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Economically Targeted and Social Investments: Investment Management and Pension Fund Performance



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**Economically Targeted and
Social Investments:
Investment Management and
Pension Fund Performance**

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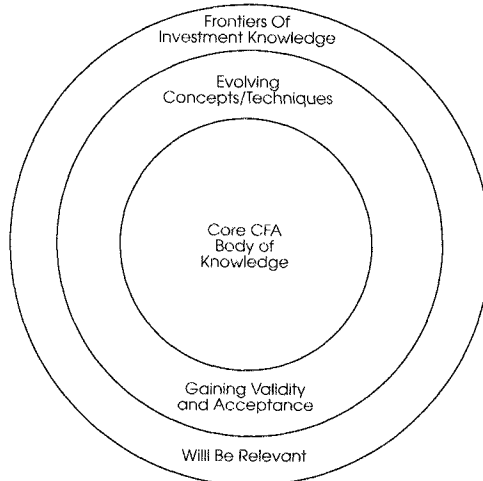
ISBN 978-0-943205-34-2

Printed in the United States of America

November 1995

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Foreword

During the past several decades, financial economic theory has provided us with considerable guidance on making prudent investment decisions. For instance, the benefits of reducing volatility by holding a diversified portfolio of securities is by now a well-established principle, as is the notion that investors can expect to be compensated for performing the twin functions of supplying financial capital and bearing risk. Indeed, much of the modern approach to security analysis is built on these two tenets alone. What happens, however, when we are also asked to evaluate a prospective investment by other, non-economic criteria? How, for instance, do we incorporate often nebulously defined factors involving social welfare into our existing decision-making calculus, and what will be the ultimate impact of such inclusions on investment performance?

Pursuing answers to these questions is the goal of this monograph. Specifically, Wayne Marr, John Nofsinger, and John Trimble present us with a detailed account of the recent trend in pension fund management toward selecting investments that are thought to serve a broader social purpose in addition to their traditional economic attributes. The funds' primary interests in this regard are the acquisition of (1) economically targeted investments (ETIs), such as community mortgage programs and union-preferenced construction contracts, and (2) socially restricted investments (e.g., prohibitions against South African or Northern Ireland holdings). Following an interesting discussion on the historical development of both of these investment approaches, the authors provide evidence on their relative merits. In particular, using new and existing data sets, they contrast the investment performance of pension funds with and without ETIs, as well as of those funds with and without social restrictions.

Marr, Nofsinger, and Trimble's message is quite clear: Pension funds with economically targeted and socially restricted investments have underperformed their unconstrained counterparts by anywhere from 1 to 2.5 percentage points per annum. Although their empirical evidence is not overwhelming in its statistical strength, it is remarkably consistent in supporting that basic message. Further, they document recent efforts on the part of the federal government to expand the mandate for ETIs from the public to the private sector. Taken together, the authors' analysis creates a strong indictment of the entire concept of social investing, especially when done on an involuntary basis.

Despite the consistency of the empirical findings, the conclusion is not

really as clear-cut as the authors suggest. Readers should bear two caveats in mind while perusing this study. First, in their comparison of successful and unsuccessful ETIs, the authors admit that data limitations prevented a thorough examination of the former group, even though it represented more than half of their sample. Second, and more fundamentally, it is quite possible that some of the ETIs adopted into investment portfolios do produce some or all of the intended benefits. Unfortunately, no attempt has been made to quantify these benefits and capture them in the comparative analysis. Although the authors argue persuasively that pension funds should not bear financial costs to produce returns for anyone other than the direct beneficiaries, it is nevertheless the case that a complete statement on this topic must include this dimension.

It would be naive to think that pension funds connected to political organizations can themselves remain completely apolitical. It would also be wrong, however, to assume that the mere presence of such pressures on the investment process are necessarily hazardous to a fund's wealth. The more interesting and relevant issue, then, is to measure the extent of the cost associated with using retirement money to advance a social engineering agenda and to determine whether this cost is justified by any other benefits associated with the program. Marr, Nofsinger, and Trimble have done the reader a service by placing the first of these two issues directly on the table. As such, this research is likely to stimulate as many new questions as it has managed to answer. We are pleased to present it to you, both for its present content, as well as what it may lead to in the future.

Keith C. Brown, CFA
Research Director

Economically Targeted and Social Investments: Investment Management and Pension Fund Performance

... the Work Group concludes that many sound investments exist in areas not usually targeted by pension funds. In some cases, investing in projects which are of local or occupational interest to a pension fund's participants can create a primary benefit from competitive financial returns and a collateral benefit from the creation of jobs, wealth, and other local economic ripple effects. In some cases, these benefits are measurable. In others, they are not measurable but can be presumed.¹

A major underpinning of modern investment management is the efficiency of capital markets, which should ensure that prices of assets reflect their fundamental values. Financial economists generally agree that capital markets function well but are not perfectly efficient. Bargains may be found in the trenches of day-to-day investing, but they are not easy to find. They are likely to be random occurrences and not systematic in nature. They are found by diligent search for value that follows sound investment practice by assessing risk against expected return for each and every investment prospect.

Economically targeted investments (ETIs) seek to turn sound investment practice on its head by adding economic development objectives to investment decisions. They presume systematic inefficiencies in capital markets, but no identification or evaluation procedures exist to separate possible capital gaps from inferior investments. ETIs are dual-purpose investments, with the investment decision made in the joint interests of society and of pension plan participants/beneficiaries. Dual-purpose investing has two goals: achievement of a risk-adjusted market rate of return and achievement of some social or other economic gain external to the investment project's cash flows. Currently, most money managers and plan sponsors of pension funds in the private sector are

¹Executive summary of *Economically Targeted Investments: An ERISA Policy Review*, a report of the Work Group on Pension Investments, Advisory Council on Pension Welfare and Benefit Plans, U.S. Department of Labor (November 1992).

largely avoiding the obvious ethical dilemma of trying to serve two masters. Money managers and plan sponsors of *public* pension funds, however, have often embraced ETIs, if not mandated their use.

The first widespread mandate for investment managers of public pension portfolios to “share” their fiduciary duty occurred with the divestiture from their portfolios of firms that do business in South Africa. In the early 1980s, many states directed their retirement systems to purge themselves of companies operating in South Africa. The investment characteristics of social restrictions have been well documented. ETIs, our focus, have been around in small numbers for decades, and these dual-purpose investments became more common in the late 1980s. Data and empirical analyses of such investments are scarce, however.

In this monograph, we first review the history of ETIs and present evidence for their investment performance and governance characteristics. We then review the current state of knowledge concerning social investments, including new evidence of investment return and the effect of social investments on fiduciary duty. We also investigate the characteristics of public pension funds, which are most susceptible to pressure for social restrictions and economic development investments, and the implications of concessionary mandates. Concessionary investments have impacts on pension funding and retirement benefits. Finally, we review the U.S. Department of Labor’s investigation of ETIs and its policy implications.

