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Plans and Social Investing: When Doing the Right Thing Is Not Enough

When public defined benefit plan fiduciaries seek to invest plan assets in a way they consider to be socially responsible, they must show that such investments are both prudent and justified economically, industry insiders told BNA in a recent series of interviews.

In the national grief and outrage sparked by the slaying of 20 children and six adults at Sandy Hook Elementary School in Newtown, Conn., in December, a number of public entities from coast to coast have decided either to remove firearms and ammunition companies from their pension plan portfolios or to review the role firearms investments play in their investment strategies.

• The California Public Employees' Retirement System (CalPERS) decided Feb. 19 to divest from investments in manufacturers of assault weapons illegal for sale in the state.

• New York State Comptroller Thomas P. DiNapoli announced Jan. 15 that the state's Common Retirement Fund would freeze its investments in publicly traded commercial firearm manufacturers.

• Chicago Mayor Rahm Emanuel Jan. 14 ordered the city comptroller to analyze city pension funds with the aim of finding and ending investments in assault weapon manufacturers or sellers. By the end of the month, three city pension funds had decided to divest holdings in such companies.

• The Investment Committee of the California State Teachers' Retirement System (CalSTRS) directed its staff Jan. 9 to commence divesting from firearms companies that produce weapons illegal for sale or possession in that state.

Whether to avoid the so-called sin stocks of tobacco and alcohol, to protest unsavory conduct by foreign governments, to promote environmental or other causes, or to disinvest from gun manufacturers, public pension plans have been employing social investing strategies—or strategies that include nonfinancial, socially responsible, and/or ethical objectives—for decades. Even so, there remains an ongoing debate as to the appropriateness of such investments and whether they are consistent with plan fiduciaries' duties to plan participants and beneficiaries.

Opponents of public plans' use of socially targeted investing argue that investing for nonfinancial reasons lowers investment return and increases risk for participants. Proponents contend that such strategies are, in fact, financial decisions required for long-term investors and that the failure to apply these principles might itself be a breach of fiduciaries' duties.

Industry insiders discussed in interviews the history of public plans' use of socially targeted investing, studies of investment results from such an approach, case law, and arguments for and against its use.

Socially Targeted Investing and How Plans Use It

Socially targeted investing refers to investment strategies to divest existing assets and refrain from future investments in companies and industries deemed to be socially irresponsible—what many call “negative” social investment strategies. Companies targeted under negative strategies might be considered bad corporate citizens because of how they run their operations, how they treat their employees, the products they make or sell, the safety or ethics of processes they use, or the potential harm to the environment they might be causing, among a number of other criteria.

Social Investing as ‘Necessary Imperative’

S. Prakash Sethi, university distinguished professor at the Zicklin School of Business of the City University of New York's Baruch College, and chief executive officer of the International Center for Corporate Accountability in New York, said that socially targeted investment practices are not merely discretionary and desirable activities, “they are a necessary imperative, which both the corporations and public pension funds, and other large institutional holders, will ignore at serious peril to themselves.”

All institutional investors, like individual investors, have a right to exclude some companies from their portfolio, Sethi said. By doing so, he said, there will not be any meaningful impact on the plan portfolio's financial performance, given that socially undesirable investments form a very small part of an otherwise large and well diversified pension fund's portfolio. In addition, he said the fund should have no trouble finding suitable alternatives in which to invest, given the enormous size and liquidity of the stock market and the multiplicity of investment options available in the marketplace to investors.

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Furthermore, Sethi said “there is nothing in the law or trustees' mandate that defines the scope of trustees' duties and obligations in such narrow terms that they must base their investment decisions solely on the basis of financial considerations.” In fact, Sethi said this argument is generally made by “financial intermediaries who are uncomfortable with relegating their discretionary authority and potential loss of fee income.”

Public plan fiduciaries do and should consider broader aspects of their investments and what impact it may have on their participants and beneficiaries, he said. This would also include taking into account the negative effects that individual companies may have on the broader society of which these beneficiaries are an integral part, Sethi said.

Duty to Consider Long-Term Negative Impact

The fiduciaries of employee pension funds, and especially of those that cover a broad swath of workers, have a duty to consider the long-term negative impact of their investments on ethical and social grounds, as well as financial grounds, Sethi said.

If a company creates “negative externalities” that impose a cost to society, society will eventually respond to those costs by imposing greater regulation on the company or its business, he said.

For example, although natural gas company investments might be profitable in the short term, there is a long-term risk that people will be harmed by its extraction process, known as fracking, and that society will respond with strict regulation of the industry and with costly lawsuits filed by those who are injured, Sethi said.

Another reason why plans must look at long-term risk assessment and containment is that their large size makes it difficult, if not impossible, to shift their investments from one group of companies to another group of companies, Sethi said. In addition to incurring high transaction costs, plans might be no better off if they did shift to another group because corporate executives on the boards of other companies might be equally inclined to follow similar policies of short-term risk orientation and avoidance of long-term risk assessment. This is a situation that is further exacerbated by the fact that, in many companies, especially in the United States, the same person holds the positions of chief executive and chairman, he said.

Investment manager Kurtz of Nelson Capital Management said he generally agreed with Sethi that most socially targeted investments will not have much of an impact on a public defined benefit plan's investment returns, given the small size of such an investment relative to the plan's total invested assets.

