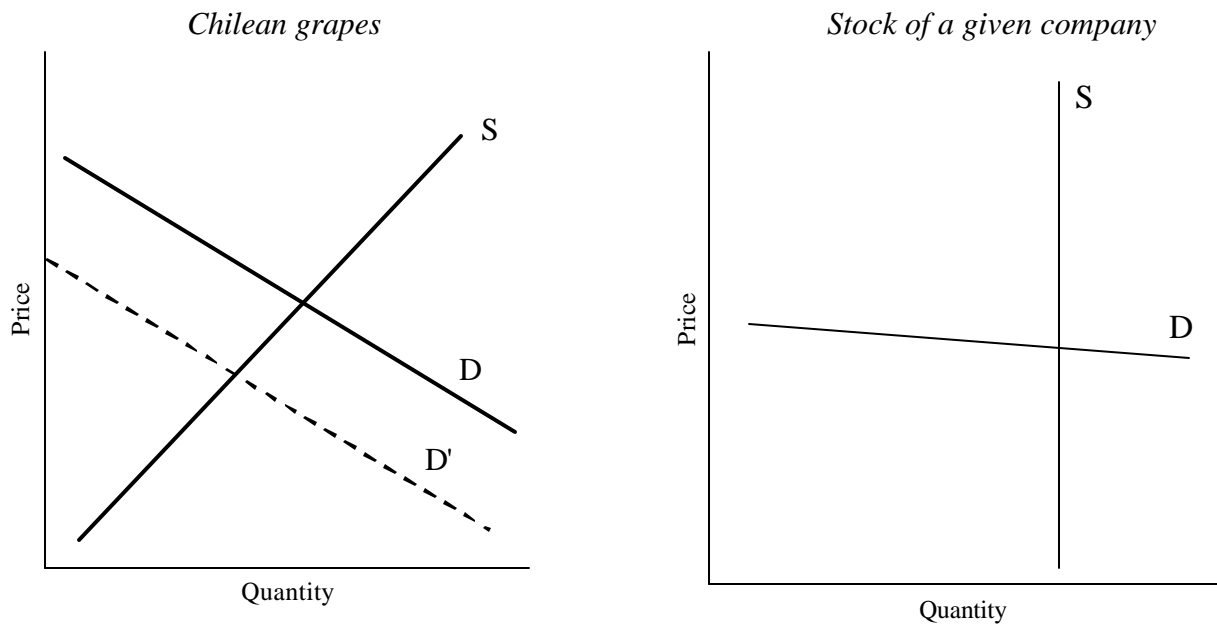
studies suggest that the demand curve may be less than perfectly elastic, but these studies are looking at sales and purchases that dwarf those involved in social investing. And a comprehensive survey on the effect of South African boycott – the largest and most visible social action – documents virtually no effect, suggesting the real world mirrors the textbook model.

*The Textbook Argument.* According to standard finance theory, the price of a stock equals the present discounted value of expected future cash flows. Any significant deviation from the fundamental price would represent a profitable trading opportunity that market participants would quickly exploit and thus correct. As a result the demand curve for a stock should be almost perfectly horizontal, and investors should be able to buy and sell large blocks of stock without having a meaningful effect on the price. The shape of the demand curve is an issue whose importance goes well beyond social investing. Several of the basic propositions in finance rely on the ability of investors to buy any amount of a firm's equity without affecting the price.

Thus, the textbooks say that the demand curve for a stock looks very different from the demand curve for, say, Chilean grapes – an item that consumers boycotted in the early 1970s to protest the coup by General Pinochet. The demand curve for Chilean grapes has a relatively steep slope, so a consumer boycott of the product, which shifts the demand curve to the left results in less grapes sold and a lower price, assuming an upward sloping supply curve (Figure 2). The action hurts Chilean grape growers and the Chilean economy.

In contrast, the demand curve for stocks is essentially horizontal. (The supply curve is vertical since in the short run the supply of outstanding stock is fixed.) That is, in economists' terms, the demand curve is almost perfectly elastic. Elasticity measures the percentage change in the quantity demanded for each percentage change in price. If an item is relatively unique and has few close substitutes, the demand curve will be steep and less elastic. In contrast, if an item – such as the stock of a particular firm – has a lot of close substitutes, the demand curve will be relatively flat and more elastic. That is, a small change in price will lead to a big change in the quantity demanded. Or conversely, a big change in quantity demanded will lead to a small change in price.

Figure 2. Supply and Demand of Chilean grapes and the stock of a given company



The caveat is, of course, that potential buyers must not think the sale (purchase) reflects a negative (positive) assessment of the firm's financial condition or business prospects that could affect future cash flows. If potential purchasers believe that the seller is disposing of the stock because he knows something adverse they do not, they will revise down their assessment of the stock's value, and the transaction will reduce the price of the stock. Thus, asymmetric information can generate steep demand curves where the purchase or sale of a stock is construed by others as a good or bad news about future cash flows.<sup>6</sup> But if the transaction is not perceived to be based on new information, the demand curve for a stock should be virtually horizontal and the price unaffected by any sale or purchase.

In short, the price of the stock is equal to the present discounted value of future cash flows. Boycotting tobacco stocks may result in a temporary fall in the stock price, but as long as some buyers remain they can swoop in, purchase the stock, and make money. Thus, the textbooks suggest that boycotting tobacco companies is unlikely to have any impact on the prices of their stocks.

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<sup>6</sup> Grossman and Stiglitz (1980) and Kyle (1985).

*Counter Examples.* Because of the importance of a horizontal demand curve to much of financial theory, researchers have undertaken a number of studies to test it directly. At first, testing whether the demand curve for stocks is horizontal seems easy – simply look at instances when buyers or sellers have traded large blocks of stocks and see whether the price changed. A number of early studies took this approach and found significant price movements.<sup>7</sup> But the evidence is also consistent with the hypothesis that the sales or purchases reflected either bad or good news about the stock price. The challenge, therefore, is to find an event where the buying or selling has nothing to do with new information about the underlying value of the stock.

One such event is the addition or deletion of stocks from widely tracked stock indexes, and researchers have exploited this natural experiment. The first of these studies, which appeared in 1986, examined the change in stock prices when the S&P 500 announced it was going to add a company to the index.<sup>8</sup> From 1966 to 1986, between 5 and 35 companies were removed from the S&P 500 each year, usually as a result of takeovers. When the S&P removes a stock, it usually replaces it with another. In response, index funds usually purchase the new additions so that they can mimic the return on the S&P for their institutional clients. All six criteria for inclusion in the S&P 500 – size, industry classification, capitalization, trading volume, emerging companies or industries, and responsiveness of the stock price to changes in industry economics – are well known, and none pertains to the future performance of the firm. Nevertheless, this event study revealed that for the period 1976-1983, the announcement of inclusion in the S&P 500 was accompanied by a 3 percent capital gain, most of which persisted for ten or twenty trading days. The study provided no information on what happened after 20 days. Several other papers have followed this approach and found somewhat larger price effects (about 15 percent) around S&P 500 index changes, most likely reflecting the growing popularity of indexing from about 3 percent of the market in the mid 1980s to 10 percent today.<sup>9</sup>

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<sup>7</sup> One group of researchers looked at large block trades (Scholes (1972) and Holthausen and Leftwich (1987)), and another at seasoned equity offerings (Loderer, Cooney, and van Drunen (1991)). Except for the early study by Scholes, these papers typically found price effects, but in each study it was not easy to control for the information conveyed by the event.