Economically Targeted Investments

ETIs are dual-purpose investments designed to stimulate economic development, growth, or job creation for a specific group or region while achieving competitive returns. These investments often take the form of mortgage programs, construction loans for projects with union workers, venture capital, commercial development programs, direct private placements, and bailout loans to in-state companies. In very small numbers, ETIs have been around for decades, but in the late 1980s, they proliferated among public and union pension funds. “Our Money’s Worth,” a report commissioned by New York Governor Mario Cuomo, kicked off the public debate concerning the risk–return characteristics of ETIs.² The report recommends that, instead of investing for maximum returns or maximum safety, pension funds should invest for the purpose of optimizing returns. This controversial report spurred research, debate, and legislative action on the question of pension fund investments.

²“Our Money’s Worth,” The Report of the Governor’s Task Force on Pension Fund Investment, New York State Industrial Cooperation Council (June 1989).

In 1989, the Institute for Fiduciary Education (IFE) issued the first survey of public pension funds on the topic of ETIs. Of the 99 pension funds responding, 78 had specific ETI programs. The IFE survey used a much broader definition of ETIs than is generally recognized. For example, many of the IFE's ETIs are Government National Mortgage Association (GNMA) securities, which are classified as mortgage-backed securities and have known risk and return benchmarks. Of the 78 ETI programs identified, the performance of 29 programs (37.2 percent) was unknown and 17 pension funds (21.8 percent) did not respond to the performance question. In a follow-up 1993 report, the IFE found that public pension funds invested \$19.8 billion in ETIs in 1992, up from \$7.3 billion in 1989. The survey found that although the money in ETIs had increased significantly, the number of public pension funds investing in them had grown only marginally: a net increase of only three public pension funds investing in ETIs between 1989 and 1992.

Some proponents of ETIs argue that below-market rates of return are justified by the added economic benefits. Others contend that ETIs can provide both market rates of return and additional benefits (see Watson 1994). Opponents of ETIs argue that the fiduciary standards of "the exclusive benefit" rule must remain permanent.

Assets labeled as ETIs fall into two categories. The first category is those erroneously labeled as ETIs. These assets are in recognized asset classes, such as mortgage-backed securities and venture capital. The second group is focused on economic development. Much of the debate about ETIs centers on the financial performance of this second group.

"Competitive PLUS" Revisited. In 1990, Governor Cuomo issued a second report: "Competitive PLUS: Economically Targeted Investments by Pension Funds." The purpose of this report was to record the experience of pension funds that have made targeted investments and to determine the best way to implement ETIs. At the outset, the report recommended that

. . . pension funds should not undertake investments which produce concessionary rates of return for the funds in order to promote social goals or achieve economic development goals. A concessionary investment is one with a low rate of return unjustified by a suitably low level of risk or a high risk investment without suitably high returns. (p. 4)

The report provides detailed examples of the experiences of public pension funds in ETIs. These ETI programs were handpicked to support the use of pension assets in targeting groups of people or geographical areas to receive some collateral benefit.

In reviewing the ETI programs described in “Competitive PLUS,” we categorized them into three groups: concessionary ETIs, successful ETIs, and non-ETIs. The concessionary group consists of ETI programs that appear designed to earn below-market returns or that (*ex post*) experienced investment catastrophes. The successful ETIs group consists of programs designed to earn market rates of return; their performance (*ex post*) has been near that of standard investment benchmarks. To be conservative, we classified programs whose financial performance is not public as successful ETIs. The third group, non-ETIs, comprises investment programs that are erroneously classified as ETIs.

■ *Concessionary ETIs.* Many ETIs take the form of mortgage programs, such as the *residential mortgage program* for members of California’s Calpers and Calstars systems. “Competitive PLUS” states, “The program offers fixed-rate mortgages and charges points of only 1.25 percent, less than prevailing market rates.” This ETI is concessionary by design. Another concessionary ETI described is a program from the Pennsylvania State Employees’ Retirement System to buy individual mortgages. The report states, “The whole loans [which the pension system buys] are not as liquid as the FNMA securities, but offer a yield advantage of 30 to 50 basis points.” The purchased mortgages are not backed by the federal government and thus have more risk than FNMA securities. To compensate for the added risk and reduced liquidity, these mortgages should pay at least 100 basis points more than the FNMA benchmark.³ Another concessionary ETI is the Community Preservation Corporation (CPC) sponsored by the New York City Employees Retirement System. The CPC investments return slightly more than GNMA mortgage-backed securities and are fully insured by the State of New York Mortgage Agency. Finally, consider the State of Connecticut teacher and public employee fund’s ETI mortgage program. Rather than linking the interest rate of their mortgages to the 17.25 percent rate quoted by local banks at the time, State Treasurer Henry Parker pegged the rate to that of an AA industrial bond, 13.75 percent—3.5 percent below the current market rate.

For *commercial mortgage programs*, the Oregon Public Employees’ Retirement System buys pools of commercial mortgages priced at the ten-year Treasury rate plus 300 basis points. Compensation of 3 percent over the

³In a 1983 study, Alicia Munnell, economist and senior vice president at the Federal Reserve Bank of Boston, found that mortgages insured by the Mortgage Guarantee Insurance Corporation that were sold on the open market had to compensate investors 1.0–1.5 percentage points for the added risk and reduced liquidity from Government National Mortgage Association (GNMA) Securities.

ten-year Treasury rate is not an adequate expected return for the high risk of commercial mortgages. A second example is from two Baltimore retirement systems. In this investment process, a local bank searches for commercial development investments with the proper economic and social aspects. A committee of the pension fund uses a 20-year AA corporate bond as the investment benchmark to make the final decision. This benchmark is too low to compensate for the risks and illiquidity of commercial mortgages and construction loans, especially considering the additional costs of this program. “[The funds] found the management of these investments to require additional staff and trustee time compared to other asset classes.”

Many ETIs are designed to *create* or *keep jobs* in the local economy. These ETIs often take the form of equity positions, loans, or venture capital for local companies. Many of these ETIs, however, have had less than satisfactory results.

- The State of Connecticut Trust Fund experienced a failure with its only in-state investment—a venture capital program. The system paid \$25 million for a 47 percent stake of Colt in 1990. The company filed for bankruptcy protection on March 19, 1993 (Schwimmer 1993).
- In 1987, the Missouri legislature mandated that the Missouri State Employees’ Retirement System (MOSERS) create the Missouri Venture Partners program. The Partners program required 3–5 percent of MOSERS’ assets to be used in venture capital investments in small companies based in Missouri. In 1990, after only three years and \$5 million invested, the program was terminated. The program resulted in less than satisfactory investment returns and two lawsuits.⁴
- The Kansas Public Employees Retirement System (KPERS) lost a \$65 million investment in Kansas-based Home Savings Association after federal regulators seized the thrift. KPERS’s \$14 million investment in Kansas-based Tallgrass Technologies has become virtually worthless. KPERS also invested \$7.8 million in Christopher Steel, which is now an abandoned steel plant; KPERS may salvage \$1 million of the investment after liquidation. KPERS has already written off \$138 million from its ETI programs, and by some estimates, the total could reach \$236 million (Philip 1993).
- Pennsylvania state officials promised Volkswagen assistance in financing a new \$70 million plant in the state. State officials then pressured the public school employees’ and state employees’ retirement funds to

⁴Letter from MOSERS to Wayne Marr (November 25, 1991).

assist in financing. The plant closed a decade later. After four years, Sony occupied the plant when the state forgave \$40 million of the loan (see *Wall Street Journal*, July 9, 1976, and Dvorchak 1992).

