

Social Investing: Pension Plans Should Just Say "No"

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*“Socially Responsible” Investing and Pension Funds:
Welcome Reform or Fiduciary Nightmare?*

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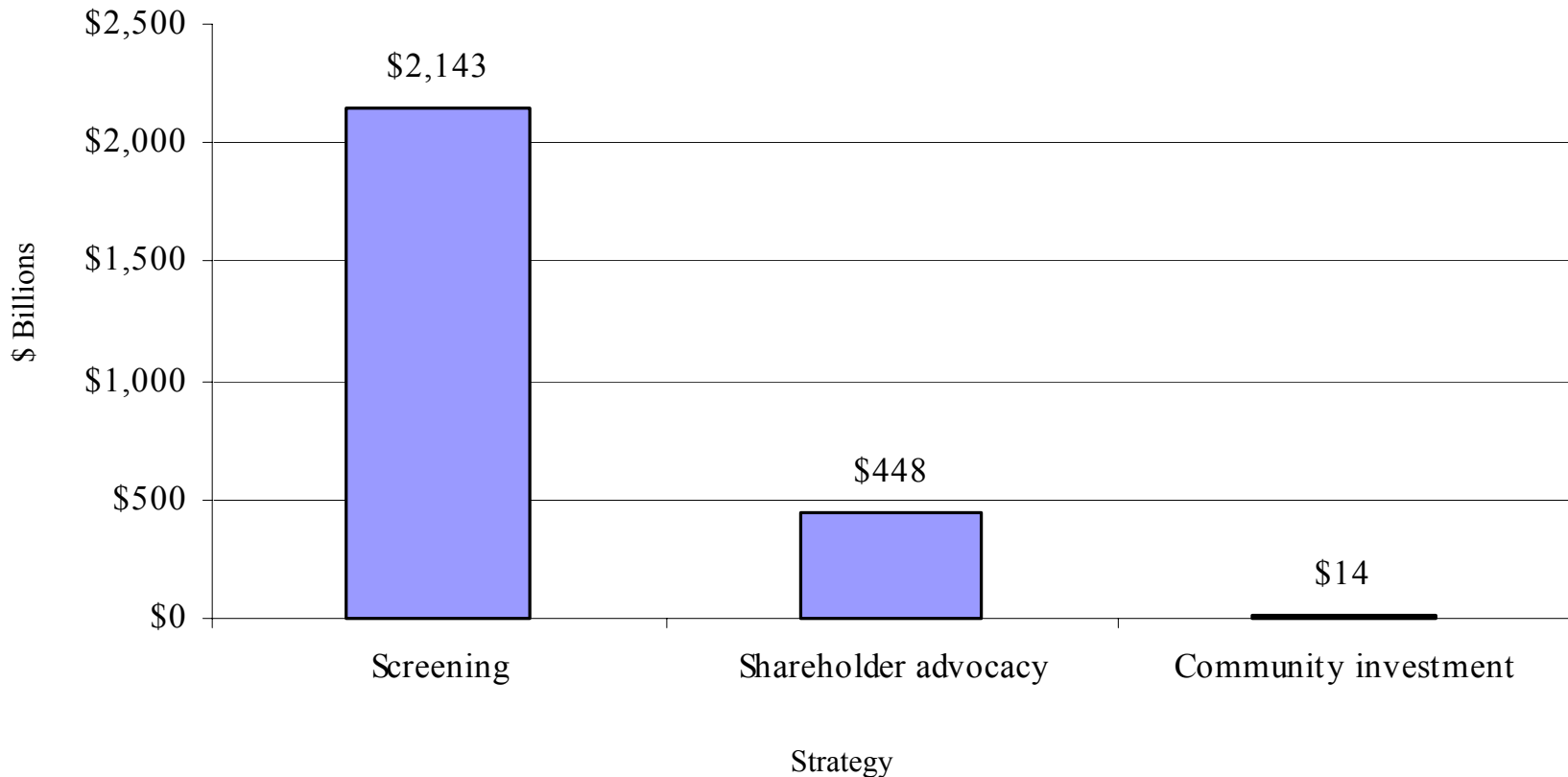
Washington, D.C.

