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# ARTICLES

## “SOCIALLY RESPONSIBLE” INVESTING: DOING GOOD VERSUS DOING WELL IN AN INEFFICIENT MARKET

MARIA O'BRIEN HYLTON\*

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## INTRODUCTION

The debate about the desirability and efficacy of socially responsible investing (SRI) is about as old as the practice of investing itself.<sup>1</sup> Indeed, in spite of a persistent inability on the part of all participants in the debate to develop a simple, coherent definition of what is meant by socially responsible investing,<sup>2</sup> the debate continues.<sup>3</sup>

1. See ANNE SIMPSON, *THE GREENING OF GLOBAL INVESTMENT: HOW THE ENVIRONMENT, ETHICS, AND POLITICS ARE RESHAPING STRATEGIES* 27 (1991) (summarizing history of ethical investment in U.S. and noting that socially responsible investing can be traced back to 1928, when ecclesiastical group established first ethical investment fund called Pioneer Fund). The focus of these initial efforts was avoidance of "sin stocks," which was a term used to characterize investments in companies that produced liquor or tobacco or had a financial interest in gambling. See MYRA ALPERSON ET AL., *THE BETTER WORLD INVESTMENT GUIDE 2* (1991) (tracing history of socially responsible investing to its genesis in religious investment movement). Until the late 1960s, ethical investing drew scant interest outside the religious community. *Id.* During the 1960s, however, a surge in SRI took place as a means of expressing opposition to the Vietnam War, most visibly with the targeting of Dow Chemical Corporation by social investors outraged by its production of napalm, an antipersonnel weapon used in the jungles of Vietnam. *Id.*

2. There is no single accepted definition of SRI, although many efforts to define SRI have been made. See, e.g., SEVERYN T. BRUYN, *THE FIELD OF SOCIAL INVESTMENT* 1 (1987) (stating that socially responsible investments are designed to effect positive social change and maintain economic returns); Matthew Bromberg, *Social Investing: The Good Guys Finish First*, BUS. & SOC'Y REV., Fall 1988, at 34 ("Any one definition of social responsibility will be highly personal at best and hopelessly nebulous at worst, and usually fall somewhere in between."); John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 73, 83 (1980) (defining social investment as practice of avoiding investment in companies deemed "socially irresponsible" and investing instead in socially laudable firms, but noting that "[t]here is no consensus about which social principles to pursue and about which investments are consistent or inconsistent with these principles").

3. Some critics of socially responsible investing maintain that decisions based on social criteria entail higher risks and the prospect of lower economic returns. See Langbein & Posner, *supra* note 2, at 85-94 (asserting that social investing yields increased portfolio risk and lower net expected returns). Critics of SRI further assert that SRI is illegal. See, e.g., John H. Langbein, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal*, in JOHN H. LANGBEIN ET AL., *DISINVESTMENT: IS IT LEGAL? IS IT MORAL? IS IT PRODUCTIVE?* 16, 16-25 (1985) (charging that social investing of pension funds violates federal Employment Retirement Income Security Act of 1974 (ERISA) and fiduciary duty to manage trust assets). Some critics believe it is more appropriate for the goals of social investing to be pursued through the political process than through investment decisions by pension fund trustees. See *id.* at 28 (stating that "trustees will best serve the cause of social change by remitting the advocates of social causes to the political arena"). Yet despite these concerns, SRI has continued to grow in importance. See RITCHIE P. LOWRY, *GOOD MONEY: A GUIDE TO PROFITABLE SOCIAL INVESTING IN THE '90s* 19-31 (1991) (detailing history and development of socially responsible investment in U.S.); "Social Investing": *Pressure Grows to Pump Pension Money into "Worthy" Causes*, AARP BULL. (AARP, Washington, D.C.), Oct. 1990, at 17 (noting that socially responsible pension fund investment is increasing). Moreover, techniques of SRI have been well-established. See ALAN J. MILLER, *SOCIALLY RESPONSIBLE INVESTING: HOW TO INVEST WITH YOUR CONSCIENCE* 29-35 (1991) (describing avoidance, alternative, and activist investment strategies); SIMPSON, *supra* note 1, at 1-7 (describing negative and positive screening techniques of socially responsible investing).