■ *Successful ETIs.* Because we have limited or no data for successful ETIs, we do not discuss this group in detail.

■ *Non-ETIs.* We identified three programs from the “Competitive PLUS” report that should not be considered ETIs. The Alabama Retirement System and the New York City Employees Retirement System classify their GNMA purchase programs as ETIs; because GNMA pools diversify mortgages from across the country, however, it is difficult to argue that these are economically targeted investments. In New York, a conglomerate of unions initiated the Union Trades Non-Profit Housing Corporation, another non-ETI. The investments by the union pension fund are in federally insured certificates of deposit from local lenders. These CDs may be targeted investments, but they are fully insured by the federal government.

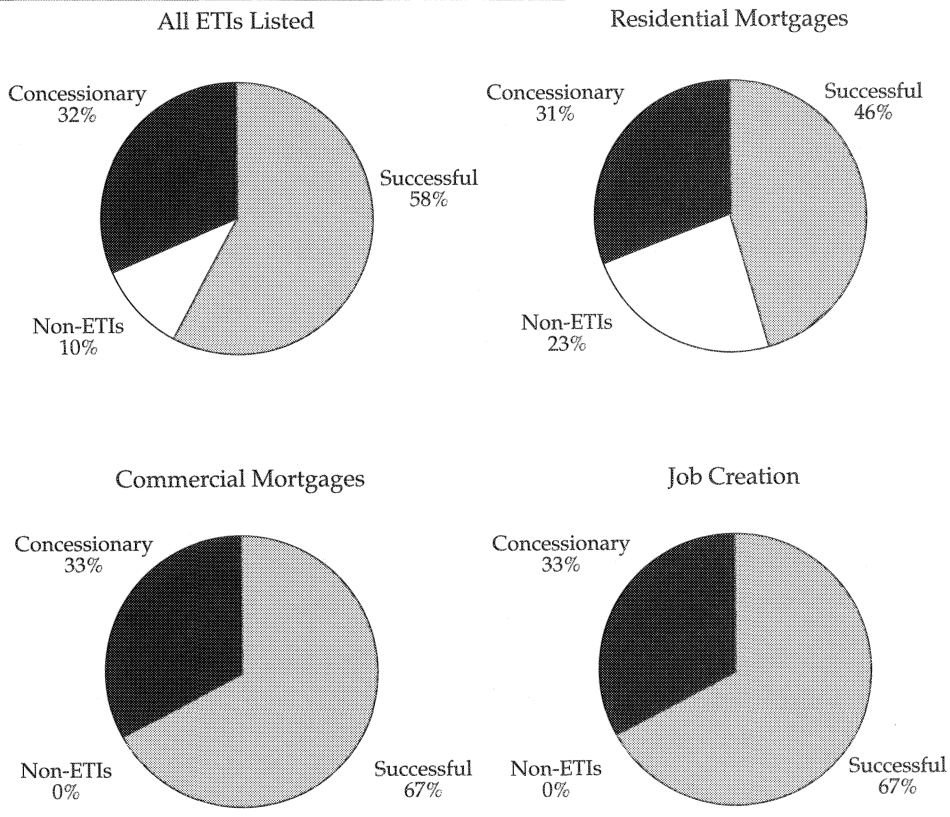
The ETI Scorecard. For all of the ETIs described in “Competitive PLUS,” we categorized 10 (32 percent) as concessionary, 3 (10 percent) as non-ETIs, and 18 (58 percent) as successful programs (see Figure 1). For the 18 successful ETIs, however, we did not have adequate information for proper classification. The subpar performance of 32 percent of the ETI programs listed in the “Competitive PLUS” report, considering they were hand-picked by a committee promoting ETIs, is striking.

For residential mortgage ETI programs, four (31 percent) are concessionary, three (23 percent) are non-ETIs, and six (46 percent) are successful. Among the commercial mortgage ETI programs, two (33 percent) are concessionary and four (67 percent) are successful. For the job-creation ETIs, four (33 percent) are considered concessionary and eight (67 percent) successful.

As evidence of the prudence of ETIs, many proponents refer to a study conducted by The Marco Consulting Group (MCG) and released on April 15, 1992.⁵ This study has become important because it has been cited in government documents as evidence of successful performance by ETI programs. These documents include “Economically Targeted Investments: An ERISA Policy Review” (U.S. Department of Labor 1992) and “Financing the Future: Report of the Commission to Promote Investment in America’s Infrastructure” (U.S. Department of Transportation 1993). In addition, the study has been discussed in trade magazines such as *Pensions & Investments*.

⁵MCG is the largest U.S. consultant to multiemployer pension plans.

Figure 1. Classification of Program Success for the ETI Programs Highlighted in “Competitive PLUS”



Source: Based on data in “Competitive PLUS.”

The MCG study surveyed 6 mortgage real estate funds and 16 open-end real estate funds. Of the six mortgage funds, MCG found five that were union-sponsored ETI programs. All five outperformed the sixth fund in 1991, as well as during the previous ten years. Our investigation revealed that a comparison of these funds with mutual funds investing in government mortgage-backed securities is not as favorable for the five union funds. In fact, returns for four of the five union funds were below the average return of all 42 mortgage mutual funds for 1991.⁶ Three of the five were below average for the three-year period from 1989 through 1991. Three of the union funds have

⁶Data for the government mortgage-backed mutual funds were obtained from “Investment Companies 1992,” CDA/Wiesenberger Investment Companies Service.

performance histories of five to ten years. Of these three, only one beat the average mortgage mutual fund for five years and none was above average for the ten-year period.

This comparison suggests a different evaluation from that in the MCG study. The MCG study claimed the mortgage ETIs were superior performers, but compared with other mortgage funds, the majority of mortgage ETI funds were below-average performers. The MCG study states, "No other nontargeted mortgage funds were found in the survey." We believe this statement is incorrect, because mortgage fund data are widely available.

The MCG survey of the 16 open-end equity real estate funds was a little more comprehensive than the mortgage fund survey. MCG found that the 2 ETI funds outperformed the other 14 funds for 1991. The study does not mention that returns for these funds are based on appraisals of the properties. Appraisal values do not represent market values very accurately because of the high degree of subjectivity involved in the appraisal process. Large commercial properties are not traded frequently, and comparisons are difficult because of large variances in location, size, and quality of comparable property. These problems are compounded by the conflict of interest for the appraiser, who tries to value property accurately but also wants repeat business from the fund. Appraised values are partly based on previous appraisal estimates.