1. Overview

- Most social investing involves screening.
- Screening firms produces few benefits.
- Screening creates few costs for shareholders.
- Fine when stakeholder = decisionmaker.
- Not desirable for public pension funds.
- Neither public nor private funds should sacrifice returns for social concerns.

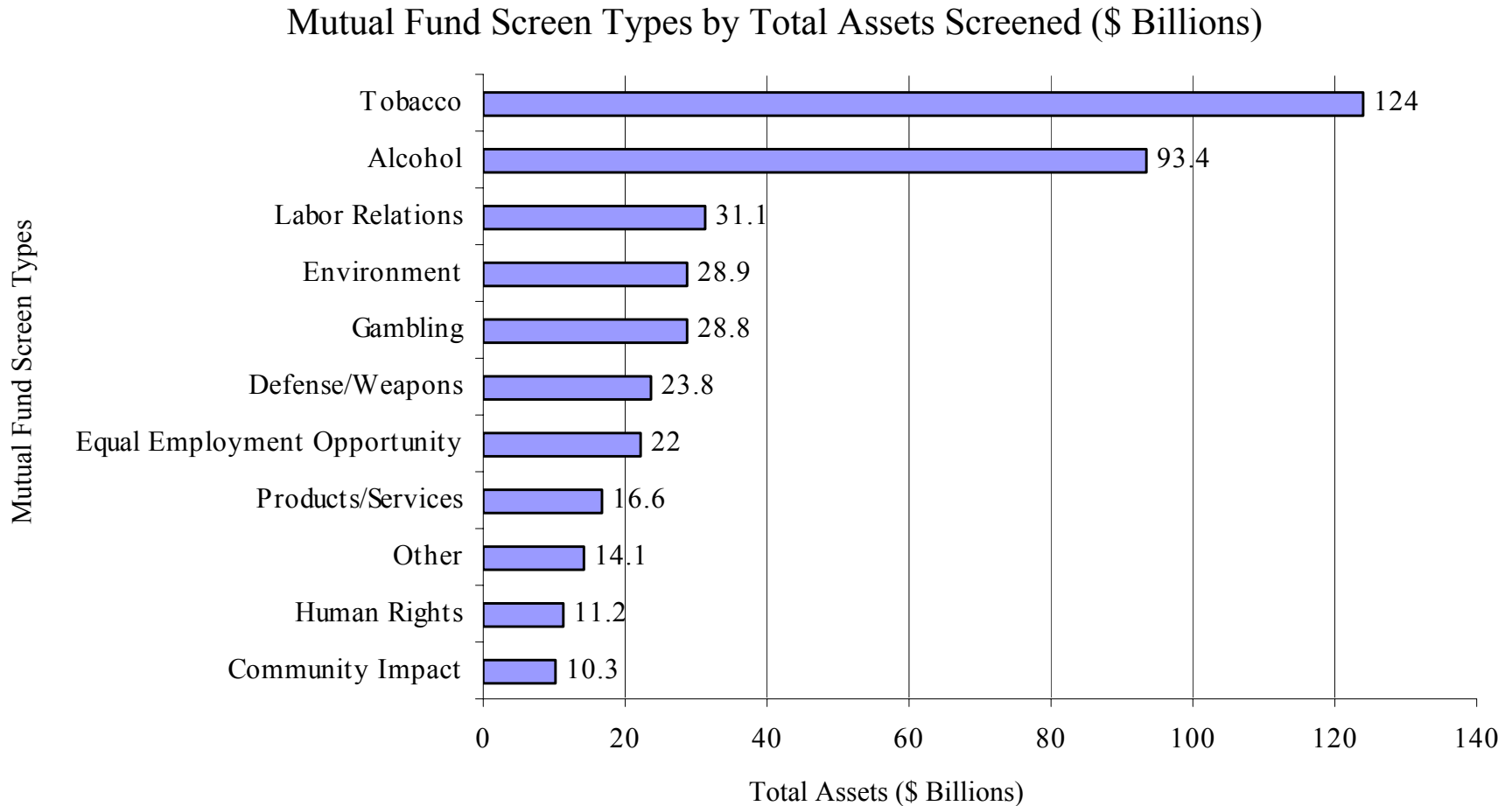
2. Social investing takes three forms; screening most prevalent.