Proponents of SRI dispute that incorporation of socially responsible principles into investment strategy must come at a cost to the investor. See Bromberg, *supra* note 2, at 32 (maintaining that because of "exceptional returns and widespread popularity" of select socially responsible funds, "profit-seeking investors . . . have unwittingly become the strongest proponents of ethical investment strategies"); Stephen P. Ferris & Karl P. Rykaczewski, *Social Investment and the Management of Pension Portfolios*, J. AM. SOC'Y CLU & CHFC, Nov. 1986, at 60

Many funds that purport to engage in SRI have surprisingly little in common.<sup>4</sup> However, if a single political issue could be said to have attracted the attention of virtually every socially responsible fund currently in existence, it would have to be South Africa's abhorrent practice of apartheid.<sup>5</sup> Current political developments in that country<sup>6</sup> and the abandonment of economic sanctions against the country by the United States, the European Community, Israel, and others<sup>7</sup> have ignited debate about the usefulness of punitive meas-

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(stating that advocacy of socially responsible investing is premised on assumption that retirement security can be pursued in conjunction with other objectives); *South Africa-Free Portfolios Don't Suffer*, PENSIONS & INVESTMENT AGE, Oct. 16, 1989, at 40 [hereinafter *South Africa-Free Portfolios*] (surveying strong performance of mutual funds that restrict investment in South Africa).

4. See *infra* notes 33, 37 and accompanying text (detailing wide variety of investment objectives sought by different socially responsible mutual funds).

5. See SOCIAL INVESTMENT FORUM, SOCIALLY RESPONSIBLE MUTUAL FUNDS 1-2 (May 1992) [hereinafter SOCIALLY RESPONSIBLE MUTUAL FUNDS] (noting that major socially responsible mutual funds using South African ties as litmus test to avoid corporate investment include: Calvert-Ariel Appreciation Fund, Calvert Social Investment Fund, Covenant Investment Management, Domini Social Index Trust, Dreyfus Third Century, Green Century Balanced Fund, New Alternatives, Parnassus Fund, Pax World Fund, and Righttime Social Awareness Fund); see also ELIZABETH JUDD, INVESTING WITH A SOCIAL CONSCIENCE 11 (1990) ("The range and possibilities for socially responsible investing were not tested until the issue of exiting South Africa aroused a popular sentiment in the mid-1980s."); MILLER, *supra* note 3, at 28 ("Before environmentalism leapt to the forefront as the crusade of the 1990s, the issue of apartheid in South Africa was far and away the biggest concern of socially responsible investors."); Bromberg, *supra* note 2, at 32 ("The proliferation of socially responsible funds in the 1980s has in large part been a reaction to the passion of the movement to divest from South Africa.").

6. The South African Government has given white parents a chance to desegregate public schools by popular vote. If 80% of parents at a school vote on a desegregation initiative and 72% of those approve it, the school can enroll other races. See Christopher S. Wren, *South Africa Integrates Some Schools*, N.Y. TIMES, Jan. 10, 1991, at A3 (noting that one-tenth of South Africa's public schools were desegregated by means of parental voting process for 1991 school year). In addition, the government of South Africa has repealed the Reservation of Separate Amenities Act (Act No. 49 of 1953), the Black Land Act (Act No. 27 of 1913), the Group Areas Act (Act No. 36 of 1966), and the Population Registration Act (Act No. 30 of 1950). The Reservation of Separate Amenities Act, revoked by the Discriminatory Legislation Regarding Public Amenities Act (Act No. 100 of 1991), had allowed municipalities to restrict the use of public facilities to whites. The Black Land Act, which restricted black land ownership to 13% of the country, was repealed by the Abolition of Racially Based Land Measures Act (Act No. 108 of 1991). Legally, blacks may now purchase property anywhere in South Africa. The Group Areas Act, which was also repealed by the Abolition of Racially Based Land Measures Act (Act No. 108 of 1991), had determined where people could live based on their race. Another statute that was repealed, the Population Registration Act, revoked by the Population Registration Repeal Act (Act No. 114 of 1991), had classified South Africans from birth on the basis of race. The classification was the cornerstone of apartheid and determined the privileges or hardships of each individual. See Christopher S. Wren, *South Africa Scraps Law Defining People by Race*, N.Y. TIMES, June 18, 1991, at A1 (describing repeal of Population Registration Act, which was viewed as legal foundation of apartheid).