All these factors lead to the conclusion that the investment returns fund managers provide are highly subjective. Any comparison among funds using these data could be inaccurate and misleading. In light of this information, this part of the MCG study appears to be very weak. Even if the reported returns were valid, an investor would have achieved a higher rate of return in any of the several real estate equity mutual funds.⁷

ETIs and Investment Performance. The evidence presented thus far suggests that "successful" ETIs achieve risk-adjusted returns near those of a proper benchmark. "Unsuccessful" ETIs are concessionary and often have enormous downside risks, but the evidence is largely anecdotal. Case studies can be found in Marr, Nofsinger, and Trimble (1993) and Romano (1993). Although desirable project-specific returns are unavailable, two recent back-to-back surveys offer enough information to analyze the performance of funds

⁷We identified Fidelity Real Estate Investment, Fidelity Select—Construction and Housing, the U.S. Real Estate Fund, and the Templeton Real Estate Securities Fund. These funds invest in real estate investment trusts, which are publicly traded, so the quoted investment returns are accurate.

engaged in social and economically targeted investing.

Our data are taken primarily from two surveys of public pension funds.⁸ These surveys contain information on social restrictions, targeted investments, portfolio returns, asset allocation, and governance provisions for fiscal years 1990 and 1991. We supplemented these data with retirement system annual reports, investment documents, the two IFE studies mentioned earlier, and personal communication with the funds. The data used in all the empirical work presented in this monograph were for defined-benefit pension funds. The participants in a defined-benefit plan rely on the fiduciary duty of the trustee to select investments that are in their best interests; they cannot choose from a menu of investment strategies as is the case for participants in many defined-contribution plans.

Table 1 presents the mean one-year returns and standard deviations for public pension plans with and without ETIs. For the entire data set, 55 funds

Table 1. Annual Returns for Pension Funds with and without ETIs

Measure	Full Sample	Pendat 1991	Pendat 1992
Non-ETI funds			
Mean return	12.35%	7.81%	15.22%
Standard deviation	7.70%	4.68%	7.86%
Observations	333	129	204
ETI funds			
Mean return	9.89%	6.67%	12.03%
Standard deviation	6.84%	5.55%	6.85%
Observations	55	22	33
Difference in means (<i>t</i> -statistic)	2.46%* (2.23)	1.14% (1.03)	3.19%* (2.20)

*Significantly different from zero at the 5 percent level.

invested in ETIs and 333 funds did not. The mean return for the ETI funds (9.89 percent) is 246 basis points less than that of the funds without ETIs (12.35 percent), a difference that is statistically significant at the 5 percent level. The difference is 114 basis points for the Pendat 1991 sample and 319 basis points for the Pendat 1992 sample. The standard deviation for the 55 ETI funds was 6.84 percent versus 7.70 percent for the pension funds without ETIs. Note that in the Pendat 1991 sample, the non-ETI funds mean-variance-dominated the ETI funds.

⁸Both surveys were conducted by Paul Zorn and are entitled "A Survey of State and Local Government Employee Retirement Systems." They were published by the Public Pension Coordinating Council in 1991 and 1992, and we refer to them as Pendat 1991 and Pendat 1992.

To adjust the one-year returns for differences in asset allocation and risk, we calculated an expected return by matching the fund's return with a benchmark. The benchmark return consisted of returns from common indexes.⁹ The benchmark return represents the return expected from a well-diversified portfolio with the same asset allocation as the pension fund. For example, the Illinois State Teachers' Retirement System (ISTRS) earned 20.8 percent in 1991. The benchmark return with the same asset allocation as ISTRS was 19.4 percent. We defined the unexpected return as the difference between the fund's return and the benchmark return, or 1.4 percent for ISTRS.

Analysis of the unexpected returns is shown in Table 2. The difference

Table 2. Annual Unexpected Returns for Pension Funds with and without ETIs

Measure	Full Sample	Pendat 1991	Pendat 1992
Non-ETI funds			
Mean return	-4.08%	2.33%	-7.43%
Standard deviation	7.83%	4.21%	7.18%
Observations	224	77	147
ETI funds			
Mean return	-4.51%	1.19%	-8.78%
Standard deviation	7.41%	4.18%	6.37%
Observations	28	12	16
Difference in means (<i>t</i> -statistic)	0.43% (0.27)	1.14% (0.87)	1.35% (0.72)

Note: The unexpected return for each fund is calculated by subtracting, from the annual return, a benchmark portfolio return that has the same asset allocation as the fund.

between non-ETI funds and ETI funds was 43 basis points in aggregate and 114 and 135 basis points for the Pendat 1991 and 1992 samples, respectively. The low difference in the total sample is mainly attributable to pension funds outperforming their benchmarks in the 1991 sample and underperforming in the 1992 sample. Although the difference between the two types of funds is

⁹Our benchmark for cash holdings was the Treasury-bill return (monthly returns compounded for an annual return); for domestic stocks, we used a value-weighted index of all stocks trading on the New York Stock Exchange (NYSE) and American Stock Exchange (Amex); for U.S. securities, we used the long-term U.S. Treasury-bond; for corporate bonds, we used the Salomon Brothers Long-Term High-Grade Corporate Bond Index; for mortgages, we used the Salomon Brothers Mortgage-Backed Index; for real estate equities, we used the Russell-NCREIF Property Index; for international equities, we used the Morgan Stanley Capital International World Index; and we used the Salomon Brothers World Government Bond Index (non-U.S.) for the international fixed-income benchmark.

economically large, these estimates are not statistically different. Note that pension funds with ETIs usually limit their total asset allocation in ETIs to no more than 5 percent. The variation in portfolio return caused by this 5 percent of assets is what we are trying to capture; thus, the lack of statistical significance is not problematic because we do not expect a large difference in unexpected returns. Apparently, however, asset allocation does not explain all the difference in performance between pension funds with ETIs and funds with no ETIs.

As a third test, we used cross-sectional regression analysis on the two groups of pension funds to estimate risk-adjusted abnormal returns. The regressions produced the following results:¹⁰

For the non-ETI regression,

$$r_i - r_f = 1.35\% + 0.32(r_M - r_f),$$

and for the ETI regression,¹¹

$$r_i - r_f = -0.76\% + 0.30(r_M - r_f),$$

where r_i is the fund's annual return, r_f is the risk-free rate (U.S. T-bill yield), and r_M is the market return as proxied by a value-weighted index of NYSE and Amex stocks.

The risk-adjusted abnormal return for non-ETI funds (1.35 percent) is greater than the ETI funds' abnormal return (-0.76 percent)—significantly greater at the 10 percent level, according to an *F*-test. The beta estimates between the two groups are not statistically different. The small beta coefficients are indicative of the high allocation to fixed-income investments in public pension funds.

Proponents of ETIs argue that investments in the local economy have low correlation with traditional pension investments (such as stocks and bonds) and will thus reduce the risk of the investment portfolio. We found that the standard deviations of ETI funds' returns were mostly lower than those of non-ETI funds, but the beta risk measures were nearly identical. This argument is deceptive, however. ETIs may have low correlation with traditional investments, but they are highly correlated with the local economy. When the local economy suffers, government unemployment costs increase while tax revenues decrease. The very time that governments cannot afford to contribute to their pension funds is the time that ETI investment performance

¹⁰Both estimates are significantly different from zero at the 1 percent level. The adjusted R^2 is 36.1 percent, and n is 333.