<sup>8</sup> Shleifer (1986).

<sup>9</sup> Lynch and Mendenhall (1997) and Morck and Young (2001).

Two points merit consideration before applying these results to social investing. First, the magnitudes are very large. The index funds buy as much as 10 percent of the company's stock within a day or two of the announcement, and we believe social investing amounts to only a fraction of that amount and does not occur instantaneously. Second, the experiment is far from perfect because addition to the S&P 500 may have implications for liquidity, the investor base, and financial health, which in turn affect prices.

**Increased Liquidity:** Stocks in the S&P 500 are generally more liquid than those not in the index, probably due to the fact that they tend to be bigger companies, enjoy a large pool of investors, and have a lot of information disseminated about them.<sup>10</sup> The liquidity is reflected in greater trading volume and smaller bid-ask spreads for S&P stocks than for the rest of the market. It would be rational for investors to pay a premium for liquidity because it reduces the likelihood of any adverse price impact when they sell the stock. If investors had been anticipating an adverse price impact from selling a less liquid, non-S&P-index stock, then a liquidity premium could be capitalized into the price when the stock was added to the index. The effect could be significant.

**Enlarged Investor Base:** Another reason that the addition of a stock to the S&P 500 might result in a price increase is a model that suggests, in equilibrium, an increase in the relative size of a firm's investor base reduces its cost of capital and therefore increases expected future cash flows.<sup>11</sup> To the extent that the model holds true, adding a stock to the S&P 500 could increase its visibility to investors, make information more widely available, and open the stock to investors who might be limited to the S&P 500. The effect here is likely to be relatively small, however.<sup>12</sup> For example, one researcher, who attempted to quantify the predictions of this model, concluded that if 50 percent of investors do not hold a stock – that is, if the investor base is cut in half – the cost of capital for a company that constitutes 1 percent of a market portfolio will increase by 32 basis points.<sup>13</sup>

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<sup>10</sup> This discussion comes from Petajisto (2003).

<sup>11</sup> Merton (1987)

<sup>12</sup> Merton (1987) clearly states that the effect of his analyses is “likely to be most important for smaller and lesser-known firms.”

<sup>13</sup> Angel and Rivoli (1997).

Endorsement Effect: One could argue that the S&P 500 does not want to add a stock of a company that will shortly go bankrupt, in which case inclusion might have some informational value. Although the S&P explicitly states that inclusion in the index should not be construed as investment advice, it could still convey some positive information about the reliability of the firm. In this case, the endorsement effect that accompanies the addition of a stock to the index would be expected to have a positive impact on its price.

In short, while the S&P studies suggest that the demand curve may be downward sloping, other factors – liquidity, investor base, and endorsement – could also explain the price response. Moreover, the magnitudes are enormous; index managers now account for 10 percent of the market. With that caveat in mind, it is useful to look at the findings from a study of the most visible and successful instance of social investing – the boycott to end the Apartheid in South Africa.

*South African Boycott.* A 1999 study took a comprehensive look at how equity prices responded to sanctions and pressures for firms to divest their holdings in South Africa.<sup>14</sup> The conclusion that emerges from a series of event studies is that the anti-apartheid shareholder and legislative boycotts had no negative effect on the valuation of banks or corporations with South African operations or on the South African financial markets. This is not to say that the boycott was not important politically, but merely that it did not impact financial markets. The study is organized around the sources of pressure for U.S. firms to divest: 1) congressional action; 2) pension funds and universities; and 3) the individual companies themselves.

The bulk of the congressional action occurred in 1985 and 1986, when the U.S. government passed legislation imposing trade embargoes, currency sanctions, and lending restrictions. Most importantly, the Comprehensive Anti-Apartheid Act of 1986 prohibited new private or public loans to South Africa other than for humanitarian purposes. To test the impact of this prohibition, the study identified ten important legislative events leading up to the 1986 Act and examined their impact on a portfolio of nine banks with South African loans. The results showed few significant effects on bank stock prices and where significant they were of the wrong sign.

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<sup>14</sup> Hong, Welch, and Wazzan (1999).

The purpose of the 1986 legislation was not to hurt U.S. banks, however, but rather the South African economy. Therefore, the study then looked at the impact of the legislative events on 1) the largest South African firm, Anglo-American; 2) two stock-based indexes, the Johannesburg Stock Exchange Gold Index and Industrial Index; and 3) the dollar/rand exchange rate. The effect on Anglo-American was significant in four cases, but the stock price increased rather than declined in response to the legislative events. Similarly, the gold index responded positively for three of the dates, but again the sign was positive. The exchange rate responded negatively, the expected response, to one House vote but no other impact was evident. Thus, the U.S. legislative initiatives had no impact on a portfolio of banks or on the South African financial markets.

Pension funds and universities also put pressure on corporations. Pension fund involvement in the South African issue began when a number of churches threatened to divest from banks doing business in South Africa. In 1977, the first iteration of the “Sullivan principles,” which called for non-segregation of races and equal pay for equal work, was adopted in the hope that by adhering to these principles, companies could continue doing business in South Africa and at the same time promote non-discrimination policies.<sup>15</sup> But many felt that the Sullivan principles did not go far enough, and in the wake of the continued controversy, Reverend Sullivan called in 1987 for companies to withdraw completely from South Africa. Many funds began to divest themselves even of companies that had followed these principles. For example, CalPERS divested itself of \$9.5 billion worth of shares of companies holding a South African subsidiary. Pressure to divest and a worsening economic and political environment in South Africa led many companies (IBM, Exxon, Ford, GM and Chrysler) to sell their holdings.

The study looked at the effect of 16 pension fund divestments on a portfolio of firms with the highest exposure in South Africa. The results showed no evidence that the pension fund divestment announcements hurt firms with major South African operations. But perhaps the divestment hurt the South African financial markets. Again, the

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<sup>15</sup> During the 1970s, as opposition against the apartheid government increased, social activists charged that companies investing in South Africa indirectly supported the government and its discrimination policies. In an initial effort to resolve the conflict, the Reverend Leon Sullivan in 1977 introduced a set of guidelines for companies doing business in South Africa, the so-called “Sullivan Principles.” By 1987, 127 U.S. companies had signed onto the Sullivan principles (Auerbach, 1987).

divestments taken individually or together did not affect any of the South African financial indexes. The study also explored how pension funds and other institutional holders of stocks responded to the divestment announcements. Here, there was some mild evidence that institutional investors withdrew from pension funds before their divestiture announcement and returned when these companies announced their divestment.

