

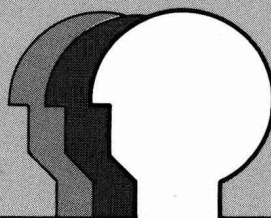
SOCIAL INVESTING

PENSION RESEARCH COUNCIL

DAN M. MCGILL, EDITOR

Social Investing

Dan M. McGill, *Editor*



1984

*Published for the
Pension Research Council
Wharton School
University of Pennsylvania*

by

RICHARD D. IRWIN, INC. Homewood, Illinois 60430

© 1984 by the
Pension Research Council
of the
Wharton School
University of Pennsylvania

All Rights Reserved

ISBN 0-256-03170-3

Library of Congress Catalog Card No. 83-82624

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0 MP 1 0 9 8 7 6 5 4

Social Investing

Other publications of the
PENSION RESEARCH COUNCIL:

- Fundamentals of Private Pensions—Dan M. McGill
Concepts of Actuarial Soundness in Pension Plans—Dorrance C. Bronson
Social Aspects of Retirement—Otto Pollak
Positive Experiences in Retirement—Otto Pollak
Ensuring Medical Care for the Aged—Mortimer Spiegelman
Legal Protection of Private Pension Expectations—Edwin W. Patterson
Legal Status of Employee Benefit Rights under Private Pension
Plans—Benjamin Aaron
Decision and Influence Processes in Private Pension Plans—James E.
McNulty, Jr.
Fulfilling Pension Expectations—Dan M. McGill
Collectively Bargained Multi-Employer Pension Plans—Joseph J. Melone
Actuarial Aspects of Pension Security—William F. Marples
Status of Funding under Private Pension Plans—Frank L. Griffin, Jr. and
Charles L. Trowbridge (out of print)
Guaranty Fund for Private Pension Obligations—Dan M. McGill
Preservation of Pension Benefit Rights—Dan M. McGill
Retirement Systems for Public Employees—Thomas P. Bleakney
Employer Guarantee of Pension Benefits—Dan M. McGill
Reciprocity among Private Multiemployer Pension Plans—Maurice E.
McDonald
A New Look at Accounting for Pension Costs—William D. Hall and David
L. Landsittel
Social Security and Private Pension Plans: Competitive or
Complementary?—Dan M. McGill (ed.)
Pension Mathematics—Howard Winklevoss
Indexation of Pension and Other Benefits—Robert J. Myers
Joint Trust Pension Plans—Daniel F. McGinn
Financing the Civil Service Retirement System—Dan M. McGill (ed.)
Continuing Care Retirement Communities—Howard E. Winklevoss and
Alwyn V. Powell

PENSION RESEARCH COUNCIL

Dan M. McGill, *Chairman and Research Director*

Chairman, Insurance Department

The Wharton School of the University of Pennsylvania

J. Vance Anderson, *Counsel for Employee Relations, Mobil Oil Corporation, New York City*

Preston C. Bassett, F.S.A., *Consulting Actuary, Wallingford, Pennsylvania*

Kenneth Blaylock, *President, American Federation of Government Employees, Washington, D.C.*

Edwin F. Boynton, F.S.A., *Vice President and Consulting Actuary, The Wyatt Company, Washington, D.C.*

Laurence E. Coward, F.C.I.A., *Executive Vice President and Director, William M. Mercer, Ltd., Toronto*

Harrison Givens, F.S.A., *Senior Vice President, Equitable Life Assurance Society of America, New York City*

Donald S. Grubbs, Jr., F.S.A., *Consulting Actuary, George B. Buck Consulting Actuaries, Washington, D.C.*

Russell H. Hubbard, Jr., Esq., *Corporate Employee Relations, General Electric Company, Fairfield, Connecticut*

G. David Hurd, *Vice President, Bankers Life Company, Des Moines*

Raymond C. Lauver, *Partner, Price Waterhouse, New York City*

George M. Lingua, *Executive Vice President, Citibank, N.A., New York City*

Alicia H. Munnell, *Vice President and Economist, Federal Reserve Bank of Boston*

