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Cambridge University Press
978-0-521-40776-2 - The Field of Social Investment
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Part I The idea of social investment

1 The meaning of social investment

We are accustomed in our society to the idea of making economic investments, but not to the idea of making social investments. Social investments introduce noneconomic criteria into investment decisions and thus change the order of business. Social investors are interested in the impact of their investment on people as well as in making a profit. They believe they can maintain economic returns on their capital while expressing a social concern about corporate conduct; that by investing only in socially responsible companies they can have an effect on corporate behavior; and that social criteria can provide incentives for business to function more reliably in the public interest. Other investors hold that social investments will help business become more self-regulating. Still others contend that investments should be directed toward the cultivation of social objectives within the economy. At a more theoretical level, we might say that they are all interested in social development while remaining steadfastly committed to economic development and financial returns on their investment. They all seek to encourage the development of social values within the free enterprise system.

The origins of the movement are hard to trace, but the use of social criteria became visible among large organizations in the 1960s during a period of urban unrest. In 1967 the Ford Foundation, stimulated by a concern already being expressed by church and university leaders, announced that social investments would become part of its philanthropic program. It hoped to increase the impact of its giving by making higher-risk, lower-return investments in minority businesses, housing, and conservation projects.[1]

Churches also took a turn toward social investment during the 1960s. Although it might be said that they have the oldest tradition in this field because some churches refrained from investing in companies producing liquor and tobacco in the nineteenth century, now the churches became interested in a great variety of corporate activities. The National Committee on Tithing in Investments recommended investing in open

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(integrated) housing and avoiding investment in South Africa. The Cooperative Assistance Fund, initiated by the Taconic Foundation, welcomed social investing by churches. It agreed to assess the likelihood that a company would "show reasonable security and economic return" and "produce institutional change." In 1968 the General Assembly of the Presbyterian Church established an independent corporation, the Presbyterian Economic Development Corporation, to manage the church's unrestricted funds, which were to be spent in higher-risk lower-return ventures in the public interest. One-fifth of the investments and loans went toward housing; two-fifths toward minority economic development; and two-fifths into securities of banks with strong minority-loan records.[2]

More recently, mutual funds, pension funds, and banks have begun utilizing social criteria for directing their stock purchases. The Dreyfus Third Century Fund, for example, is a mutual fund that has set up a special arrangement for its customers to invest with human concern. U.S. Trust, a major bank in Boston, has several officers working with investors on issues of social investment. The Teachers Insurance and Annuity Association and College Retirement Equities Fund (TIAA-CREF), an employee retirement plan with assets of about $9 billion, has been utilizing social criteria in making its investment decisions. The AFL-CIO has established a national committee to develop social criteria for investing its pension funds. Other investment corporations, such as Shearson American Express, Drexel, Burnham Lambert, Travelers Corporation, the Calvert Social Investment Fund, Franklin Research, the New Alternative Fund, the Pioneer Fund, and Pax World Fund, are utilizing social criteria. Numerous universities have been making social investments and are studying the social criteria most appropriate for their portfolios. Indeed, a new field of study is evolving around the proper mix of social and economic criteria for investment.

Investment analysts are interested in developing systematic studies of social criteria to determine their reliability and validity. They are also interested in evaluating the social impact of their investments on investees and evaluating their own efforts on a larger scale of values. There is no systematic theory guiding these separate efforts to utilize social criteria for investments, and almost no empirical research on the issues. The problems in the field have yet to be clarified and formulated for systematic criticism. Indeed, there is need for developing a social science of investment that can track and study these new financial interests.

The traditional field of investment is a well-established course of study in schools of business, but the introduction of social criteria radically changes its conceptual foundation and renders the area of inquiry immensely broad and complex. Yet some investors argue that this step could make it easier to

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anticipate investment outcomes and make the study of investments more logically complete because social variables have always existed in investment but have generally been left unobserved and unmeasured. By taking account of this larger universe, analysts say they can better predict the results of their investments.