But what happened to the stock price of the individual companies? Three hypotheses are possible. 1) Political or social preferences are an additional attribute in investors' evaluation of stocks. In this case, the demand curve would be downward sloping and regaining the approval of social activists – enlarging the investor base – would increase the firm's share price. 2) Alternatively, social activism by forcing firms to leave South Africa causes them to forego profitable investments and lowers their share price. 3) Divestment has no impact either because the two previous hypotheses balance or because the event is simply not that important. The study looked at the stock price effect of divestiture for 46 firms, and found that the firms were neither positively nor negatively affected by the divestment announcement. Moreover, the no-effect result was not due to offsetting positive and negative effects. The likely explanation is that the boycott reallocated shares and operations from "socially responsible" investors to indifferent investors and countries. This finding is consistent with the assumption that the demand curves for stocks are highly elastic and so have little downward slope.

In short, financial textbooks characterize the demand curves for individual stock as infinitely elastic. This is a crucial assumption for much of financial theory. Because of its importance, researchers have undertaken a number of studies to test the hypothesis directly. A few suggest that the curve may be less than perfectly horizontal and that changes in quantity demanded could affect the price. But other factors could be at play, and the results depend both in theory and practice on the magnitude of the change and the size of the firms involved. The fact that an effort as large of the boycott of firms doing business in South Africa had virtually no effect on stock prices suggests that the financial effect of social investing on target firms is roughly zero.

### III. How Does Social Investing Affect Shareholder Returns?

But does social investing affect returns to shareholders? Theoretical models of portfolio choice imply that restricting the portfolio to socially responsible investments could have a negative effect on the rate of return by limiting the ability to diversify. Given the large number of stocks available, however, the cost – using traditional asset pricing models – is likely to be negligible. The bulk of the studies, which compare risk-adjusted returns for socially screened portfolios to those of unrestricted portfolios, supports this claim.

*Theory.* Modern portfolio theory states that investors should diversify their asset holdings over a variety of securities. The gains of diversification build on the idea that the returns on all financial assets do not move in lockstep. An asset can be characterized by its expected return and the risk associated with that return, measured by the variance in returns. The risk of a specific asset can be broken down in two parts: risks that are unique to that stock (firm risk) and risks that stem from market-wide variations such as business cycle variation, inflation, and interest rate fluctuations (market risk).

When assets are combined in a portfolio, the return on the overall portfolio is given by the average return of the assets. And the risk associated with the portfolio is determined by the variance of the individual returns and the degree to which the individual returns vary together (covariance). Thus, by combining assets into a portfolio that have differing risk characteristics, an investor can create an efficient portfolio – a portfolio that is expected to achieve a given level of expected returns while minimizing risk.<sup>16</sup>

How many securities are needed for the portfolio to be efficient? Suppose an investor plans to divide his money among  $n$  stocks. The portfolio variance is given by:<sup>17</sup>

$$\text{Portfolio variance} = 1/n * \text{average variance} + (1 - 1/n) * \text{average covariance}$$

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<sup>16</sup>All the portfolios on the efficient frontier involve some risk and investors may also want to include some risk-free investment such as Treasury Bills in their portfolios.

<sup>17</sup>Brealey and Myers (1988).

As the number of securities in the portfolio increases, the contribution to total risk from the individual firm-specific risk decreases and the contribution from how the risks vary in relation to each other (covariance) increases. Thus, as the number of securities increases, the overall portfolio variance approaches the economy-wide risk, represented by the second term in the equation. With 2 stocks in the portfolio, half of the overall variance is due to firm specific risk and half to market risk. By the time a portfolio contains 10 securities, 90 percent of the portfolio's variance should be determined by the market risk. With a 20 stock portfolio, 95 percent of the variance should be determined by the overall market risk.

Social investing implies that investments are based on considerations other than the trade off between risk and return. Portfolio choice is restricted by excluding "bad" companies or – less frequently – by including only companies that are following socially responsible policies. Screening securities could make it more difficult to achieve an efficient portfolio. But because an investor needs only 20-30 stocks to construct a fully diversified portfolio, the cost of a carefully screened portfolio is most likely zero. Eliminating tobacco stocks, for example, leaves enough securities to construct a market index, or conversely, it is possible to put together an efficient portfolio from the full supply of socially responsible funds and companies.

*Evidence.* In the early days of social investing, studies pointed to the South Africa divestiture and argued that screening out stocks meant large losses. For example, in the 1970s Princeton University reported that the stocks that had been excluded because of South Africa ties outperformed other holdings by 3 percent.<sup>18</sup> As time passed and researchers undertook more comprehensive studies, the conclusions shifted. For example, one study examined the performance of a South-Africa free portfolio compared to an unscreened NYSE portfolio for the period 1960-1983 and found that, after adjusting for risk, the portfolio excluding South Africa companies actually performed better than the unscreened portfolio.<sup>19</sup> The positive results occurred because companies with South Africa ties were large and excluding these companies increased reliance on small-cap stocks, which performed better on a risk-adjusted basis during this period. After

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<sup>18</sup> Malkiel (1991).

<sup>19</sup> Grossman and Sharpe (1986).

adjusting for the size effect, the study concluded that effect on performance of the divestiture was negligible. During the late 1980s, the results were more mixed. On the one hand, the S&P 500 including South Africa stocks performed slightly better than the index without the stocks, and one study of public pension plans found that South Africa restrictions had a small negative effect on returns.<sup>20</sup> On the other hand, in a 1998 study we analyzed data from the Surveys of State and Local Employees (PENDAT) from the early 1990s and found no significant effect on returns from restrictions on South Africa investments.<sup>21</sup> Thus, taking the period of the South Africa action as a whole, the conclusion is that it had a negligible effect on returns.

In addition to the South Africa studies, other research has compared the risk-adjusted return of screened portfolios to the return of unscreened portfolios, while controlling for other factors such as firm size and industry effects. Most of the studies cover the period since the mid 1980s. Overall, the results show that the differences in risk-adjusted returns between the screened portfolios and unscreened portfolios are negligible and in most cases zero.<sup>22</sup> A few studies have focused on the effects of divestiture of tobacco stocks in the 1990s and show that the risk and returns for the S&P 500 with and without tobacco stocks were almost identical.<sup>23</sup>

In addition to comparing the performance of screened portfolios to the S&P 500, several studies have examined the performance of social investment funds, such as those constructed by Domini and Calvert, relative to the S&P 500. The Domini Social Index includes 400 U.S. companies that pass multiple and broad-based social screens, and the Calvert Social Index is a broad-based index including 659 companies. The majority of these studies show that socially screened funds have no significant effect on risk-adjusted returns.<sup>24</sup> A few researchers have found that for sub-periods, the Domini Index

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<sup>20</sup> Romano (1993).