Roger F. Murray, *Emeritus Professor of Banking, Columbia University, Wolfeboro, New Hampshire*

Robert J. Myers, F.S.A., *Former Chief Actuary, Social Security Administration, Silver Spring, Maryland*

James E. Pesando, *Professor of Economics, University of Toronto*

Therese F. Pick, *Director, Benefits Administration & Gen. Personnel Practices, AT&T, Morristown, New Jersey*

Jerry S. Rosenbloom, *Professor of Insurance, University of Pennsylvania, Philadelphia*

L. Edwin Wang, *Administrator, Board of Pensions of Lutheran Church in America, Minneapolis*

Randolph W. Westerfield, *Professor of Finance, University of Pennsylvania, Philadelphia*

Howard E. Winklevoss, *Adjunct Associate Professor of Insurance, University of Pennsylvania, Philadelphia*

Howard Young, F.S.A., *Director of Social Security Department, United Automobile Workers, Detroit*

PURPOSE OF THE COUNCIL

The Pension Research Council was formed in 1952 in response to an urgent need for a better understanding of the private pension mechanism. It is composed of nationally recognized pension experts representing leadership in every phase of private pensions. It sponsors academic research into the problems and issues surrounding the private pension institution and publishes the findings in a series of books and monographs. The studies are conducted by mature scholars drawn from both the academic and business spheres.

Preface

The assets of public and private pension plans constitute one of the largest aggregations of capital in the United States. Their market value is approaching \$1 trillion, and it is estimated that they may grow to \$3 trillion by 1995, a staggering figure. The collective cash flow of pension plans is a major source of funds for capital formation and the regeneration of the industrial infrastructure of the country. It is only natural that there should be great interest in how these funds are going to be deployed in the years ahead.

Until recent years, it was generally assumed that the sponsor of a pension plan—a business firm or a governmental entity—would determine how the assets of the plan were to be invested, the goal being to maximize the total rate of return within an acceptable level of investment risk. This was the pattern for both defined benefit and defined contribution plans, even though it was recognized—philosophically, at least—that the participants in a defined contribution plan might logically have some voice in deciding how the assets were to be invested since their benefits would be directly affected by the investment results.

As pension plan assets grew in magnitude and became a dominant factor in the financial marketplace, a realization developed in various quarters that the assets could—and perhaps should—be invested in a manner that would achieve goals beyond the maximization of return within given risk parameters, important as that objective might be. Elected officials of states and municipalities began to view the assets of their respective retirement systems as a source of funds to accomplish certain public goals, such as encouraging local economic development; facilitating home ownership; providing a market for tax-exempt governmental paper; and even staving off default on financial obligations.

Organized labor saw pension assets, especially those accumulated under collectively bargained multiemployer plans, as a device for preserving and creating jobs in unionized employment and for promoting the broad interests of organized labor in various ways. Labor officials have sought to employ pension assets to provide subsidized residential mortgages, to resuscitate

depressed industries and regions, and to provide various types of facilities that would promote the social welfare of the working population.

Some corporate managements embraced the notion that the corporation's pension plan is an extension of the corporation and can properly be used in ways to promote the general welfare of the corporation. This philosophy has led some companies to use their pension plan assets to ward off unfriendly takeover attempts, to support the market price of the company's common stock, to protect the cash flow of the corporation, and to provide estate liquidity for key corporate officials through purchase of personal stockholdings.

Finally, some groups would employ the economic power represented by pension plan asset holdings to pursue certain broad social and political goals. Through divestment, the filing of stockholder resolutions, and other such tactics, these groups would attempt to influence the policies and practices of companies that engage in questionable labor or marketing practices, produce products of doubtful social merit, manufacture products or materials supportive of nuclear warfare, disregard environmental concerns, or violate the civil rights of minorities. The most visible of these activities are the efforts to persuade institutional investors to divest their holdings in companies that do business in South Africa.