7. See Exec. Order No. 12,769, 3 C.F.R. 342 (1991) (invoking presidential authority under Comprehensive Anti-Apartheid Act, Pub. L. No. 99-440, 100 Stat. 1086 (codified at 22 U.S.C. §§ 5001-5117 (1988)), to terminate economic sanctions on South Africa). In spite of the Bush administration's recent decision to lift sanctions against South Africa, many U.S. companies have indicated that they do not intend to resume business activities in or with that country at any time in the near future. See *Businesses Avoid South Africa Ties*, N.Y. TIMES, July 24,

ures as a means to prevent capital from finding its way to a variety of otherwise attractive projects.<sup>8</sup> Consequently, it is an appropriate moment in which to assess the merits of social investment as both an income-producing tool and an instrument for political coercion.

Professors John Langbein and Richard Posner posed an important theoretical challenge to SRI by arguing that SRI through pension funds is prohibited by the Employee Retirement Income Security Act of 1974 (ERISA).<sup>9</sup> Langbein and Posner's analysis is heavily dependent on modern portfolio theory,<sup>10</sup> and in particular, on the hypothesis that capital markets are efficient.<sup>11</sup> This Article argues that in light of increasing evidence developed in recent years that capital markets do not always operate efficiently,<sup>12</sup> a pension fund manager can maximize income by following a program of ethical investing.<sup>13</sup>

Part I of this Article contains a description of the mechanics of social investing, as well as examples of some of the most common "screens" used by socially responsible fund managers to avoid objectionable investment targets. The section also considers major differences between socially responsible and traditional investing. To the extent that capital markets are not efficient, a stronger eco-

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1991, at A1 (indicating that few U.S. businesses plan to invest in South Africa in immediate wake of end of economic sanctions).

The European Community decided on April 15, 1991, to lift a ban on the importation of South African gold coins, iron, and steel. Craig Whitney, *Britain Backs End to South African Sports Barriers*, N.Y. TIMES, Apr. 24, 1991, at A5. Similarly, Israel lifted economic and cultural sanctions against South Africa on July 15, 1991. *Israel Lifts Sanctions on South Africa*, CHI. TRIB., July 15, 1991, at M5.

8. See *infra* notes 22-24 and accompanying text (describing method of barring investment in certain companies presumed to be attractive but for their South African connection).

9. See Langbein & Posner, *supra* note 2, at 77-89 (concluding that socially responsible investments entail higher risks because portfolio constructed in accordance with social principles will be less diversified than portfolio constructed on principle of profit maximization). The authors analyzed a socially responsible portfolio and demonstrated that it contained a "substantial increment of risk" beyond a conventional investment portfolio. *Id.* at 88-89.

The Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001-1461 (1988), the federal statute that insures pension plans, imposes a fiduciary duty on pension fund managers to exercise a "prudent [person] standard of care," *id.* § 1104(a), and to discharge their duties "solely in the interests of the participants and beneficiaries . . ." *Id.* § 1104(a)(1). Professors Langbein and Posner concluded that SRI would violate these fiduciary duties because the minimal diversification characteristic of SRI entails higher risks without the promise of higher returns. Langbein & Posner, *supra* note 2, at 104.

10. See *infra* notes 57, 63-70 and accompanying text (describing principles of modern portfolio theory and importance of risk minimization through diversification).

11. See Langbein & Posner, *supra* note 2, at 77-79 (stating that stock market establishes prices based on risk and return of securities in portfolio and projected future value); see also *infra* note 49 (describing "efficiency" as ability of capital markets to process all available economic information to point where prices fully reflect future value).

12. See *infra* notes 92-113 and accompanying text (reviewing recent findings that capital markets do not operate efficiently).

13. See *infra* notes 141, 142, 144, and 152 (illustrating that some socially responsible investment funds match or exceed traditional profit-centered market performance).

conomic and legal case can be made for SRI. Part II focuses on the legal environment in which socially responsible investment decisions are made. Part III considers whether pension income security is threatened by SRI and argues that the noneconomic benefits derived from SRI cannot possibly be cost-free in an efficient market. Nevertheless, so long as plan participants are informed about the costs of SRI in an efficient capital market, there is no reason to prohibit what is essentially a form of consumption. In addition, to the extent that capital markets are inefficient, it may be possible to take advantage of market "bubbles," or speculative "booms," and maximize income by engaging in ethical investing.