<sup>21</sup> Munnell and Sundén (1999).

<sup>22</sup> Guerard (1997), Hamilton, Jo, and Statman (1993), Statman (2000), Bauer et al. (2002), Dhrymes (1998), Stone et al (forthcoming). A similar result has been found for bond portfolios (D'Antonio, Johnsen and Hutton 1997).

<sup>23</sup> DiBartolomeo (2002). In the late 1980s and early 1990s tobacco stocks performed slightly better than the S&P 500 but during the second half of the 1990s the tobacco stocks underperformed the S&P 500 on a risk-adjusted basis (Social Investment Forum 1999 and Ferrari 2000). However, the overall effect of divesting tobacco stocks should be small because tobacco stocks only account for about 1 percent of the S&P 500.

<sup>24</sup> Kurtz and DiBartolomeo (1996), DiBartolomeo and Kurtz (1999) and DiBartolomeo (1996)

performed slightly better after controlling for market risk, size, and industry.<sup>25</sup> But the overall evidence supports the theory that the cost of carefully screened social portfolio is zero.

A recent study challenges this view. The theoretical model for portfolio choice underlying the literature described above is the capital asset pricing model (CAPM). Since the development of the CAPM, alternative asset pricing models have emerged that associate returns with several independent influences or “factors.”<sup>26</sup> Furthermore, portfolio models do not say anything about how the skill of fund managers may affect returns and thereby the cost of social investing. The new study claims that both these considerations – the assumption regarding the asset-pricing model and one’s belief in the skills of fund managers – could affect the cost of social investing.<sup>27</sup>

The new study compares the risk-adjusted rate of return over the period 1963-2001 of portfolios consisting of socially invested mutual funds to an unconstrained optimal portfolio. Investors are assumed to make their investment decisions based on the historical returns of the funds combined with their perceptions about the usefulness of various asset-pricing models and the skills of fund managers. The optimal portfolio was constructed for the same range of beliefs about asset pricing and manager skill.

First, a portfolio invested only in socially responsible funds was compared to an unconstrained portfolio for an investor who believes in the CAPM and does not believe in fund managers’ skills. The optimal strategy for such an investor is to choose a portfolio that closely tracks the market index. Restricting the portfolio to socially responsible funds means that this investor simply chooses socially screened index funds where the returns mimic those of index funds without social screens. As a result, the cost in terms of reduced risk-adjusted returns is negligible; the socially screened portfolio earns only a few basis points less per month.

If the CAPM investor allows for the possibility that mutual fund managers may be skillful in implementing active strategies, the cost of following a socially responsible investment strategy increases. In this case, the investor abandons the passive investment

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<sup>25</sup> Statman (2000), Luck and Pilotte (1993)

<sup>26</sup> These models states that portfolios are good substitutes if their exposure to the “factors” are equivalent and the portfolios are large enough to diversify away idiosyncratic risk.

<sup>27</sup> Geczy, Stambaugh, and Levin (2003).

strategy by shifting from a diversified index-style portfolio to an actively managed portfolio. The study found that this strategy increased the difference in returns between the unrestricted portfolio and the socially screened portfolio, and that the magnitude depended on how much faith the investor put in the managers' skills. For investors who believed in a 10 percent probability that a manager would add at least about 3.5 percent to performance, the cost of social investing was significant (about 99 basis points per month).

The study also examined the costs of social investing if investors' investment strategies were based on asset pricing models other than CAPM. These alternative models imply optimal investment strategies that are quite different from the market-index tracking in the CAPM. As a result, the cost of restricting the portfolio to socially responsible funds when skill is precluded was about 31 basis points per month compared to only a few basis points in the case of the CAPM. Alternative asset-pricing models raise the cost because it is more difficult to construct a socially responsible portfolio that mimics the optimal portfolio.

Critics of the new study argue that other factors explain the results. The optimal portfolio under the alternative asset pricing models included stocks concentrated in certain sectors that have performed very well over the past few years. The socially responsible funds, on the other hand, were broad-based multi-industry funds, and the results could therefore be driven by differences in industry composition.<sup>28</sup> Furthermore, the optimal funds required large minimum investments and for this reason were not available to the average investor. Nevertheless, this study highlights the sensitivity of the "no-effect" results to the choice of the underlying investment model.

At the other extreme, some researchers claim that social investing results in higher returns because socially responsible companies are more successful than their less responsible counterparts. The argument is that policies such as the protection of the environment, good employee relations, and the promotion of product safety have positive effects on companies' performance.<sup>29</sup> For example, several studies have examined the effects of environmental policies. In one study of 243 stocks in 1991 and 1992,

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<sup>28</sup> Baltzell (2003)

<sup>29</sup> Moskowitz (1972) was one of the first to suggest that a screened portfolio may outperform an unscreened portfolio.

researchers concluded that environmental policies had a positive impact on the firms' returns after controlling for characteristics such as industry, firm size, and capital intensity.<sup>30</sup> Another study argued that good environmental management reduces firm risk and supported this argument by estimating the risk for 330 firms in the S&P 500.<sup>31</sup> Advocates of the "positive-return" hypothesis also claim that a socially responsible investment policy indicates that a company has a skillful management and contend that companies with "good" boards performed better than those with "bad" boards.<sup>32</sup> Yet, other studies look at companies that are rated "100 best to work for" and conclude that they have superior performance.<sup>33</sup>

One problem with the "positive-return" studies is that it is difficult to prove which way the causality goes. It could be that profitable companies are the ones that can afford to be "good" simply because they are doing well and that promoting socially responsible policies has no effect at all on performance. Thus, because these studies cannot distinguish between these two explanations it is not possible to conclude that socially responsible policies have a positive effect on rate of return.

Another aspect that has received less attention is the administrative costs of social investing. It is possible that social investing is associated with higher fees and therefore has lower net returns because additional resources are required by fund managers to do the screening. The 2003 SIF Report concluded that socially responsible funds appear as competitive as other funds when it comes to administrative costs. However, others challenge this view by pointing out that some of the large-cap social index funds have above-average fees.<sup>34</sup>

To sum up, the vast majority of the empirical evidence supports the theoretical argument that the impact on risk-adjusted returns of a carefully constructed socially screened portfolio is zero. Researchers have shown that social investing could have negative effects if investors believe in fund managers' skills. However, these results stem from comparing a broad-based socially screened portfolio to a portfolio investing in

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<sup>30</sup> Russo and Fouts (1998). Other studies that have also found positive effects of firms with good environmental policies include Cohen et al. (1997) and Blank and Carty (2002).

<sup>31</sup> Feldman et al. (1997).

<sup>32</sup> Waddock and Graves (1997, 1999).

<sup>33</sup> For example, Kurtz and Luck (2002).