Some of the foregoing ancillary goals of investment policy would be achieved by directing or persuading the institutional managers of pension plan assets to invest them in a manner designed to stimulate certain industries; revitalize the economy of designated geographical regions; meet particular consumer needs, such as suitable housing; or favor certain social or ethnic groups. This is known as the "inclusive" approach and is potentially the most disruptive of traditional investment behavior and, hence, most inimical to the interests of plan participants and others who bear the investment risk. Some of the goals would be accomplished by having the asset managers avoid or divest themselves of the stocks and bonds of certain companies. This is the "exclusive" approach, whose impact on investment performance depends upon the scope of the excluded category and the opportunities remaining within the permissible universe of investments. Some advocates of the inclusive approach press their case even when it can be expected to result in a lower risk-

adjusted rate of return, on the premise that the social benefit outweighs the loss of investment earnings. Other advocates argue that the targeted investments will produce competitive rates of return. They would urge that approach only if investment returns are not materially affected.

Any investment posture that introduces into the investment decision a consideration other than maximization of return consistent with risk is referred to as *social investing* in this volume, although the term is not descriptive of some of the motivations involved. The term is used herein and for the title of this volume because it is simple, widely used, and generally understood.

For the most part, this volume is made up of papers presented at the 1982 symposium for institutional members of the Pension Research Council. Two papers were solicited after the symposium and another was picked up, with permission, from an unrelated conference.

The first chapter of the book deals with the ethical and philosophical considerations involved in the social investing issue. The author, Dr. Clarence Walton, former president of Catholic University, expounds on several relevant philosophical concepts and attempts to draw guidance from those classical concepts in resolving contemporary, pragmatic issues surrounding the control and management of pension plan assets.

The second chapter, written by two Washington attorneys, James D. Hutchinson and Paul Ondrasik, Jr., describes the legal framework within which social investing issues must be resolved. As might be expected, they emphasize the constraints imposed by ERISA and the numerous regulations that have been promulgated in interpretation of ERISA. Under present law, the trustees of a qualified pension plan owe a duty of sole and undivided loyalty to the plan's participants and their beneficiaries. In the discharge of this fiduciary obligation, they must invest the plan's assets in the exclusive interest of the participants and their beneficiaries. Social considerations can enter the equation only if the investment in question meets all the requirements of the federal prudent man rule.

The next three chapters present the views of three representatives of organized labor. Jack Sheinkman, secretary-treasurer of the Amalgamated Clothing Workers and Textile Union of America, recounts how his union has pursued certain social investing goals. John Lyons, general president of Iron Workers Interna-

tional and chairman of the AFL-CIO Economic Policy Committee, outlines the policy positions adopted by the AFL-CIO. Howard Young, director of the Social Security Department of the United Automobile Workers, makes a reasoned argument in favor of certain types of social investments and counsels against making ultimate judgments in terms of existing law. He points out that the strictures of ERISA could be suitably relaxed by Congress if a consensus should develop that certain kinds of social investing would be in the public interest.

The practical problems encountered in implementing a policy of social investing are described in Chapter 6. This chapter was prepared by Madelon De Voe Talley, at that time director of investments and cash management for the Comptroller of New York State. In that capacity, Ms. Talley had responsibility for investing all the assets of the New York State retirement systems. In her paper, she describes the various proposals for “nontraditional” investing that come to the Comptroller’s Office and the manner in which that agency responded to such pressures during her tenure there.

In Chapter 7, Professor Randolph Westerfield of the Wharton School evaluates the social investing concept within the framework of the capital asset pricing model (CAPM). The two concepts are inherently contradictory. Thus, if social investing concerns were to be given priority over traditional investment criteria, the return on the pension plan portfolio would inevitably be adversely affected. However, Professor Westerfield demonstrates that modest social and political objectives can be pursued via the exclusionary approach with only minimal effect on the portfolio’s risk-adjusted return. He does not deal with the inclusionary approach, a much more controversial and difficult policy issue.

The final chapter of the book addresses the process by which decisions concerning social investing can be responsibly made. Written by Tamar Frankel, professor of law at Boston University, the chapter identifies the concerns of the various parties that may be affected, for good or ill, by social investing and delineates a decision process that would recognize and safeguard their interests.