Social Investing by Type of Strategy (\$ Billions)



Source: Social Investment Forum. 2003. *2003 Report on Socially Responsible Investing Trends in the United States*. Available at: http://www.socialinvest.org/areas/research/trends/sri_trends_report_2003.pdf.

3. The most common screens are for tobacco and alcohol.

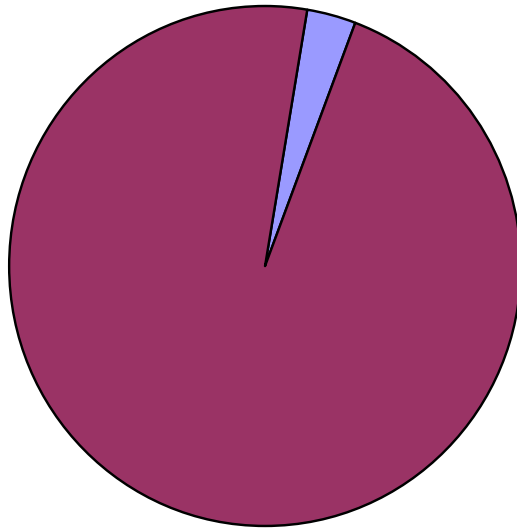


Source: Social Investment Forum. 2003. *2003 Report on Socially Responsible Investing Trends in the United States*. Available at: http://www.socialinvest.org/areas/research/trends/sri_trends_report_2003.pdf.

4. SIF reports social investing for mutual funds and “separate accounts.”

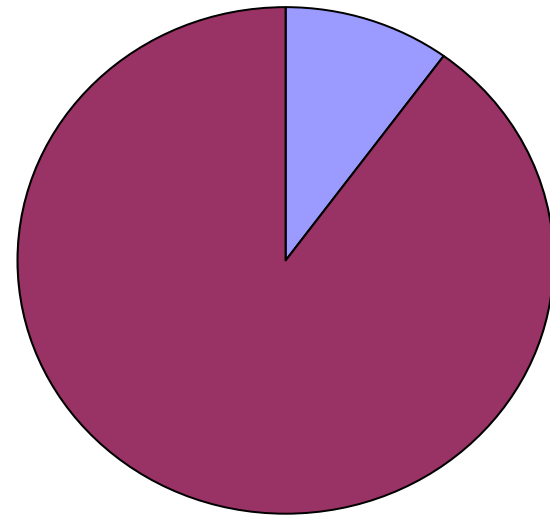
Percent of Mutual Fund Assets ^a

Socially Invested Assets, 3.1%



Percent of Financial Assets Under Management

Socially Invested Separate Accounts, 10.4%



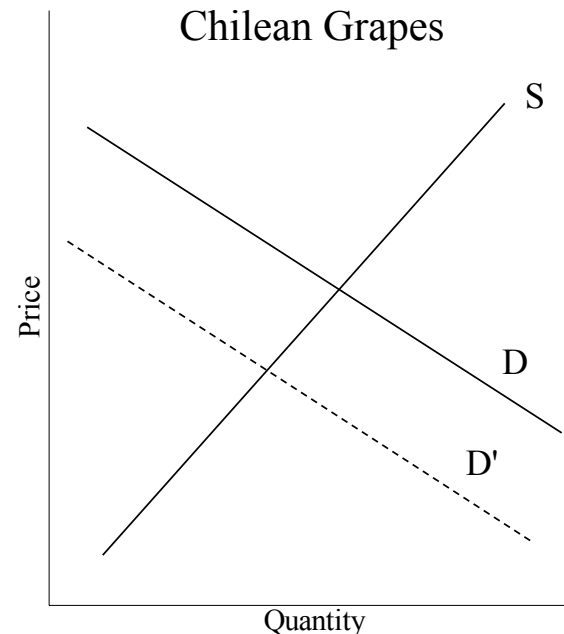
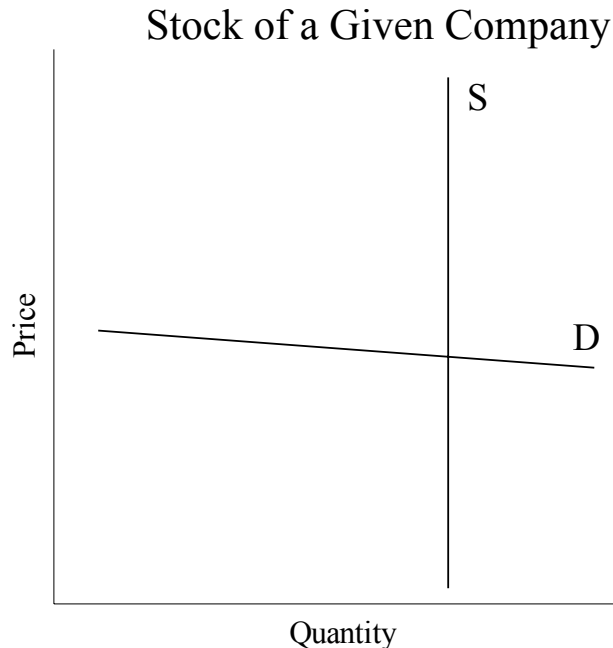
Source: Social Investment Forum. 2003. *2003 Report on Socially Responsible Investing Trends in the United States*. Available at: http://www.socialinvest.org/areas/research/trends/sri_trends_report_2003.pdf.