However, Kurtz said this would not be the case if, for example, a plan divested itself of all of its energy-related investments in an effort toward sustainability or combating climate change. The energy sector consists of companies making up more than 11 percent of the capital equity market, and a plan's decision to divest its investments in it would both depress the stock price of companies in that sector and undermine the plan's ability to sufficiently diversify its investment portfolio, he said.

Social Factors May Be Economic Factors

Nixon said a problem with divesting plan assets from companies that a plan perceives to be “adverse to the greater good of society” is that, on every issue, there are others who see the value of a particular company, industry, or product.

Unless a company or industry is engaging in illegal practices, such as hiring child labor in the United States, then the plan cannot assume or predict that the company's allegedly irresponsible, but legal, conduct will ultimately be held illegal in this country or cause the company to suffer a significant decline in shareholder value, he said.

As an example, Nixon said “some people believe that it is inappropriate for companies to classify low-skill workers as independent contractors rather than employees” because employers may be trying to avoid paying benefits to these workers. Others, he said, say that because this practice is legal under current law, it “should not factor in the investment decision.”

However, some plan fiduciaries do think the risks of socially irresponsible behavior are more predictable.

“Social factors may also be economic factors.”

—New York State Comptroller's Office

For example, California State Treasurer Bill W. Lockyer, who serves on the board of administration of CalPERS and the Teachers' Retirement Board of CalSTRS, called on each to divest from manufacturers of guns and large-capacity ammunition clips that are illegal in California. In separate letters to the investment committee chairs of each board Jan. 9, Lockyer said investments in such companies ultimately put the plans' investment portfolios “at greater risk than comparable investments in companies whose products do not pose such a threat to public health and safety. The firms that make these guns are subject to considerable litigation and regulatory risk. The growing, bipartisan support for stricter gun control laws makes this risk much more than mere speculation,” he said.

More broadly, the New York State Comptroller's Office said that “social factors may also be economic factors,” and so there can indeed be a confluence of sustainability and profitability in a potential investment or an investment strategy. The spokesperson said the Common Retirement Fund is a “long-term investor and, as such, the comptroller encourages robust corporate governance standards that will help ensure the sustainability and profitability of the portfolio companies.”

Argument Against Social Investing

Regardless of whether plan fiduciaries can satisfy their duties when employing socially targeted investments, some think such investments are not a good idea. In that camp is Alicia H. Munnell, professor of management sciences at Boston College's Carroll School of Management and the director of the Center for Retirement Research at Boston College in Chestnut Hill, Mass., who said that “socially targeted investing is inappropriate for public pension plans.”

Munnell said successful investing is hard to do, even among sophisticated investors. Furthermore, she said not all public plans are sophisticated investors. Adding additional criteria to a plan's investment calculation merely increases the likelihood of investment mistakes, she said.

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—Alicia H. Munnell

Boston College Center for Retirement Research

Next, she said there is a danger of a “slippery slope.” Munnell said that a small number of socially targeted investments is unlikely to have an effect on a public plan's investment returns, given the size of a typical plan's portfolio and the alternative investments available to the plan. However, once such investing begins, a plan might ultimately increase the amount of such investments to a point at which socially targeted investing becomes part of the plan's general investment operation. In such a case, there is an increased likelihood that the plan will experience lower returns and higher administrative costs, she said.

Finally, Munnell said there is a risk-and-reward disconnect between the people making the decision to socially target a plan's investments and those who might be affected by that decision. She said that, in the case of public pension plans, it is often politicians who make the decisions to employ such strategies. However, it is the plan's participants who might face lower benefits and a state's taxpayers who risk paying greater taxes if a plan's poor investment choices prevent the plan from meeting its funding obligations, she said.

Inappropriate Vehicles for Political Statements

Public plans are inappropriate vehicles for making a “political statement,” which Munnell said is what plans are doing when they employ such a strategy, because socially targeted investing itself is unlikely to stop companies from continuing to operate and be profitable or to change their internal policies.

Munnell said she was perplexed by the goals of the public plans that have or are considering divestment of assault weapons and large-ammunition-clip manufacturers. Given the need for such weapons by law enforcement and the military, she said, it was unlikely that politicians or plan fiduciaries truly want such companies to be put out of business.

Munnell said that socially targeted investing would be appropriate, however, for individuals desiring to make a political statement with their own money.

Although Sethi said a conscience-based decision not to invest in certain companies or industries is defensible on sound investment grounds, he agreed with Munnell that such a decision is unlikely to be effective—in the case of guns and ammunition, for example—if the intent is to discourage the manufacture and sale of firearms. As long as there is a market demand for these products, the companies making them will be profitable and would have no problem raising new capital. Similarly, there would be lot of buyers for the shares sold by conscience-based sellers if such sales have the short-term impact of a fall in share prices, he said.

Despite the debate over whether such investment strategies are appropriate or even will accomplish the objectives of its proponents, investment adviser Kurtz said “social investing will always be with us,” since it “can play a valuable role in helping resolve” the “tension between financial logic and values.” These values are deeply held, and more universal than many realize, as “every major religion has some form of the Golden Rule—the idea that we should treat others as we would like to be treated,” he said.