The inclusion of three papers on labor’s point of view might suggest to some that the overall presentation is biased in favor of social investing. It was not the intent of the editor or the Pension

Research Council to publish a polemic for or against social investing. There is a general presumption within the corporate community and among plan administrators that pension plan assets should be invested to provide a maximum rate of return, consistent with preservation of principal. Indeed, this presumption has been given statutory expression in ERISA. Both ERISA and interpretive regulations make it abundantly clear that pension plan assets are to be invested in accordance with traditional investment criteria and applicable fiduciary standards. As a practical matter, those who advocate social investing in any form have the burden of proving that, on balance, social investing of pension plan assets is sound public policy. Since, by and large, the advocates are found among the ranks of organized labor, it seemed desirable that the most articulate of these proponents should be given a forum in which to state their views. It is hoped that the collection of papers as a whole will make a constructive and meaningful contribution to the national dialogue on the subject.

The editor expresses his deep appreciation to the authors of the various papers in this volume. It goes without saying that the views expressed herein are those of the authors and should not necessarily be attributable to the Pension Research Council or its individual members.

Dan M. McGill

Contents

1. Pension Funds and Social Investments: A Tale of Two Cities

Clarence C. Walton	1
The City of Finance	2
The City of Morals	4
Definitions and Purpose	7
Toward an Ethical Geometry	9
Omissions	11
Axioms and Theorems: Fulfillments and Frustrations	13
Relevant Theorems	17
Applications of Selected Theorems to Social Investments	18
Theorems: Conjunctions and Conclusions	29
Possible Criteria for Social Investments	30
General Criteria	32
Specific Criteria	35
Conclusion	37

2. Legal Restrictions on Social Investing

James D. Hutchinson and Paul J. Ondrasik, Jr.	39
Introduction	39
General Obligation of ERISA Fiduciaries	41
Prudence of Investment Decisions	42
Diversification of Portfolio	44
Undivided Loyalty to Plan Participants and Beneficiaries	46
Prohibited Transactions	48
Grumman Corporation Case	50
Factual Background	50
Analysis of the Judicial Decision	51
Relevance to Social Investing	54
Guidelines for Social Investing	56