a. Non-Money Market Assets Only

5. Report likely overstates social investing; in economic terms, it is relatively small.

- Some mutual fund assets overstated.
- Full assets of institutions included even if only screened for a single product.

6. Textbooks say social investing has no effect on stock price of target firm.



- Price of a stock = present discounted value of cash flows.
- Boycotting => temporary fall in price => buyers come in, buy stock, and make money.
- Demand curve for stock is essentially horizontal.

7. South African experience backs up the textbooks.

- Impact of legislative changes on banks with South African loans – none.
- Impact of legislation on South African financial markets – none.
- Impact of divestitures on stock prices of individual companies – none.

Source: Siew Hong Teoh, Ivo Welch, and C. Paul Wazzan. 1999. "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South Africa Boycott." *Journal of Business*, Vol. 72, No. 1: 35-89.

8. Exception: Additions to S&P 500 appear to increase stock prices.

Other factors likely explain the effect:

- Increased liquidity.
- Enlarged investor base.
- Endorsement effect.

Sources: Andrei Shleifer. 1986. Do Demand Curves for Stocks Slope Down? *The Journal of Finance*, Vol. 41, No. 3: 579-90; Lynch and R. Mendenhall. 1997. "New Evidence on Stock Price Effects Associated with Changes in the S&P 500 Index," *Journal of Business*, Vol. 70, No. 3: 351-383; R. Morck and F. Yang. 2001. "The Mysterious Growing Value of S&P 500 Membership," NBER Working Paper. Available at: <http://papers.nber.org/papers/w8654.pdf>; Petajisto, Antti. 2003. "What Makes Demand Curves for Stocks Slope Down?" Yale School of Management Working Paper (November 15). Available at: <http://icf.som.yale.edu/pdf/dcurve54.pdf>; and Robert C Merton. "A Simple Model of Capital Market Equilibrium with Incomplete Information." *The Journal of Finance*, July 1987, Vol. 42, No. 3, 483-510.

9. For the investor, textbooks say social investing is costless.

- An efficient portfolio requires only 20-30 stocks.
- So excluding tobacco or alcohol does not impede ability to construct efficient portfolio.

10. Most empirical evidence supports this view.

- Returns on South African-free portfolios same as unscreened NYSE portfolios.
- Risk-adjusted returns of socially screened portfolios same as unrestricted portfolios.
- Performance of Domini, Calvert etc. same as S&P 500.

Sources: John B. Guerard. 1997. "Is There a Cost to Being Socially Responsible in Investing?" *Journal of Investing*. Summer 1997. Vol. 6, No. 2: 11-19; Dan DiBartolomeo. 2000. "A View of Tobacco Divestiture by CalSTRS." Working Paper (April). Northfield Information Services. Available at: http://www.northinfo.com/papers/pdf/20000405_calstrs_tobacco.pdf; Dan DiBartolomeo, and Lloyd Kurtz. 1999. "Explaining and Controlling the Returns of Socially Screened Portfolios." Working Paper. Available at: http://www.northinfo.com/papers/pdf/19990909_social_screen.pdf.