This Article focuses on SRI as practiced by pension funds.<sup>14</sup> Certainly, universities, foundations, churches, private individuals, and others make socially conscious investment decisions. Churches and individual investors, however, are making private consumption choices in exchange for a lower rate of return and are presumably obtaining the satisfaction that comes from "knowing their money is not part of the problem . . ." <sup>15</sup> As for universities, many are chartered as charitable corporations, and the legality of expending university funds for social or political purposes will turn in each in-

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14. For general information about the management of pension fund assets, see SIDNEY COTTLE ET AL., *PENSION ASSET MANAGEMENT: THE CORPORATE DECISION* 9-27 (1980) (describing investment management of pension funds and related regulatory climate); PETER O. DIETZ, *PENSION FUNDS: MEASURING INVESTMENT PERFORMANCE* 31-43 (1966) (reviewing investment strategies available to pension fund managers); WILLIAM C. GREENOUGH & FRANCIS P. KING, *PENSION PLANS AND PUBLIC POLICY* 135-52 (1976) (reviewing growth and characteristics of pension fund investments); ERNEST J.F. GRIFFES ET AL., *EMPLOYEE BENEFIT PROGRAMS: MANAGEMENT, PLANNING, AND CONTROL* 282-303 (2d ed. 1990) (explaining management of pension fund investments); MARIO LEO, *FINANCIAL ASPECTS OF PRIVATE PENSION PLANS* 117-31 (1975) (reviewing development and implementation of investment objectives of pension funds); JOHN J. MCFADDEN, *RETIREMENT PLANS FOR EMPLOYEES* 199-209 (1988) (reviewing fiduciary duty of pension plan trustee to manage fund assets for benefit of participants and beneficiaries); DAN M. MCGILL, *FUNDAMENTALS OF PRIVATE PENSIONS* 50-57 (3d ed. 1975) (describing fiduciary duty of trustee in management of pension fund assets); ALICIA H. MUNNELL, *THE ECONOMICS OF PRIVATE PENSIONS* 93-129 (1982) (describing role of pension funds as increasingly important financial intermediaries between savers and investors).

For discussions of the practice of social or ethical investment, see LOUIS A. KOHLMEIER, *CONFLICTS OF INTEREST: STATE AND LOCAL PENSION FUND ASSET MANAGEMENT* 17-26 (1976) (maintaining that investment of public pension funds in state and local securities may result in lower rates of return and underfunding of pension plans); MCFADDEN, *supra*, at 298-99 (suggesting that socially responsible investment of pension fund would be inconsistent with ERISA if fund participants were injured through lower rates of return); MUNNELL, *supra*, at 110-14 (reviewing debate about social investing, particularly regarding issue whether ERISA permits socially responsible investing if such investment entails higher risk); JEREMY RIFKIN & RANDY BARBER, *THE NORTH WILL RISE AGAIN: PENSIONS, POLITICS AND POWER IN THE 1980S* 215-26 (1978) (proposing that state and union pension funds be used to encourage social goals of promoting worker ownership and unionization and rebuilding declining industries).

15. See Gene Meyer, *Ethics in Investing Takes Off*, KANSAS CITY STAR, June 5, 1990, at D1, D15 (quoting Leslie Gottlieb, spokesperson for Council on Economic Priorities in New York, N.Y., as stating that "[w]e believe there are investors who feel more secure knowing their money is not part of the problem than they would making more of it quickly").

stance on the terms of the charter.<sup>16</sup>

SRI raises serious agency questions about participant information and consent in the pension context that are generally absent in other investment situations. Given the generally precarious financial status of many elderly citizens<sup>17</sup> and the well-known limitations of Social Security,<sup>18</sup> permitting SRI where the market is efficient and where retirement income is at stake is a serious matter. In contrast, to the extent that the capital market does not function efficiently, there is less reason to be concerned about losses in retiree income.