¹¹The abnormal return is not statistically significant. The beta estimate is significant at the 1 percent level; adjusted R^2 = 37.9 percent, and n = 55.

suffers, potentially requiring higher contributions than normal. This situation is analogous to employees investing their retirement money in their employers' stock.

ETIs and Fiduciary Duty. All pension funds are fiduciaries because they manage assets on behalf of others. Because situations may arise in which a fiduciary's own interests conflict with the best interests of the account beneficiaries, the law imposes a high standard of conduct on a fiduciary's behavior and investment decisions. The federal law governing fiduciary standards for private pension funds is the Employee Retirement Income Security Act (ERISA), passed in 1974. Although ERISA does not apply to public funds, many states have enacted similar laws or policies for their own public fund trustees. This duty of care is known as the *prudent man rule*. The rule compels fiduciaries to examine all reasonable options, deliberate carefully, and record their deliberations in order to justify their final decisions. These requirements mean that all assets held for the benefit of others must be prudently managed for the exclusive benefit of the beneficiaries.

Some public pension funds operate under standards similar to the prudent man rule. These funds can use the fiduciary standards to protect themselves from making inferior investments mandated by state legislatures. Indeed, among the pension funds using ETIs, those operating under the prudent man rule had an average one-year return of 10.4 percent (7.2 percent standard deviation). Those funds not using the fiduciary standards and using ETIs averaged a 7.7 percent return (5.1 percent standard deviation). Note that the annual difference in returns between pension funds with no ETIs and pension funds with ETIs and no prudent man rule is 470 basis points. Apparently, the fiduciary duty of public pension investment managers is compromised when they are not protected by prudent man laws or policies.

To investigate this issue further, we regressed the funds' unexpected returns against several variables. The first, *Risky*, is a measure of the funds' risk aversion; it is defined as the assets allocated to nongovernment securities (less cash) divided by total assets. Managers who are conservative in asset allocation seem to be also conservative in security selection. Dummy variables are included for whether the prudent man rule applies, *Prudent*, and whether the fund invests in ETIs, *ETI*. A dummy, *Pendat92*, is also used to correct for differences in unexpected return between the two years of data.¹² The appli-

¹²As mentioned earlier, the unexpected returns for the pension funds were generally positive in the 1991 sample and negative in the 1992 sample. The absence of this dummy variable does not change the sign on the other coefficients or the conclusions.

cation of the prudent man rule and oversight of ETI projects takes enormous time, so the variable, *Staff*, the number of investment management staff in the pension fund, was also included in the regression. The coefficients of these variables are as follows:¹³

$$\begin{aligned}\text{Unexpected return} &= 0.039 - 0.084(\text{Risky}) + 0.035(\text{Prudent}) \\ &- 0.021(\text{ETI}) + 0.124(\text{Staff}) \\ &- 0.098(\text{Pendat92}).\end{aligned}$$

These results indicate that pension funds using the prudent man rule experience a higher unexpected return, 350 basis points, and that pension funds with ETIs decrease their unexpected return by 210 basis points, which is consistent with the evidence previously presented. Pension funds taking more risk in our sample were penalized in their unexpected return. Funds with a higher number of investment staff received higher unexpected returns.

Social Investing

The investment implications of restricting the investment universe for social reasons has been well investigated. (Although divestment from South Africa received all the press, there has also been a quiet divestiture from companies operating in Northern Ireland.) In the 1980s, the divestiture from companies conducting business in South Africa burdened portfolios in three ways. It entailed divestment and monitoring costs and reduced the investment universe. Love (1985) estimated the one-time divestiture cost to be 1.3 percent, or \$13 million per \$1 billion portfolio. Ennis and Parkhill (1986) estimated a cost of \$15 million per \$1 billion portfolio for an unqualified divestment. In addition to the divestment costs are the recurring costs of monitoring firms' presence in South Africa.

The largest effect of divestiture is probably on portfolio risk and the trading costs of optimizing a portfolio with restrictions. Wagner et al. (1984) found that 152 companies in the S&P 500 Index (47 percent of the total capitalization) had operations in South Africa, including 31 of the largest 50 U.S. companies. The authors identified ten industries within the S&P 500 in which divested portfolios would lose more than 75 percent of the "opportunity set." Replacing each of these 152 companies with the large companies without South African operations and from the same industries would produce a "new S&P 500" with only 62 percent of the market capitalization of the actual S&P 500. These

¹³We used weighted least squares where size (market value) of the fund is the weights to correct for heteroscedasticity among different size pension funds. All estimates are significantly different from zero at the 5 percent level; $R^2 = 53.2$ percent, and $n = 238$.

replacement stocks would be much smaller in capitalization than the eliminated stocks.

Loeb (1983) presented evidence that trading costs are significantly higher for mid-cap stocks than for the large-cap stocks for large block trades. Therefore, operating under these conditions, managers cannot maximize portfolio return and must settle for some “optimized” return. Freeman and Winchester (1994) described the investment management problems associated with social investing and presented strategies for optimizing return under the restrictions put in place by the Connecticut State Legislature, which in the name of social responsibility, prohibits its pension fund from investing in 250, mostly large-cap stocks.

Using a divestment strategy to achieve political or social goals does not appear to be in the best interest of beneficiaries. As pension portfolios become more globalized and companies become more international, restrictions of this type will have even more impact on portfolio optimization and fiduciary duty than currently.

Most restrictions dealing with South Africa were still in existence in 1991, the last year of our data. Social investing has recently taken a new direction for pension funds—restrictions are being levied on companies that contribute to domestic social problems and ills. Hamilton, Jo, and Statman (1993) studied mutual funds with domestic social restrictions and found that their risk-adjusted returns are slightly lower than (but not significantly different from) those of other mutual funds.

Empirical Evidence. Because of the extensive work already done on this subject, we simply verified that empirical results from our data set are consistent with previous studies. For the work in this monograph, pension funds with social investing constraints are defined as having restrictions on investing in companies that have operations in South Africa or Northern Ireland or that conduct ETI programs.

Our data indicate that pension funds with social investing restrictions earn, on average, 109 basis points a year less than funds without the restrictions, although the difference is not statistically significant. The result from a cross-sectional regression of excess returns (as was done with ETI and non-ETI funds) for the nonsocial funds is¹⁴

$$r_i - r_f = 1.21\% + 0.33(r_M - r_f).$$

¹⁴The intercept is significantly different from zero at the 5 percent level, and the slope coefficient is different at the 1 percent level; adjusted $R^2 = 35.9$ percent, and $n = 244$.

The result of the regression for social funds is¹⁵

$$r_i - r_f = 0.75\% + 0.30(r_M - r_f).$$

Note that the abnormal return for the nonsocial funds is higher than for the funds with social restrictions, but the difference in abnormal returns is not statistically significant. These results are consistent with Hamilton, Jo, and Statman (1993).

As shown with ETIs, a prudent man rule helps investment managers under social constraints. Social funds using the rule earn an additional 130 basis points a year. These results are consistent with previous studies on social investing and with the evidence presented on funds with ETIs.