<sup>34</sup> Hickey (2000).

only specific sectors, and therefore it is not clear that the results can be generalized. The studies that argue that socially responsible companies have higher returns because they are more successful have not been able to prove that the causality is not going the other way. Hence, the most useful assumption is that the effect of careful social investing on returns is zero, provided that it is undertaken with proper diversification and an absence of political pressure.

#### **IV. Should Pension Plans Engage in Social Investing?**

The argument regarding pension plans modifying their investment decisions to reflect social considerations consists of several tiers. First, if the decision makers and stakeholders are not the same, pension plans should not engage in social investing because tastes and incentives of the two parties are not necessarily aligned. Moreover, any deviation from maximization of return for a given level of risk is dangerous when activities are conducted in a highly political environment. These concerns make social investing particularly undesirable in public plans. Second, if the stakeholders and decision makers are the same, as is often the case with private plans, then costless – and most likely ineffective – social investing seems acceptable. But social investing that involves a sacrifice of return for other considerations should never be undertaken even by trustees of private plans. The reasons here are twofold. First, such activity may result in a significant lack of diversification on the part of plan participants. Second, the reduced return is equivalent to a tax-subsidized gift to the recipient of the invested funds, and while the tax code allows deductions for gifts to non-profit entities it has no equivalent provisions for gifts to profit-making concerns.

##### **Public Pensions**

Social investing is not a good idea for public pension funds. The decision maker and the stakeholders are not the same, and these plans have gotten into trouble in the past. Furthermore, recent stories suggest that investment policies are often still highly political. And the stakes are large. About 2,600 state and local pension funds hold about \$2 trillion for more than 20 million public employees and retirees. Assuming that most state and local plan assets belong to defined benefit plans (although a few states have added

defined contribution components), these assets exceed those held by private sector defined benefit plans (Table 5).

Table 5. Distribution of Pension Assets by Financial Instrument, Yearend 2002 (Percent)

Asset	State and local plans	Private plans	
		Defined benefit	Defined contribution
Equities	51.0	43.0	37.8
Mutual funds	--	5.4	23.0
Bonds	18.4	14.7	5.1
U.S. Gov't Sec.	18.6	14.8	3.8
Cash	2.7	9.0	2.5
GICs	--	5.0	14.5
Mortgages	1.6	0.4	0.5
Other	7.7	7.7	12.7
Total	100.0 <sup>a</sup>	100.0 <sup>a</sup>	100.0 <sup>a</sup>
Total assets (billions)	\$1963.8	\$1585.1	\$1947.5

Source: Federal Reserve Board, Flow of Funds (2003).

a. Totals may not add due to rounding.

*Stakeholders versus Decision Makers.* State and local retirement systems are overseen by retirement boards of elected, appointed, and ex-officio members. The boards typically have between five and eight members, although one third has between nine and eleven members.<sup>35</sup> In other words, investment decisions are generally made by between five and eleven people including mayors, treasurers, comptrollers, city councilors, union leaders, and citizens. Investment restrictions generally take the form of the ‘prudent person’ standard, requiring that investments be made with the “care, skill, and diligence” of a prudent individual. In some cases, the prudent person standard is supplemented by “legal lists” specifying the allowed types of investments and the maximum amount of assets that can be invested in certain securities.

Despite the restrictions, the process is often conducted behind closed doors and subject to little public scrutiny. Moreover, many state and local plans are still run in-house and involve the selection of individual stocks rather than broad-based indexes. Although our perception is that investment practices have improved a lot over the last 20 years, scandals still arise. A recent front page *New York Times* article reported that

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<sup>35</sup> Harris (2002).

political money sometimes affects pension investment decisions. In the worst cases, pension trustees dole out investments not on merit but rather on the basis of the money managers' contributions to the official's campaign. As a result, pension boards may overlook excessive fees or high rates of turnover, and they may approve inappropriate investments.<sup>36</sup> In short, the decision makers consist of a small group of people who may not reflect the will of the constituents, who operate under little scrutiny, and who may be subject to financial and political pressure.

On the other side of the pension divide are the stakeholders. These include current state and local workers, retired public employees, and tomorrow's taxpayers. The idea is that today's taxpayers make pension contributions on behalf of today's public employees to cover the cost of compensation for services provided; that is, accrued pension benefits are simply the deferred wages of public sector workers. Although states and localities could always levy taxes to cover pension benefits in the future, it is sensible to put aside money for these benefits when they are earned, so that the taxpayers who enjoy the services pay the full costs associated with the provision of those services.

These accumulated contributions to the pension fund are invested in an array of financial instruments, and the success of those investments determines the funds available to pay public sector workers when they retire. Since state and local pensions tend to be defined benefit, the amount paid to retiring workers is determined by a formula rather than by the holdings in the pension fund. Thus, to the extent that returns are inadequate, future taxpayers will have to contribute more to cover the cost of benefits. Future taxpayers are not represented on the investment boards of the public pension funds. In the extreme, current and future retirees could also lose out. While it is unlikely that their initial benefits would be cut, future legislatures facing a pension shortfall could reduce cost-of-living adjustments or cap the base to which these adjustments are applied. Current and future beneficiaries usually have only limited representation on the pension boards. Because the stakeholders are unlikely to be involved in the decision making, the investment boards of public plans should not undertake social investing. Even simple screens may well not be consistent with the interests of stakeholders.<sup>37</sup>

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<sup>36</sup> Walsh (2004).

<sup>37</sup> Furthermore, views on social investing are likely to differ within the group of stakeholders (Neale 2001).

*Lessons from Experience.* One reason to take a hard line with respect to public pensions is that they have engaged in social investing in the past and have been burned. In the late 1970s, some observers identified the large and rapidly growing funds in state and local pension plans as a mechanism for achieving socially and politically desirable objectives. The initial debate focused on attempts to exclude from pension portfolios companies with undesirable characteristics, such as those with almost totally nonunion workforces or investments in South Africa. The focus quickly shifted to undertaking pension investments that would foster social goals such as economic development and home ownership.<sup>38</sup> Advocates generally contended that the broader goals could be achieved without any loss of return.

Early reports, however, suggested that the targeting did involve sacrificing return. For example, a 1983 study of state-administered pension funds showed that 31 states had undertaken some form of targeted or social investment.<sup>39</sup> By far the most prevalent form was the purchase of publicly or privately insured mortgage-backed pass-through securities to increase the supply of mortgage funds for homeownership. Analysis of the risk/return characteristics of these targeted mortgage investments revealed that 10 states either inadvertently or deliberately sacrificed return in an attempt to foster homeownership. The sacrificed return sometimes exceeded 200 basis points. Although mortgages accounted for only 5 percent of total state and local assets, state and local pension funds were on a naïve and dangerous path.