Our purpose here is to clarify the major problems that must be addressed so that systematic studies can begin. The problems are interdisciplinary and need to be confronted by behavioral scientists, corporate lawyers, social investors, and business scholars. The problems are the following. First, we want to clarify the kind of institutional power exercised by investors and the abuses that may exist in the investment field. This tells us something about the type of research needed and any relationship it may have to the public interest. It also tells us how investment analysts must be properly informed in making decisions and how researchers must take account of the interdisciplinary nature of their studies. Second, we want to define the meaning of *social investment*. It is important to find a common concept for the construction of a theory and the conduct of empirical studies.

The problem of power

It has become important to consider social investment today partly because staggering amounts of money are becoming concentrated in fiduciary institutions with an extraordinary power to control investment capital. Public and private employee pension fund assets, for example, are over $1 trillion in the United States, and are expected to reach $4 trillion in the 1990s. The nation's three major religions – Protestant, Catholic, and Jewish – have invested billions in the stock market and other types of securities as well as directly in commercial businesses. In 1970 religious organizations had over $22 billion in the stock market alone. The Corporate Information Center of the National Council of Churches studied ten denominations with portfolios totaling $1.5 billion. Universities have invested still more billions and, like churches and unions, have become interested in the social direction of their investments. The significance of these astronomical sums is that they are in the hands of a relatively small number of trustees. This fact leads to questions of public policy in regard to control and raises issues about the direction of investments.

The control of securities by trustees in financial institutions has been heavily criticized by unions. In 1975 the hundred largest banks managed over $145 billion in pension funds; Bankers' Trust and Morgan Guaranty each managed nearly $15 billion. Unions are protesting on the grounds that pension funds are legally "employees' money."[3]

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The House Banking and Currency Committee has documented many abuses in the use of managed funds, including undue pressure by fund managers on big corporations through "self dealing" (favouring stock investment in the bank's best loan-customers). Banks have developed interlocking directorates that allow them to pyramid control over sectors of the economy, an illegal practice that may result in government action. Also, bank trustees may hold stock in declining companies in which they also have loans because the bank fears large loan losses, but such support can be detrimental to fund beneficiaries, who stand to lose when a company finally goes under.[4]

The return on pension funds administered by the banks is very low, so low that many fiduciaries have raised questions about prudence and legality. *Fortune* describes the situation: "During the five years ending in 1975, the total return (i.e., including dividends, which are assumed to be reinvested) on the Standard & Poor's 500 . . . was 3.3. percent. The median rate of return for managed pension fund stock portfolios over those ten years was only 1.6 percent."[5] During this same period FHA and VA federally guaranteed home mortgages were paying 8 and 9 per cent; passbook accounts, 4 and 5 per cent. Managed pension funds could have been socially directed and received a higher rate of return. The trustees could have invested more profitably in low-income housing and even charitable enterprises.

Trade unions have learned that trustees not only lose pension money but also invest in corporations opposed to union interests. For example, trustees may invest in conglomerate corporations that move plants overseas. They may invest in businesses where their union is fighting nonunion employers. Pension trustees have also invested heavily in the South, where companies have relocated to avoid unions.[6] In the face of these realities, the AFL-CIO has begun to look into the possibilities of obtaining greater control over pension funds and of utilizing investment criteria that would be in unions' interest.

The AFL-CIO Executive Council in 1980 adopted a broad policy regarding the investment objectives of union-negotiated pension funds. The policy was based on a Department of Labor study showing that pension funds in the private sector will own between 54 per cent and 60 per cent of all corporate stock by 1995. State and local government pension funds were not included in the study, but estimates suggest that they will own 10 per cent to 15 per cent of the corporate stock. In the manufacturing industries, the funds will amount to over $2 trillion; in transportation, to over $400 billion; in the service sector, to almost $400 billion; in the construction industry, to about $300 billion; and in the financial sector, to some $200 bil-

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lion. The council's social criteria for investment included job creation through reindustrialization, advancing "social purposes such as worker housing and health centers," improving "the ability of workers to exercise their rights as share-holders in a coordinated fashion," and excluding "from union pension plan investment portfolios companies whose policies are hostiile to workers' rights."[7]

The council further recommended that the AFL-CIO work toward the establishment of an independent institution to facilitate the investment of pension funds for reindustrializing the nation's economic base. "The new institution should be directed by a tripartite board of directors, equally representing the labor movement, employers and the public. To assure that the interests of the pensioners are protected, the government should guarantee a minimum return on the invested funds." The council proposed that the institution be created by Congress, and that it be given specific responsibilities and authority to pool monies, grant guarantees, and negotiate investments.