## I. WHAT IS SOCIALLY RESPONSIBLE INVESTING?

I have called [the notion of corporate social responsibility] a "fundamentally subversive doctrine" in a free society, and have said that in such a society, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."<sup>19</sup>

### A. Portfolio Screening and Shareholder Activism

As the phrase "socially responsible" suggests, investment activity meeting this description is dogged by a troubling threshold question: what is the social good and how is it defined?<sup>20</sup> SRI invariably involves subjective determinations about ethics and morality.<sup>21</sup> Therefore, it is hard to generalize about the ambitions and methods

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16. Langbein, *supra* note 3, at 26 (noting that various causes championed by proponents of SRI are not within scope of some university charters). For a review of the law of charitable corporations, see RESTATEMENT (THIRD) OF TRUSTS (PRUDENT INVESTOR RULE) §§ 379, 389 (1990) (describing duties of charitable trusts as set forth in prudent investor rule).

17. See David L. Wilson, *Income and Poverty in the United States*, NAT'L J., Jan. 12, 1991, at 100 (stating that elderly accounted for 11.4% of those below poverty line and about 20% of 11.1 million people near poverty line in 1989).

18. See, e.g., Leonard Sloane, *Going Beyond Social Security*, N.Y. TIMES, Mar. 9, 1991, at A28 (quoting Alan W. Herman, senior vice president of Retirement Systems Group, as stating that Social Security typically replaces only about 30% of pre-retirement income).

19. Milton Friedman, *A Friedman Doctrine—A Social Responsibility of Business Is To Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, § 6 (Magazine), at 126 (quoting from MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962)).

20. The numerous names by which SRI is known give some indication of the host of issues embraced by those who consider moral and ethical issues in trying to evaluate investment alternatives. Some socially responsible investors refer to themselves as green investors, responsive investors, or environmentally friendly investors. See generally SIMPSON, *supra* note 1, at 3 (discussing difficulty in defining socially responsible investing).

21. See BRUYN, *supra* note 2, at 1 (noting that social investments introduce ethical and moral criteria into investment decisions); *id.* at 25 (observing that wide variety of ethical criteria are relied on by socially responsible investors); MILLER, *supra* note 3, at 26-29 (summarizing issues socially responsible investors consider, such as national defense, environmentalism, animal rights, and racism).

of socially responsible investors. Nonetheless, because there are a wide variety of organizations that purport to practice SRI, it is possible to distinguish two distinct approaches.

The first and simplest method of SRI is portfolio screening. The investor who practices portfolio screening refuses to invest in an enterprise that engages in activities that are antithetical to his or her moral beliefs.<sup>22</sup> Portfolio screening was most prominently practiced at the height of the South Africa divestment movement, when many potential investments were shunned because of their ties to that country.<sup>23</sup> Portfolio screening, also referred to as investor boycott,<sup>24</sup> requires that the would-be investor identify those social, ethical, or political issues that concern him or her and then research the activities of potential investments to determine which investments are incompatible with his or her views.<sup>25</sup>

At the institutional investor level, objectionable corporate practices are detected by the use of detailed questionnaires, or

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22. See, e.g., AMY L. DOMINI & PETER D. KINDER, *ETHICAL INVESTING* 2 (1984) (defining "avoidance approach" to portfolio screening as refusal to invest in companies whose business activities are offensive to investor); JUDD, *supra* note 5, at 9 (noting that "[p]robably the simplest and most intuitive of the [socially responsible investment] approaches is avoiding 'un-ethical' companies"); MILLER, *supra* note 3, at 29 (stating that avoidance approach entails determining "socially irresponsible" activities and refusing to invest in companies engaged in those activities); SIMPSON, *supra* note 1, at 5 (describing portfolio screening of ethical investment as including avoidance of companies engaged in activities morally opposed by investor).

23. See, e.g., DOMINI & KINDER, *supra* note 22, at 3 ("Perhaps the best known example of avoidance is the current movement, especially among universities and pension funds, toward divestiture of stocks or bonds of companies with operations in South Africa."); MILLER, *supra* note 3, at 28 (stating that "more investors probably still screen out the stocks of companies doing business in South Africa than any other class of securities"); SIMPSON, *supra* note 1, at 5 (noting that involvement in South Africa is commonly used in portfolio screening).

24. See SIMPSON, *supra* note 1, at 5 (describing practice of portfolio screening as avoiding or boycotting investments in certain disfavored companies).