In their initial forays into economically targeted investments, public pension fund managers generally did not appear to recognize the “Catch-22” nature of the exercise. For the most part, the goals of increasing in-state housing investment and maximizing returns are inconsistent in the United States’ highly developed capital markets. Any housing investment that offers a competitive return at an appropriate level of risk, such as a GNMA, does not need special consideration by public pension plans nor would such consideration increase the long-run supply of mortgage loans. Investments by pension funds that would increase the supply of housing funds must by definition either produce lower returns or involve greater risk. Sophisticated advocates of targeted investments

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<sup>38</sup> Two books were instrumental to broadening the social investing debate – Rifkin and Barber (1978) and Litvak (1981).

<sup>39</sup> Munnell (1983).

recognized the efficiency of the market for housing finance and argued that pension funds could make a contribution through innovative forms of housing finance.<sup>40</sup> But that was not what was going on in 1983; the in-state mortgages purchased by public pension funds tended to be conventional fixed-rate 30-year mortgages.

The losses in the early 1980s were a sharp wake-up call to a number of public pension fund managers who appeared to believe that they could accomplish social goals without sacrificing returns. Over the last 20 years the rhetoric associated with targeted investments has changed markedly. Public pension fund managers, sensitive to the potential for losses, go out of their way to make clear that they are no longer willing to sacrifice returns for social considerations; almost every definition of social investing includes a requirement that the investment produce a “market rate of return.”

In 1998, we undertook a detailed study to determine the extent to which pension funds were engaging in social investment, and the answer was “not very much.”<sup>41</sup> The study looked at all three avenues discussed above through which social or political consideration could enter the investment decision. The first was community or “economically targeted” investing, which caused such a stir in the 1980s. Three separate surveys conducted during the 1990s suggested that it accounted for a maximum of 2.5 percent of total state and local portfolios.<sup>42</sup> Pension fund managers universally agree that it is improper to sacrifice returns for social consideration, and therefore look for

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<sup>40</sup> Litvak (1981).

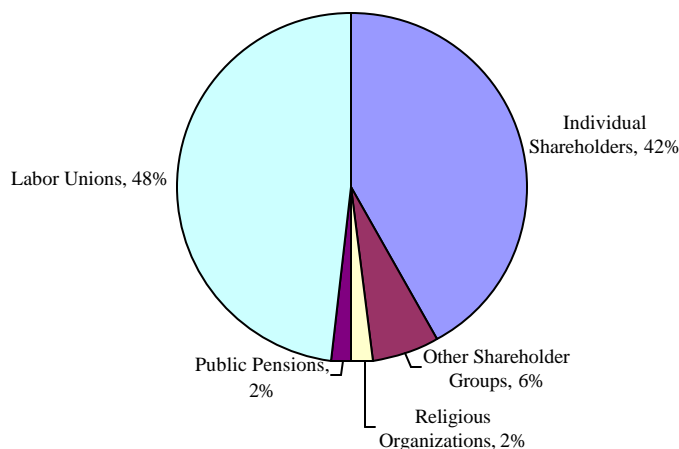
<sup>41</sup> Munnell and Sundén (1999).

<sup>42</sup> Perhaps the most comprehensive listing of economically targeted investment (ETI) activity was by the Boice Dunham Group (1993), which was commissioned by Goldman Sachs to explore whether the growth in ETI activity may have created a market for Goldman Sachs services. ETI was defined as “an investment by a public pension fund which, in addition to offering financial returns in proportion to financial risk, also offers collateral local economic benefit (e.g., job creation, home ownership).” Using this definition, Boice Dunham concluded that ETIs accounted for \$17.5 billion or 2 percent of the \$887.3 billion of assets covered by their survey (roughly 73 percent of total state and local assets). The second source of information on ETI activity comes from the Government Accounting Office (1995). Fifty of the 119 respondents to a survey indicated that they had invested a total of \$19.8 billion in ETIs to promote housing, real estate, or small business development. This amounted to 2.4 percent of total respondents’ assets. Since the respondents accounted for 85 percent of the assets of state and local plans, the results are broadly representative. At the low end in terms of identifying investments as ETIs were the Surveys of State and Local Employee Retirement Systems for Members of the Public Pension Coordinating Council (Zorn, 1991, 1993, 1995, 1997). The question included in these surveys varied slightly over time, but generally asked “What percentage of the portfolio is directed in-state for developmental purposes?” The emphasis on ‘developmental purposes’ could easily lead respondents to omit residential mortgages made at market rates and private placements—the two largest categories in the Boice Dunham study. As a result, the percentage of total assets designated for in-state investment averaged between 0.1 percent and 0.3 percent over the four surveys.

investments that offer market return and provide collateral investments. Whether this is a useful exercise or not depends on one's view of the efficiency of markets.

Shareholder advocacy was the second avenue through which public plans introduced social considerations into the investment decision. In 1998, public pension plans – primarily California, New York, and Wisconsin – accounted for 6 percent of the total shareholder proposals related to corporate governance.<sup>43</sup> In 2003, that share had dropped to 2 percent with labor unions and individuals shareholders dominating the scene (Figure 3). It is hard to evaluate the success of shareholder activism using survey data because so many factors affect the bottom line. Some detailed studies suggest some positive effects, but the results are somewhat sketchy. We found no effect on the rate of return. The main point, however, is that not much was going on.

Figure 3. Sponsors of Corporate Governance Proposals, 2003



Source: Georgeson Shareholder (2003). Annual Corporate Governance Review: Shareholder Proposals and proxy Contests. <http://www.georgesonshareholder.com/pdf/2003%20a.wrapup.pdf>

Screening and divestiture is the third major avenue through which social considerations entered investment decisions. The main screening story is South Africa, discussed above, when in the late 1980s public plans joined universities, foundations, and others in selling their stocks in companies doing business in South Africa. The plans

<sup>43</sup> IRRC (1998).

undertook this action reluctantly and late, only after the “Sullivan Principles’ no longer provided an acceptable compromise. As soon as apartheid ended, public plans immediately purchased previously barred stock. In the case of Northern Ireland, virtually no divestiture has occurred; the controversy has been resolved by having companies sign onto the “MacBride Principles,” a set of policies aimed at eliminating religious discrimination. Public pension funds also resisted pressures to divest tobacco stocks, even though other institutional investors began divesting in the middle 1980s. At the time of the 1998 study Massachusetts, Florida, and seven other states had introduced restrictions on tobacco holdings; California divested soon thereafter. On the other hand, by 2001 Florida and Maryland had reversed their divestment decisions.<sup>44</sup> So the story appears to be that public plans resist divestiture and try to exhaust all avenues of compromise before taking such an action.

The conclusion from our 1998 survey was that public pension funds had learned their lesson about social investing. It is very difficult to find investments that pay a market return and also produce additional benefits. Similarly, altering the portfolio in response to each political issue – Northern Ireland, Iran, Cuba, the Arab League – was not a sensible strategy. Finally, divesting “sin” stocks was to be avoided as much as possible. Public plans were on the right track; it would be a mistake for them reverse course and pursue social positions.