Pension funds supply the principal part of corporate equity and bond purchases in the United States. In the 1970s, corporate pension funds alone brought more than half of all new equity issues. Pension funds normally provide about three quarters of net corporate bond purchases. Employee pension funds are therefore critical to the operations of the basic financial institutions which, in turn, control the formation of capital in the United States.

Financial institutions utilize both voluntary and forced savings in the formation of capital. Among voluntary household savings, between one-fifth and one-quarter goes into insurance and pension fund plans. This pool of capital becomes available to financial institutions who use it to purchase equities (or make bond loans) to the largest 500 corporations. Forty per cent of the remaining voluntary household savings goes into accounts at commercial and savings banks to finance housing, small businesses and durable consumer purchases. The remaining twenty-five per cent is directed toward the purchase of corporate equity. The main form of forced saving in the United States is pension fund contributions made as a commitment to retirement income. These forced savings come under the management of insurance companies, bank trust departments, or the corporate employers' own investment department.[8]

Corporations have increasingly become indebted to outside sources of funding and the irony is that the outside sources are funded by the corporations themselves through pension payments. The credit market supplied over 50 per cent of total capital expenditure of the non-financial corporate sector in 1979. The credit markets (bond and equity shares), in turn, are

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dominated by the pension funds and the insurance companies that represent them.[9]

Pension funds are thus critical to the process of capital formation in the United States. They are organized in both the private and public sector.

Private sector pension plans are trusteed and subject to the Employee Retirement Investment Security Act regulations. Under the authority of this Act the employer establishes the fund. Unions cannot be sole administrators of these plans, but they can jointly administer them with management if they win this arrangement through collective bargaining. At present over $100 billion of pension assets is jointly trusteed. But few unions have really chosen to exercise their power over specific investment decisions.

Public sector pension plans operate under various government rules. The Federal government pension system can be held only in the form of federal government securities. Most state and local government plans are also trusteed under state laws, with standards and restrictions on trustee behavior varying between states. Employees frequently have some representation on these trustee boards but joint control is not guaranteed (see figure 1.1).

Financial institutions normally adhere to a "Wall-Street Rule" in exercising their voting rights. This means that institutional investors agree informally not to take an active role in pressing for change in the corporations in which they invest. They prefer to pass the proxies to management. If they disagree with management, they tend to sell their shares. An important control is exercised by these institutions, however, through creditor relationships and the placement of appropriate persons on the board of directors in sympathy with their interests. This policy is followed because the key decisions flow from the boards themselves. The boards determine the rate of profit retention, the rate of borrowing, the rate of share issuance, the location of plants, and the rate of net investment.

Unions have begun to bargain special arrangements for what are called "target investments." For example, the UAW does not have a joint trusteeship, but in the 1979 round of bargaining it won a set-aside of 10 per cent of pension fund growth. This set-aside is to be invested under the advice of a joint UAW-Chrysler Investment Advisory Committee, in mortgage programs and in nonprofit organizations such as nursing homes, nursery schools, and HMOs (Health Maintenance Organizations) in the communities where UAW members live.

The pooling "set-aside" is seen to minimize the risk of utilizing target criteria. In this way no single pension fund risks a significant portion of its portfolio and no individual worker's pension is greatly jeopardized.

The trade unions have a legal case for exercising greater control over the investment of their funds because they are legally defined as "deferred