3. Evolving Role of Labor in Pension Fund Investment

Jack Sheinkman **59**

Awakening Concern over Investment Policy **59**

Opposition of Traditionalists **61**

Fiduciary Issues **63**

Recent Developments **66**

A Proposal **68**

4. Investment of Pension Funds—The Concerns of Organized Labor

John H. Lyons **71**

Committee on Investment of Pension Funds **72**

Industrial Union Development **73**

Mortgage Investment Trust **74**

Computer Tracking Project **76**

5. Pension Fund Investments: Union Goals

Howard Young **79**

Introduction **79**

Public Policy **81**

Housing and Other Community-Oriented Facilities **83**

Economic Revitalization **86**

Investment Prohibitions **88**

Ownership Rights **90**

Conclusion **91**

**6. Implementation of a Social Investment Policy—as Exemplified
by a State Retirement System**

Madelon DeVoe Talley **95**

Consideration of Shareholders Resolutions **96**

Corporate Giving **96**

Directors and Annual Meetings **97**

Shareholder Prerogatives **97**

Policy Statements **98**

Management Incentive Programs **98**

South African Proposals **99**

Nuclear Energy and Nuclear Weapons Proposals **100**

Corporate Political Activity **100**

Legislature and Commerce Commissioner **101**

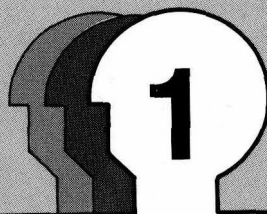
7. Capital Market Theory Perspectives

Randolph Westerfield **107**

Introduction	107
The CAPM	109
The Portfolio Problem: Idealized Case	109
Rate of Return	110
Portfolio Choice with a Riskless Asset: The Capital Market Line	113
Social Investing and the CAPM	115
Passive versus Active Portfolios	117
Caveat	119
Social Investing May Not Reduce Diversification in Pension Funds	119
Plan Beneficiaries Are Not Affected by Social Investing	121
The Cost of Social Investing Falls on the Stockholders of the Plan Sponsor	121
Conclusions	122
Appendix: The Case of Pax World Fund (PWF)	123
 8. Decision Making for Social Investing	
Tamar Frankel	131
Introduction	131
Issues and Definitions	132
Issues	132
Definition: What Is Social Investing?	133
What Is the Current Legal Status of Social Investing?	134
The Problem which Pension Investment Poses	135
ERISA	135
Should the Law Be Amended to Permit Social Investing beyond the Current Limits?	139
The Arguments for Authorizing Social Investing	139
Arguments against Social Investing	145
Allocating Decision Power	150
Who Should Participate in the Choice of Social Goals?	151
The Current Power Structure of Pension Funds	151
What Are the Reasons for Changing the Status Quo with Respect to Social Investing?	152
Those Who Bear the Investment Risk	154
Proposed Model	158
Enforcement	160
Concluding Statement	161

Pension Funds and Social Investments: A Tale of Two Cities

by Clarence C. Walton*



Individuals held responsible for managing enormous sums of money intended for the good of others—and for policy formulations on complex issues related thereto—are understandably restive when asked to consider the usefulness of an inquiry rooted in a form of moral reasoning. Moral reasoning, unlike financial analysis, draws its substance from philosophy, a discipline recently distinguished more by methodological virtuosity than by substantive solidity. Today's men of affairs would applaud Callicles, the friend of Socrates, when he said that philosophy was a "pretty thing" for youths to study but is the "ruin of man" if continued into adult life: "In a word, they are completely without experience of men's character. And so when they enter upon any activity, public or private, they appear ridiculous, just as public men, I suppose, appear ridiculous when they take part in your discussions and arguments."¹

Restiveness is likely to be intensified when inspiration for a way to approach dilemmas posed by social investments is found in so improbable and implausible a source as St. Augustine—a man who cared little for the secular dominion. However, by

* The Charles Lamont Post Distinguished Professor of Ethics and the Professions, The American College, Bryn Mawr, Pennsylvania.

¹ Plato, *Gorgias*, in *Great Books of the Western World*, ed. Robert Maynard Hutchins, (Chicago: Encyclopaedia Britannica, 1952), p. 272.

contrasting the City of God to the City of Man, he showed how tensions build when communities with different value systems intersect. Pension managers must also be concerned with two intersecting cities: one is financial and the other moral. While the contours of each are definable, the moral dimension will receive—in what may appear to be an unnecessary detour—the greater attention because ethical analysis is less familiar to financial experts.

The City of Finance

The financial world is built on fact. In 1977, when three experts discussed critical problems facing investment managers responsible for handling the \$650 billion in employee pension funds, their comments ranged over such issues as concentration of investments in stocks listed on the New York Stock Exchange, inattention to venture capital, problems occasioned by dual regulation by the Labor Department and the Internal Revenue Service, amounts held in private and public funds, the step toward institutional ownership of corporations, and the like.² If their conversation had stopped at this point—which it did not—the trio could have been seen as heirs to Bounderby and Gradgrind (Charles Dickens's heroes of *Hard Times*), who viewed ethics as “sentimental humbug.” For these Dickensian characters, reality existed only when imagination, feeling, and other useless sentimentalities had been stripped away by an ethic of personal gain and by a world of hard fact.

Now, no one is unappreciative of the importance of empirical data or unaware that certain beautiful theories have floundered on a single ugly fact. The fact world, important to pension fund managers, is the bottom line. These are part of reality, and to be able to say “that’s a fact” is to foreclose many debates. This reality, however, is not the whole. Joseph Schumpeter, one of the century’s great economists (who took great pride in his own fact orientation), put it this way: “The stock exchange is a poor substitute for the Holy Grail”—the Grail symbolizing the good life.³ At a much earlier time in the Boston environs, another

² “Private Pensions and Public Policies: A Symposium with William Greenough, Dan M. McGill and Robert Tilove,” *Employee Benefits Journal* (1977), pp. 2–13, 26–27.

³ Joseph Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper & Row, 1942), p. 137.