*Recent Developments.* The recent interest of public pensions in private equity investments raises a number of concerns. A decade ago, public plans had virtually no money in private investments; today data compiled by Wilshire Associates suggests that private equities amount to almost 5 percent of public pension assets.<sup>45</sup>

One issue is that private equity investments have the potential to combine social investing with an exemption from disclosure. Apparently, some top-tier firms have rejected investment offers from public pension funds, because the plans might be forced to disclose private equity information under state laws.<sup>46</sup> In response, the Colorado legislature recently exempted the \$29 billion Colorado Public Employees Retirement Association from having to reveal information about its private equity or other alternative

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<sup>44</sup> Pan and Mardfin (2001).

<sup>45</sup> Williams (2004)

<sup>46</sup> Jacobius (2004)

investments. In Illinois, a bill is winding its way through the legislature that would create a not-for-profit venture capital firm that would make investments in “underserved regions of Illinois” and would exempt those investments, as well as the private equity fund investments of all public pension funds in the state, from Freedom of Information Act requirements. The trade-off here is between public pension fund participation in deals with high returns/high risk on the one hand and transparency on the other hand. If there were ever an area where transparency should be given paramount importance it is public pension fund investments. Exempting public pension funds from disclosure is asking for trouble.

These private or alternative investments have also sparked an inquiry by the Securities and Exchange Commission regarding the role played by pension consultants.<sup>47</sup> Public pension funds rely heavily on the advice of consultants because fund boards are required to invest hundreds of millions of dollars but often have little financial training – only the largest can afford professional investment staffs. The problem is that the pension consultants have business relationships with both the pension funds and the money managers they recommend. It is not unusual for the consultants to host elegant gatherings for pension board members, and for money managers to pay tens of thousands of dollars to participate and meet the trustees – “pay to play.” The resulting increase in money being guided into public pension plans raises a host of concerns. These investments may offer high returns but they also carry substantial risk, and often involve bigger fees than applied to simpler publicly traded investments. And because they are not publicly traded they cannot be sold quickly to raise cash and it is much more difficult to evaluate their performance. Although these private equity investments need not fall under the heading of social investment, they are troublesome in their own right and raise additional concerns when targeted to “underserved regions in Illinois” or comparable efforts.

#### Private Pensions

With regard to private plans, the question of social investing arises primarily in the defined benefit arena, which accounts for \$1.6 trillion of the \$3.5 trillion of private

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<sup>47</sup> Walsh (2004).

plan assets. Defined contribution assets consist mainly of funds in 401(k) plans where the individual makes the investment choice. Since the 401(k) decision maker and the stakeholder are the same person, none of the agency problems arise. But individuals need to be careful, since 401(k) plans are not producing the magnitude of accumulations that were expected and the assets are over-invested in company stock.<sup>48</sup> Note that private defined benefit assets are less than those held by state and local plans.

In the case of private defined benefit plans, the decision makers and stakeholders are more likely to be closely linked. The exception, of course, arises in the case of bankrupt plans. Unlike public plans, the benefits of workers covered by private plans are insured by the Pension Benefit Guaranty Corporation (PBGC), an entity established under the Employee Retirement Income Security Act (ERISA) of 1974. The PBGC imposes premiums on sponsors of defined benefit plans to insure workers against the loss of benefits if their plan terminates with inadequate assets. Thus, really bad investment decisions have the potential of burdening the sponsors of other defined benefit plans. But the pool of potential stakeholders may be even larger, since the PBGC is inadequately funded should a number of large plans fail simultaneously. The question is then whether the congress would allow workers in bankrupt plans to lose their benefits or whether it would turn to taxpayers for a bailout to cover the shortfall. Most observers believe the taxpayer would be on the hook. Thus, in extreme cases, the decision makers and stakeholders could be quite different. For purposes of discussion, however, assume that the sponsor is sound and termination is not an issue.

When the decision makers and stakeholders are the same, screening investments seems like a harmless activity. If employees of a hospital want to keep their money away from investments in the health-debilitating tobacco industry, so be it. As discussed above, such screening probably has virtually no impact on tobacco companies, but at the same time, it is probably a costless activity when it comes to returns.

But we would argue that anything more ambitious is not a good idea for two reasons – diversification and tax policy. Take the example of the Boilermakers’ Co-Generation and Infrastructure Fund, which has been described as “one of most

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<sup>48</sup> Munnell and Sundén (2004).

sophisticated and successful alternative investment programs.”<sup>49</sup> This union fund uses a project finance model to co-invest in the construction of power generation plans that are then leased or sold to independent power producers, industrial companies, or the government. Over its first 12 years, the Boilermakers’ Fund has invested \$450 million in 30 projects and earned a 15 percent return on its funds.<sup>50</sup> Although the 15 percent rate of return equals that on equities, supporters claim that the Boilermakers Fund takes less risk since it provides just the senior or subordinated debt for each project financing and usually takes the lead in structuring the deal.<sup>51</sup> Since the goal of the investment is to ensure that the project employs union boilermakers, it also is reported that the Boilermaker’s Fund generated 1.4 million hours of work for its participants.<sup>52</sup>

Should private plans be engaged in this type of activity? Our view is “no.” First, placing a significant amount of pension money in one business means that the pension trust is holding less than a fully diversified portfolio. (This is not a problem with the Boilermakers since the Project Finance Fund accounts for only 4 percent of total assets.) Such concentration flies in the face of modern financial theory, which says that diversifying a portfolio offers large gains at little cost.<sup>53</sup> It is even more important for workers to diversify their investments away from their employers. Concentrating pension assets in the industry where workers earn their living means that participants are concentrating their financial bets in an area that is directly correlated with their own human capital (i.e. their earnings), which in almost all cases is their primary source of income.

The second issue in this kind of economically targeted investment is the potential for providing a subsidy to the lessees or purchasers of boilers. Although the returns appear quite high for industrial lending, which typically returns prime plus a couple of points, it still may be possible that the union is subsidizing the makers of boilers in exchange for using union labor.<sup>54</sup> To the extent that the union is subsidizing employers, it is equivalent to earning a market return and then making a gift to the boilermakers.

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<sup>49</sup> Calabrese (2001).

<sup>50</sup> Hanson (1999).

<sup>51</sup> Daly (1999).

<sup>52</sup> Hanson (1999).

<sup>53</sup> Markowitz (1991).

<sup>54</sup> To the extent that these loans are non-recourse to the borrower or made to single asset borrowers or are deeply subordinated or involve unproven technologies, the union may be taking on significant risk.

While the union should be free to make the gift if it so desires, its members are not entitled to favorable tax treatment on that gift. Under the personal income tax, gifts to religious and charitable institutions are tax deductible, but no equivalent deduction is available for gifts to profit making entities. Making the gift through a reduced return is equivalent to taking a deduction for that amount. The favorable treatment of pensions under the Internal Revenue Code, which allows the deferral of taxes on pension contributions and earnings on those contributions until benefits are paid in retirement, was designed to encourage pension coverage and retirement saving – not to subsidize gifts to boilermakers or other employers.