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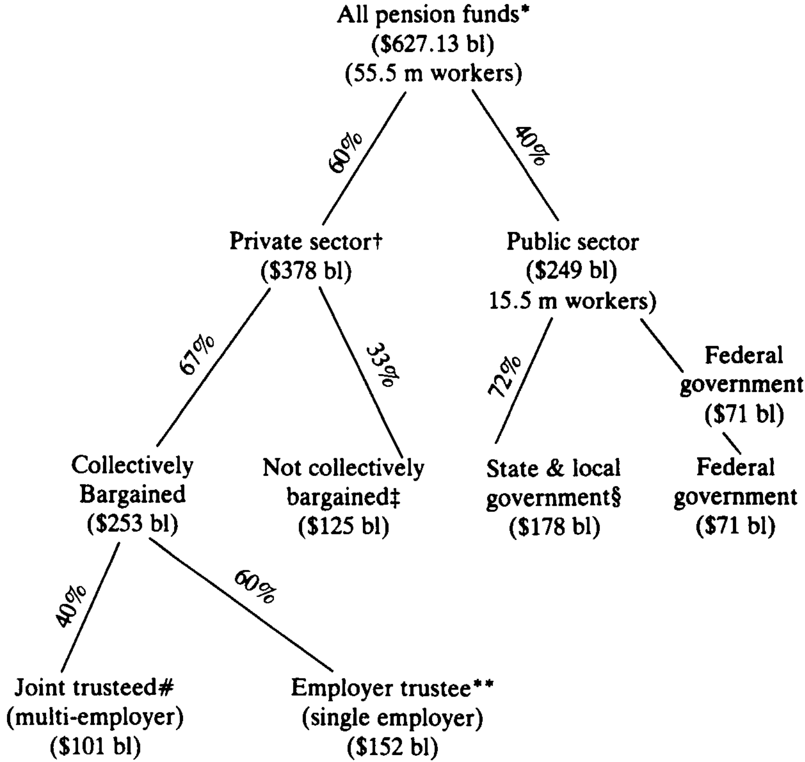
Figure 1.1
PENSION FUND SIZE AND SCOPE



* Dollar estimates, 1980. Employment estimates, 1978.

† All of these are trusteed and covered by ERISA. 1970 BLS estimates are that 79% are non-contributory for workers.

‡ Most of these are turned over to banks and insurance companies to manage, or the benefits are contracted to an insurance company directly. Large ones are likely to be managed "in house" by the corporate asset management department.

§ Virtually all defined benefit plans, subject to state legislation. They are *usually* joint contribution, with some worker representation on the controlling boards. Assets can only be invested in federal government securities.

\# Largely defined contribution plans, generally in the building and needle trades.

** Largely defined benefit plans, bargained by industrial unions, such as the UAW, Steelworkers, CWA. (ERISA provides that even if unions do not negotiate joint trusteeships, they are entitled to disclosure of portfolio information.)

Source: Jocelyn Gutchess, update of Ruttenberg et al., *AFL–CIO Pension Fund Investment Study*, August 20, 1980. Quoted in Carol Cleireacain, "Towards Democratic Control of Capital Formation in the United States," in Nancy Lieber, ed., *Eurosocialism and America*, (Phila.: Temple University Press, (1982) p. 52.

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wages" rather than as a "gratuity" provided by the company. In 1949 the Supreme Court upheld and quoted with approval the National Labor Relations Board contention that "realistically viewed, this type of wage enhancement or increase, no less than any other, becomes an integral part of the entire wage structure, and the character of the employee representative's interest in it, and the terms of its grant, is no different than any other case where a change in the wage structure is affected."[10] Subsequent Court decisions have taken the position that pension contributions by employers must be viewed as part of wages. Once a contribution has been made to the fund, the money no longer belongs to the employer. The tax laws strengthen the argument by making pensions tax exempt. Union leaders point out that employees pay income tax when they receive their pension benefits. The issue of who holds the final authority over the investment of pension funds is still under study, but the unions clearly have a strong legal position.

Who should exercise power over pension funds and the billions of dollars channeled through mutual funds and banks from other sources will be a major legal issue in the future. Capital can be invested only through a legal framework, and the legal framework is currently bound by the assumption that investments are made in the economic interest of investors, not primarily in the interest of investees or the public. It is therefore essential to examine investment law because the new investors are beginning to create a process of investment that is on the legal borderline. They open a new frontier for sociological research: "public interest" law.