Political Abuses and Social Investing. After social restrictions are imposed, how does an investment manager or state legislator know where to draw the line? If pension funds helped South Africans in a foreign land, could they also help with social issues at home? Should investment restrictions be levied on companies contributing to social ills such as alcohol, tobacco, weapons, gambling, and so forth? Which side should a pension fund take between labor and management? Fiduciary care and prudence imply that no social restrictions apply. Rather, to avoid misuses of pension assets, investments should be based solely on risk–return characteristics.

Most public pension fund trustees have felt pressure (directly and indirectly) from politicians and special-interest groups to make specific investments. This pressure is evident in the following quote from *Teacher Retirement System of Texas News* (August 12, 1991):

The Teacher Retirement System of Texas is one of several statewide U.S. pension systems fighting off attempts to control funding methods and governance structures. Other assaults on pension plans have been launched in New York, California, Illinois, Connecticut, Maine, and Pennsylvania, among others.

Large funds tend to be under more pressure than small funds. The following is a sample of the more blatant political misuses of pension assets.

- In 1975, the New York state and city pension plans were pressured into purchasing New York City bonds to prevent the city's insolvency. (Weisman 1975)

¹⁵The intercept is not significant, and the slope coefficient is different from zero at the 1 percent level; adjusted $R^2 = 36.1$ percent, and $n = 144$.

- In 1976, the New York state and city pension plans were pressured into purchasing the bonds of four financially distressed state agencies. (*New York Times*, January 21, 1976)
- In Los Angeles County, officials recently unveiled a plan to use as much as \$250 million from the county employees' pension fund to balance the county's budget. (Vise 1992)
- In the summer of 1991, Governor Pete Wilson of California tried to gain control of the Calpers retirement system by proposing to replace the board with political appointees. To stall Wilson's bid for control, Calpers offered to provide \$1.6 billion to help balance California's budget. (White 1991)
- Pennsylvania officials have intervened in two takeover attempts of Pennsylvania companies, Koppers Company and Armstrong World Industries, by foreign companies. The officials threatened to cut off Shearson Lehman Hutton from the state's and pension fund's security business for helping the foreign companies. (White 1989)
- The Illinois state treasurer threatened to withhold future investments by the state pension fund in Kohlberg, Kravis, Roberts and Company (KKR) if it did not ensure that an Illinois printing company it owned continue to operate without any reduction in employment. The state treasurer acted in conflict with the duty of a pension plan trustee by acting in the best interests of the workers of the printing plant when the pension fund was an investor in KKR and, therefore, an owner of the plant. Later, the Illinois Investment Board asked KKR to secure financing for the workers trying to purchase the plant from KKR. (Romano 1993)

Much of the pressure on public pension funds for social investments has been successfully rejected by prudent fiduciaries. If fiduciary standards are weakened, however, more pension trustees will be forced to accommodate ETIs and other social investments.¹⁶ The State Board of Administration (SBA) of Florida has kept a list of investment strategies proposed to the SBA as investment restrictions or mandated investments. The list is nearly 50 items long. We present only a few of them here:

- Interest-free loans for favored projects
- Donations to public projects
- Public housing contributions

¹⁶In 1991, the KPERS board of trustees was involved in litigation asserting that the board was subjected to political pressure in the mid- to late 1980s.

- Restrictions on Pennsylvania corporations
- Restrictions on companies that slaughter cattle, hogs, chickens, or other animals
- Restrictions on nonunion companies
- Restrictions on union companies, and
- Restrictions on road-building companies

These suggestions are indicative of the types of investment pressures that trustees will increasingly face if nonfiduciary considerations are increasingly allowed to influence the investment management process.¹⁷

Governance Structure and Social Investing. Which public pension funds are most susceptible to political pressure and mandates for social investing? To investigate this question, we regressed the dependent dummy variable, *Social*, on the four variables *Prudent*, *Risky*, *Staff*, and *Pendat92* and on four additional variables: *Elected*, the ratio of the fund's board members who are elected by beneficiaries to the total number of board members; *Union*, a dummy variable indicating whether the fund's participants are unionized and the union negotiates retirement benefits; *State*, a dummy variable indicating whether pension fund participants are statewide employees; and *Unfunded*, the extent to which the pension plan is underfunded (in decimal form).

The results of the regression follow:¹⁸

$$\begin{aligned} \text{Social} = & -1.49 - 0.31(\text{Prudent}) + 1.14(\text{Staff}) \\ & - 0.74(\text{Elected}) + 0.36(\text{Risky}) + 0.59(\text{Union}) \\ & + 1.20(\text{State}) + 1.15(\text{Unfunded}) + 0.49(\text{Pendat92}). \end{aligned}$$

State funds (usually with a large investment staff) and funds with unionized participants are very likely to have social constraints. Protection from investment restrictions come from adherence to high fiduciary standards, such as the prudent man rule. Additionally, pension funds in which investment decisions are decided by a governance board made up of members elected by the participants are less likely to operate under social restrictions. Funds that have higher funding deficits may have gotten there by investing in (often concessionary) social investments.

¹⁷SBA letter to Wayne Marr (November 15, 1991).

¹⁸We used the logistic distribution and estimated via maximum likelihood and weighted observations by $\ln(\text{market value})$. All estimates are significantly different from zero at the 5 percent level except for the coefficients for *Staff* and *Prudent*, which are significant at the 10 percent level. *Risky* is not statistically significant; $n = 238$.

Pension Funding Implications. Figure 2 shows that pension funds with social investments are underfunded, on average, by 17.2 percent of their projected benefit obligation (PBO).¹⁹ Underfunding for pension funds not involved in social investing averages 13.0 percent of the PBO. The figures are 15.6 percent and 14.4 percent for pension funds with ETIs and those without, respectively. For funds with social investments, this amount equates to an average unfunded PBO of \$822 million, compared with \$381 million for funds that have no social constraints. The difference is partly caused by a difference in underfunding and partly caused by the tendency for the social funds to be large state plans.

To make up the underfunding, sponsors amortize the unfunded PBO over a number of years. The sponsors of pension funds that invest in ETIs or have social constraints amortize the unfunded PBO over an average of 28 years, and funds not engaged in dual-purpose investing amortize over 21–23 years. Sponsors who mandate social constraints are thus statistically less likely to have fully funded pension systems and more likely to plan to take longer in making up the underfunding.