In short, social investing has virtually no place in the pension world. In the case of public plans, the dichotomy between the decision makers and the stakeholders make it unlikely that the two have similar tastes and interests. Moreover, diverting attention from maximizing return for a given level of risk in this highly political environment is asking for trouble. In private defined benefit plans – with the exception of bankruptcy – the decision makers and stakeholders are more likely to be the same entities. Therefore, costless screening seems reasonable. But more aggressive activities that reduce diversification or involve a subsidy are inappropriate.

## **V. Conclusion**

This paper has addressed the efficacy of social investing and the desirability of public and private pension funds engaging in such activity. In the end, one's view about efficacy depends on one's assessment of the efficiency of capital markets. If capital markets are efficient and the demand for a firm's stock is virtually horizontal, screening is unlikely have any impact on the company's cost of capital or the price of its stock. If the stock price dips temporarily below the level consistent with the discounted value of future earnings, investors not involved with screening will swoop in, buy shares, and restore the price. Similarly, in terms of community or economically targeted investments, in the face of efficient capital markets investors are unlikely to turn up investments that yield market returns and accomplish other goals. Finally, shareholder advocacy may create headlines but appears to have little measurable impact on the

company's performance. Thus, with efficient capital markets, social investing probably has no real impact on the economy.

In terms of desirability, social investing seems appropriate only when the interests of the decision makers and the stakeholders are aligned. Certainly that is not the case with public pensions. Moreover, it is dangerous in a politically charged environment to permit decision makers to deviate from the pursuit of maximum return for a given level of risk. Public plans have gotten into trouble in the past when they have added social considerations to their list of criteria for selecting investments. In the case of private plans, where the stakeholders and decision makers' interests are more likely to be aligned, screening is probably a relatively costless way for participants to make a statement. But these plans should not engage in activities that sacrifice returns for social goals; the pension fund is not an appropriate mechanism for gift giving.

Fortunately, in recent years remarkably little social investing has taken place at the state and local level. This is an encouraging sign when considering equity investment for Social Security – either in the form of broadening trust fund options or introducing personal accounts. Moreover, public plans lack the protections envisioned for Social Security. Little attempt is made to keep politicians away from public plans; in fact, many plans have the state treasurer or other elected officials sitting on the pension board. Certainly those who advocate investing the Social Security trust funds in equities have proposed structures that would keep politics out of the process. Most suggest that Congress would establish an expert investment board, very similar to the Federal Reserve Board or the Federal Retirement Thrift Investment Board that administers the Thrift Savings Plan for federal employees. To insulate this board from political influence, members would be appointed for long and staggered terms. The board would select a broad index fund, such as the Russell 3000 or the Wilshire 5000, and hire, on a competitive basis, private sector pension managers to manage this portfolio. Such an arrangement differs sharply from many state and local plans, which are still run in-house and involve the selection of individual stocks. The safeguards envisioned for equity investment in the trust funds should prevent even the modest amount of social investing that occurs at the state and local level. Comparable provisions could be designed for equity investment through personal Social Security accounts. The primary goal of

investing retirement funds – through employer-sponsored pensions, union plans, state and local pensions, or Social Security – should be achieving the maximum returns for a given level of risk.

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Appendix Table 1. “Sin” Socks as a Share of the Standard & Poor 500, Yearend 2003

Company	Ticker	Price	Shares Outstanding	Market Capitalization	% of S&P
<b>Tobacco</b>				<b>\$126,698,856,500</b>	<b>1.23%</b>
Altria Group, Inc.	MO	\$ 54.42	2,129,000,000	\$115,860,180,000	
RJ Reynolds Tobacco	RJR	\$ 58.15	84,600,000	\$ 4,919,490,000	
UST Inc.	UST	\$ 35.69	165,850,000	\$ 5,919,186,500	
<b>Alcohol</b>				<b>\$ 50,442,138,243</b>	<b>0.49%</b>
Anheuser-Busch	BUD	\$ 52.46	814,759,936	\$ 42,742,306,243	
Brown-Forman Corp.	BF.B	\$ 46.72	121,100,000	\$ 5,657,792,000	
Coors (Adolph)	RKY	\$ 56.10	36,400,000	\$ 2,042,040,000	
<b>Alcohol</b>					
<b>Defense Contractor</b>				<b>\$142,074,580,000</b>	<b>1.38%</b>
Boeing	BA	\$ 41.98	800,200,000	\$ 33,592,396,000	
General Dynamics	GD	\$ 90.08	197,700,000	\$ 17,808,816,000	
Goodrich Corp.	GR	\$ 29.69	117,600,000	\$ 3,491,544,000	
Honeywell Int'l Inc.	HON	\$ 33.26	862,100,000	\$ 28,673,446,000	
Lockheed Martin Corp.	LMT	\$ 51.40	450,900,000	\$ 23,176,260,000	
Northrop Grumman Corp.	NOC	\$ 95.60	183,100,000	\$ 17,504,360,000	
Raytheon Co.	RTN	\$ 30.04	416,200,000	\$ 12,502,648,000	
Rockwell Collins	COL	\$ 29.95	177,800,000	\$ 5,325,110,000	
<b>Casinos/Gaming</b>				<b>\$ 17,801,890,000</b>	<b>0.17%</b>
Harrah's Entertainment	HET	\$ 49.48	110,500,000	\$ 5,467,540,000	
International Game Technology	IGT	\$ 35.70	345,500,000	\$ 12,334,350,000	
<b>Total S&amp;P 500</b>				<b>\$10,285,452,000,000</b>	

Source: Altria Group ([www.altria.com](http://www.altria.com)); RJ Reynolds Tobacco ([www.rjrt.com](http://www.rjrt.com)); UST Inc. ([www.ustinc.com](http://www.ustinc.com)); Anheuser-Bush ([www.anheuser-busch.com](http://www.anheuser-busch.com)); Brown-Forman Corp. ([www.brown-foreman.com](http://www.brown-foreman.com)); Coors ([www.coors.com](http://www.coors.com)); Boeing ([www.boeing.com](http://www.boeing.com)); General Dynamics ([www.generaldynamics.com](http://www.generaldynamics.com)); Goodrich Corp' ([www.goodrich.com](http://www.goodrich.com)); Honeywell International Inc. ([www.honeywell.com](http://www.honeywell.com)); Lockheed Martin Corp. ([www.lockheedmartin.com](http://www.lockheedmartin.com)); Northrop Grumman Corp ([www.northgrum.com](http://www.northgrum.com)); Raytheon Co. ([www.raytheon.com](http://www.raytheon.com)); Rockwell Collins ([www.rockwellcollins.com](http://www.rockwellcollins.com)); Harrah's Entertainment ([www.harrahs.com](http://www.harrahs.com)); International Game Technology ([www.igt.com](http://www.igt.com))