The legal framework

A major question for socially oriented investors concerns the "prudent-man" ruling in 1830 by a Massachusetts court in *Harvard College* v. *Amory*. Harvard College and Massachusetts General Hospital were to be beneficiaries of $50,000, a sum that Francis Amory was to manage. Amory lost $20,000 while managing the trust and was sued by Harvard College on the count that he invested not in public securities and conservative stocks but in manufacturing and insurance stocks that were considered not safe. Amory argued that he handled the trust in good faith, and the court ruled in his favor:

> All that can be required of a trustee to invest is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering probable income, as well as the probable safety of the capital to be invested.[11]

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The argument against social investments originates with this historic ruling that asserts that trustees must be guided primarily by the economic interests of the beneficiaries and the safety of the money. Many state statutes provide lists of permissible investments (e.g., government securities, first mortgages on land, high-quality bonds) for public monies, which place still more restrictions on the options of trustees. Public pension funds have over $200 billion in assets and represent almost one-third of all pension investments. The rulings and the statutes hence have a significant impact on the direction of investment.

Michael T. Leibig makes a strong argument that social investments are permissible and even mandatory under conditions in which beneficiaries claim that social criteria should be used in investment. He points to a variety of decisions in which exceptions were made to the prudent-man rule. Recent cases include *Blankenship* v. *Boyle*, in which a union invested in public utility companies. The companies benefited the United Mine Workers because they bought coal produced by the workers. Subsequent decisions have upheld this principle that a union could receive "collateral benefits" from its investment. For example, in *Withers* v. *Teachers' Retirement System of the City of New York*, the court decided that a nontraditional investment decision of the union to invest in municipal securities at a time when the city was in severe financial crisis was acceptable and did not involve "self-dealing." The teachers, of course, benefited by helping to pull the city out of the crisis. The court said that it was acceptable for a union to invest in a corporation that might enhance the interests of the union as long as there were no self-dealing interests on the part of the executors of the fund to place the principal at undue risk.[12]

Leibig's argument rests on an analysis of the Employee Retirement Income Security Act of 1974 (ERISA), which governs pension investing. Leibig points out that the Act (Section 404(a) (1)) and its legal precedent point to such prudent rules as investing with an eye to the "overall portfolio," "diversifying assets," "looking to the benefit of the participants and the beneficiaries," "avoidance of self dealing," and "taking account of the intent of the plan and the documents" behind the investment. Each rule gives credibility to using social criteria within the law.

In responding to these guidelines on behalf of the social investor, Leibig shows first how the "overall portfolio" may be given greater weight under ERISA than under the common law rule, which had required almost completely separate consideration of each investment. This guideline then is actually conducive to socially beneficial investment policies applied within the context of the overall portfolio. The overall portfolio is judged for its percentage of economic return rather than for each of its consitituent parts.

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Second, the principle of "diversifying assets" makes it easier to invest a percentage of the plan's assets in socially desirable investments. The diversification can be made with social criteria. Third, the social investment can benefit the beneficiaries without executor "self-dealing," that is, investments can be made in collateral investments, as in the case of the coal miners and the teachers in New York City. Fourth, the rule that the investment is intended to aid "participants and beneficiaries" could be interpreted to mean current employees of the firm in which the investment is made. An Employee Stock Ownership Plan in which employees are also beneficiaries is particularly applicable to this interpretation. Fifth, the rule that self-dealing cannot enter into investments as a motive is actually on the side of the social investor whose investments are guided not by self-dealing but by social principles and can be justified on that account. Such investments are therefore not prohibited by this rule. Finally, Leibig points out that the beneficiaries are always important to the investment decision. If investments do not give full consideration to the interests of the beneficiaries and participants, the fiduciaries can be held in violation of the trust. Clearly, then, if beneficiaries mandate social criteria for their investments, the fiduciary is obligated to follow that mandate.

Other questions concerning the right of investors to use social criteria involves the Internal Revenue Service. In 1970 a taxpayer asked whether an amendment to an unemployment benefit trust permitting low-risk income-producing investments that served a social purpose would affect the tax-exempt status of the trust. The Internal Revenue Service approved the amendment with the following statement:

> Although the proposed amendment expands the factors that may be considered by the trust in formulating its investment policy, the amendment does not affect the purpose of the trust . . . low-risk investments that produce income and also serve a social purpose will not be considered a diversion of the corpus or income from the trust's purpose even though such investments yield a rate of return lower than that in the current market.[13]

Clearly, there are some legal risks that attend social investment, but social investment can be made properly without penalty under the right conditions. We must now determine the exact meaning of social investment.

The concept of social investment

The scientific meaning of investment focuses on its economic functions.

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