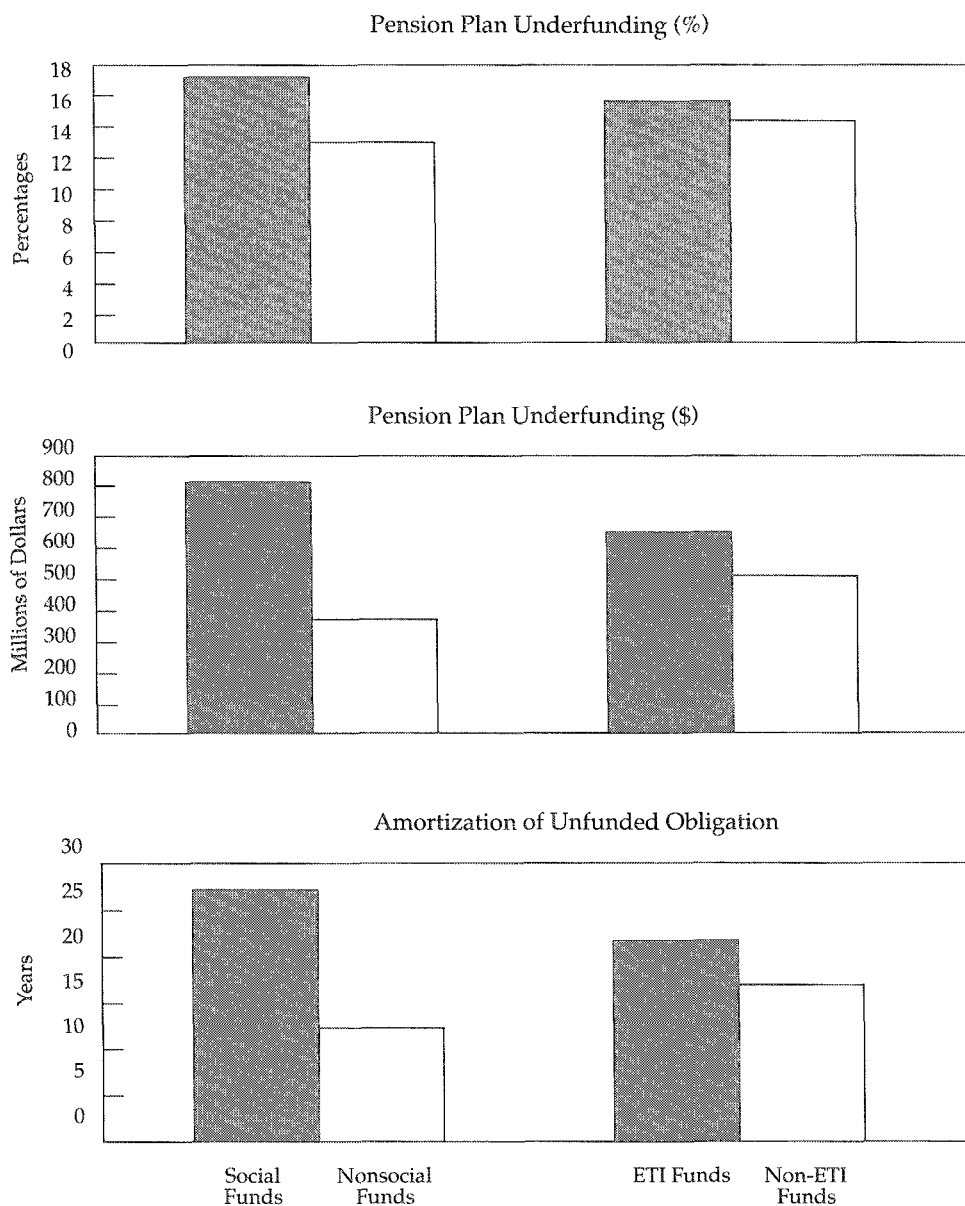
The underfunding problem is exacerbated by actuarial assumptions and actual investment performance. The present value of the sponsor's liability is calculated by discounting the future benefits owed by a discount rate called the *actuarial investment return assumption*. Pension funds with social restrictions use an average of 7.92 percent as the actuarial assumption. This assumption is 16 basis points greater than the assumption used by pension funds without social constraints. The difference may seem small, but it is statistically significant (at the 5 percent level) and can make a large difference when discounting for 30–50 years. Additionally, evidence provided earlier indicates that actual returns are 110 basis points lower for social funds than for nonsocial funds. A similar story is seen for ETI versus non-ETI pension funds. All these factors point to the same conclusion: Social constraints compromise fiduciary duty, which leads to underfunded retirement systems and, potentially, to reduced benefits.

The Federal Government and Private Pension Plans

The pressure on public pension systems to fund dual-purpose investments is now spreading to private fund managers. The Department of Labor during President Clinton's administration is considering measures to allow, even

¹⁹The PBO is a measure of the present value of expected future pension liabilities. The calculation includes actuarial assumptions about vesting, future years of service, and future salaries.

Figure 2. Pension Plan Underfunding and Amortization of Unfunded Obligations



Source: Generated from data in Pendat 1991 and Pendat 1992.

encourage, private pension managers to use ETIs. “Safe harbor” tests to allow ETIs are described in a report of the Work Group on Pension Investments (henceforth, the Work Group) of the Advisory Council on Pension Welfare and Benefit Plans, entitled “Economically Targeted Investments: An ERISA Policy Review” (November 1992).

As governor of Arkansas, Clinton mandated ETIs for the Arkansas pension systems. Some constituencies in the federal executive branch are now trying to tap pension funds and other institutional investors for financing infrastructure projects. The plan is documented in “Financing the Future,” Report of the Commission to Promote Investment in America’s Infrastructure (February 1993). The report concludes that ETIs should have market-rate returns and achieve funding by creating new infrastructure securities. It also advocates a new quasi-governmental agency to facilitate ETIs. We have argued elsewhere that the main two recommendations of the commission would not encourage funding of the magnitude being forecast without serious political pressure (see Marr, Trimble, and Nofsinger 1993). Chernoff (1993) reported that a government entity issuing infrastructure-backed securities is still several years away.

Under current consideration is a change in the interpretation of ERISA that would legalize ETIs for private funds. “In the best interest of” the beneficiaries has been interpreted as a financial interest requiring investments to meet the prevailing rate of return. The Department of Labor, however, is considering a broader interpretation that would allow ETIs to have below-market rates of return if direct or indirect secondary benefits can be achieved.

Future ERISA Policy on ETIs. The Department of Labor is responsible for interpreting ERISA, which governs all private pension plans and establishes fiduciary standards. Because the Labor Department’s interpretive rulings become law, an understanding of how the agency might interpret future fiduciary issues relating to ETIs is important. The report from the Work Group on ETIs provides some insight into upcoming interpretive rulings.²⁰

ETI projects often cannot obtain financing from private sources or from local, state, and federal governments struggling with budget deficits. The debate is whether pension fund assets should be used for projects with dual-purpose goals. If an ETI expects a market rate of return for its expected risk level, then clearly, no conflict exists between the social objective and the plan participants’ interests. One question the Work Group addressed was: If the ETI expects a below-market rate of return, in which cases (if any) could a fiduciary prudently fund the investment?

²⁰For a more detailed analysis of the report, see Marr, Trimble, and Nofsinger (1994).

The Department of Labor previously ruled that ETIs that require a sacrifice in investment return or risk but do not provide other benefits to the plan participants do not meet ERISA's fiduciary standards. But what if collateral benefits, called "externalities," accrue to plan participants to make up for the sacrifice of investment return? An investor's primary objective with an investment is to earn a risk-adjusted market rate of return, but most investments (stocks, bonds, private loans, etc.) also provide collateral benefits to society in the form of job creation, tax revenues, and other effects. If these externalities accrue to the investor, two benefits are received. In fact, some observers argue that pension funds should be allowed to accept a below-market rate of return if adequate externalities accrue to the plan participants (see Rifkin and Barber 1978 and Litvak 1981).