11. Some recent studies challenge “no-effect” conclusion.

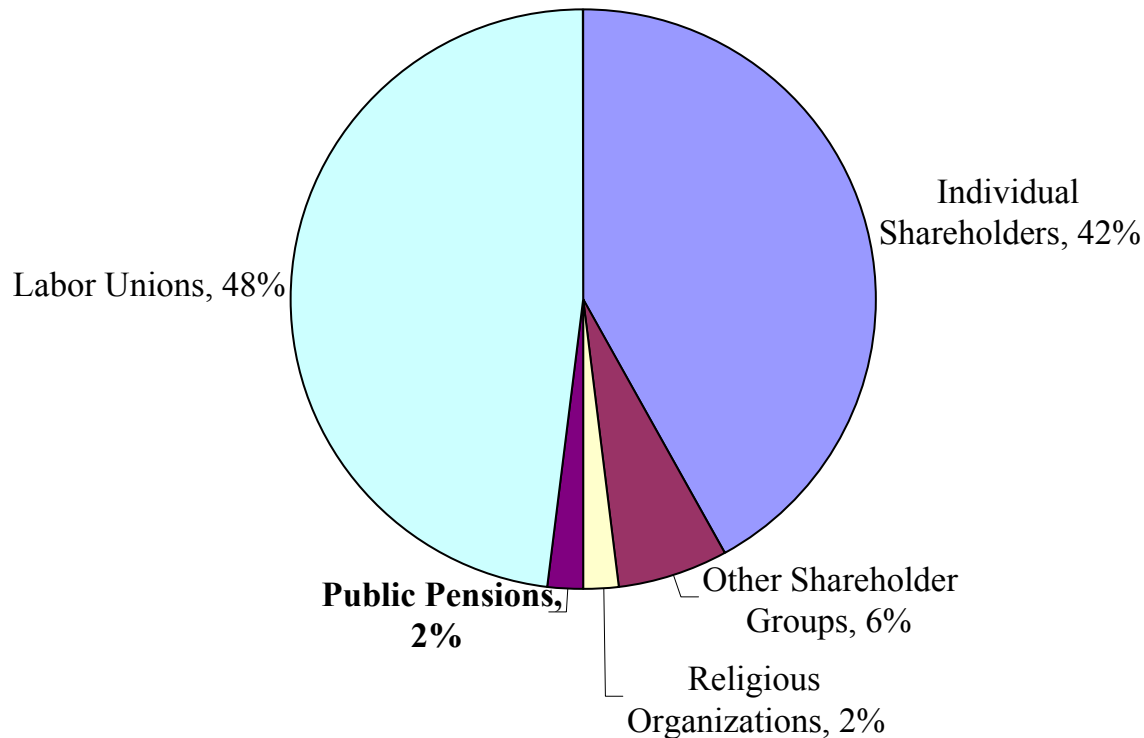
- One study claims social investing dramatically reduces returns.
 - Depends on models of asset pricing & skills of fund managers.
- Other studies argue social investing results in higher returns.
 - Causality could go either way.

12. Even if costless in theory, public pensions should not engage in social investing.

- Decisionmakers are not stakeholders; tastes and incentives may not be aligned.
- Plans operate in highly political environment.
- Plans targeting investments in the early 1980s suffered large losses.

13. Public plans have avoided social investment in recent years.

Sponsors of Corporate Governance Proposals



Source: Georgeson Shareholder. 2003. *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests*. Available at: <http://www.georgesonshareholder.com/pdf/2003%20a.wrapup.pdf>.

14. Private plans have more options, but should not sacrifice returns.

- Decisionmaker and stakeholders more likely the same, so screening is harmless.
- But sacrificing return not acceptable:
 - It may result in a lack of diversification, and
 - It may thwart intent of the tax code.

15. Lack of social investing among public plans is encouraging for Social Security.

- Public plans lack protections envisioned for Social Security:
 - Expert investment board.
 - Insulation from political influence.
 - Investment in a broad index.
- Safeguards should prevent even the modest social investing undertaken by public plans.