The Working Group's report summarizes its findings and views on whether to modify the "prevailing-rate" test used by pension fund fiduciaries under ERISA. More specifically, the Working Group examined how the prevailing-rate test could be modified to stimulate ETIs without sacrificing the fiduciary responsibility of investing for the exclusive benefit of beneficiaries. A new interpretation would focus on the total financial interest of the beneficiaries. This new interpretation would allow the evaluation of an investment to include financial benefits other than the primary risk-adjusted rate of return. Calculated externalities accruing to the plan participants could be added to the expected cash flow of the investment to determine whether an ETI meets the prevailing rate test. The new interpretation could be implemented with a Labor Department interpretive letter; no congressional debate or legislative action would be required.

In its report, the Work Group stated that "collateral benefits to plan participants and beneficiaries may be one of the justifications . . ." for using pension assets for these socially desirable programs. This interpretation would allow pensions to invest in ETIs at below-market rates of return when externalities accrue to plan participants. The second conclusion of the report states:

The existing Department of Labor regulations on ETIs allow collateral benefits to be a secondary factor in pension trustees' investment decisions. If the Department were to allow fiduciaries to consider collateral benefits which accrue directly to plan beneficiaries in meeting the prevailing returns test, an indeterminate amount of additional funding might be allocated to ETIs. (pp. 27-28)

When ETIs earn a below-market rate of return, the measurable collateral benefits could be added to the rate of return to boost the total investment benefit to make it appear to meet the prevailing-rate test. The Work Group

recognized that investment managers and pension trustees would be reluctant to fund investments that are in conflict with fiduciary standards and the prudent man rule. To overcome this reluctance, the Work Group recommended creating a “safe harbor” procedure:

For ETIs that do not meet the existing prevailing rate test, the DOL should consider designing a “safe harbor” process for evaluating, benchmarking and tracking performance (incorporating the collateral benefits to current participants through the plan to achieve a prevailing rate) and specifying the plan structures for which such considerations may be suitable. (p. 31)

The obvious problem with the Work Group’s recommendation is qualifying the collateral benefits. Also, pension plan beneficiaries are not a homogeneous group, and they may value the collateral benefits differently. As an example, consider the case of a union pension plan investing in a construction project that employs only union workers but generates a below-market rate of return. If the project would not have been funded through other means, the workers would not have been employed. One argument is that job creation for the union workers is a direct financial benefit to the plan participants. This collateral benefit does not accrue to retired beneficiaries of the plan, however, or to plan participants who are employed on a different project.

The Work Group now seems to have backed away from its earlier position that concessionary investments are acceptable when accompanied by collateral economic benefits. In its most recent report, “A Clearinghouse or Network for Economically Targeted Investments,” the Work Group tried to establish that ETIs, by definition, provide adequate returns for their risk.

The “Clearinghouse” Report. The main purpose for the second report by the Work Group on Economically Targeted Investments, dated November 1993, was to report its findings and conclusions from an investigation on the feasibility of creating a national clearinghouse on ETI programs.

In this report, the Work Group argued that some sectors of the economy have become underfinanced for reasons ranging from discrimination to demographic trends that have caused a shift in capital from local banks to pension funds. The underlying assumption requires the market for capital to be inefficient, leaving profit opportunities in these capital gaps. The Work Group’s goal is to redistribute capital so as to fill these presumed capital gaps. A free-market system, however, allocates resources far better than government agencies. Patterson (1994) pointed out that researchers have not empirically or operationally identified capital gaps. Moreover, even if capital gaps do exist,

how does an investment manager distinguish between a gap-filling investment and one so poor that no one else will fund it?

The Work Group began its report by rewriting the definition and history of economically targeted investments. It defines an ETI as an investment that is not concessionary:

What is less widely appreciated, however, is that the term “ETI” was specifically developed in an attempt to distinguish investments that otherwise meet a risk-adjusted prevailing rate standard, while also producing a collateral economic benefit, from investments that entail an investment rate or risk compromise. (pp. 6–7)

Public use of the term “ETI” and its use in the three most important ETI documents has concessions of investment return in exchange for collateral economic benefits as a key feature.²¹

As detailed in the report, the Work Group recommends creating a non-profit corporation to function as a clearinghouse for ETIs. Its immediate duties would be to document the various ETI programs, detail the structure and transactions of the programs, create ETI models for the purposes of education and replication, and list potential investments designed by financial intermediaries. Functions such as conducting seminars on ETIs and gathering and reporting performance data and benchmarks for ETIs could come later. We are not surprised that the Work Group chose to delay the collection of actual ETI performance data, because most ETIs are not profitable. How can trustees satisfy fiduciary due diligence requirements without historical performance data? The Work Group concludes that creating a national clearinghouse for ETI projects and information would “further legitimize ETI programs conceptually as prudent alternative investments” (p. 11).

For a fee, investment managers and pension fund trustees would be able to access information to find ETI projects and models comparable to investments they intend to fund. The report recognizes the fact that designing, analyzing, and monitoring an ETI program takes an enormous amount of the pension fund’s staff and time. Conducting an ETI transaction through the clearinghouse would not relieve the trustee of fiduciary duty. As stated on page 14,

A plan therefore could not expect an ETI transaction to be deemed fiduciarily prudent merely because the investment was listed within the clearinghouse or network. The clearinghouse or network is to

²¹Two of these documents, “Our Money’s Worth” and “Competitive PLUS,” were commissioned by the governor of New York. The third document is the first report of the Work Group, “Economically Targeted Investments: An ERISA Policy Review.”

facilitate gathering of information regarding ETIs; each plan will have to separately analyze the information received and make independent inquiries regarding the transaction to satisfy fiduciary due diligence requirements.

For pension funds to pay a fee for ETI information from the clearinghouse and still conduct its own investment analysis in the discharge of fiduciary requirements is an inefficient use of scarce resources. The prudence of traditional investments can be quickly and easily investigated. Pension funds have no obligation to seek out complicated investments with no track record in order to fill DOL-perceived capital gaps. Pension fund trustees do have an obligation to use the pension assets for the exclusive benefit of the participants and beneficiaries.

Summary

Economically targeted investments are designed to stimulate economic development, growth, or job creation for a specific group or region while achieving competitive returns. This study documents the emergence of ETIs, their performance, and the performance of the public pension funds that use them.

We found that ETIs and the broader class of social investments coexist with lower returns in public pension fund portfolios. Funds using ETIs underperform those that do not by 43–246 basis points a year. Funds with social constraints underperform unconstrained funds by 41–109 basis points a year. The pension fund managers who find themselves working under these types of constraints may improve portfolio returns by following the prudent man rule.

These dual-purpose investments have the troubling potential to be driven by politics and are not in the best interest of pension beneficiaries. The Labor Department's actions in promoting ETIs to private pension funds is also troubling. As champion of the U.S. labor force, the Labor Department should be strengthening fiduciary standards to protect the labor force's retirement assets. Instead, it appears to be weakening fiduciary duty and ERISA in order to subsidize housing or create jobs. Pension funds are not life-support systems for obsolete jobs, unbalanced budgets, or society's welfare.

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