25. See MILLER, *supra* note 3, at 25, 29 (stating that first step in socially responsible investing is determining which social and ethical goals are important to investor).



"screens,"<sup>26</sup> that examine a wide range of issues.<sup>27</sup> The most common screening questions seek to determine whether a company adheres to codes of behavior such as the Sullivan Principles,<sup>28</sup> the

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26. The following is an example of an institutional screening questionnaire:

#### Employee relations

This assessment looks for such specifics as inclusiveness and equality in employment, concern for the health and creative development of workers, and employees sharing in ownership, decision making and profits.

#### Questions

1. Is the workforce (including management and board) representative of the surrounding population? Does the company have programmes inclusive of those with special needs such as the handicapped?
2. How does the company's cash compensation compare with the industry average? Does the company provide equal pay for equal work? What is the employee turnover rate? Does the company open its employment records for public inspection?
3. Is the company's workforce unionised? Have there been labor disputes resulting in strikes? Has the company been actively anti-union?
4. How does the company communicate to its workforce? Does the company involve its employees in decision making? Does the company solicit ideas and suggestions from its people? Are workers stakeholders in the financial success of the company (stock ownership plans, profit sharing)?
5. Does the company go beyond traditional benefits to offer programmes such as day care, tuition reimbursement, subsidised meals or recreation facilities, maternity/paternity leave, sabbaticals, etc.?
6. What is the company's policy on reductions in the workforce? Are job retraining and employment counselling offered when a worksite is closed?

#### Ratings

1. Company is a unique leader in its employment practices as made evident by innovative employee participation, competitive compensation (including employee stock ownership and profit sharing programmes), a representation of women and minorities in its professional ranks equal to that in surrounding communities.
2. Company has strong commitment to workers, maintains healthy work areas and generally positive management/worker communication.
3. Company has average employee relations with no reports of strikes, employment discrimination or employee safety violations.
4. Company's employee relations are below acceptable standards in one major area (labor disputes, employee safety, discrimination).
5. Company has serious ongoing employee relation problems as made evident by strikes, current national labor boycotts, safety violations, or fair labor judgments against the company.

Source: ANNE SIMPSON, *THE GREENING OF GLOBAL INVESTMENT: HOW THE ENVIRONMENT, ETHICS, AND POLITICS ARE RESHAPING STRATEGIES* 19 (1991).

27. See ALPERSON ET AL., *supra* note 1, at 17-18 (noting that socially responsible funds use diverse combinations of screens to determine whether business practices of company are consistent with social and ethical goals of fund). The individual investor can fashion his or her own screens based on personal, ethical, and moral criteria. See MILLER, *supra* note 3, at 305-10 (describing how individuals can personally tailor their own socially responsible investment portfolio).

28. See INDUSTRY SUPPORT UNIT INC., *FOURTEENTH REPORT ON THE SIGNATORY COMPANIES TO THE STATEMENT OF PRINCIPLES FOR SOUTH AFRICA* 1 (Nov. 9, 1990) (explaining that Sullivan

MacBride Principles,<sup>29</sup> or the relatively new Valdez Principles.<sup>30</sup> In addition, the lesser known Slepak Principles<sup>31</sup> and the AIDS Principles<sup>32</sup> will be likely new code of behavior screening devices for the 1990s. Other screens are designed to determine companies' records on the issues of equal employment for minorities and women, environmental protection, animal rights, workplace fairness, or product safety.<sup>33</sup> In general, the portfolio screening approach to

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Principles, also known as Statement of Principles for South Africa, were developed by Reverend Leon H. Sullivan in 1977 for companies that were doing business in that country). Adherence to the Sullivan Principles requires that an annual independent evaluation of the signatories' behavior be performed and be made available to the public. *Id.* Essentially, signatories agree to try to positively affect the quality of life of South Africa's various racial groups and to promote democratic government in that country. *Id.* at 6-29.

29. See Suzanne G. Harvey & Timothy J. Conner, *South Africa Turmoil Spawns Social Investment Growth Industry*, STRATEGY WKLY. (Prudential-Bache Sec.), Feb. 28, 1990, at 30 (describing investment principles formed as reaction to South African situation and noting related MacBride Principles that theoretically serve as "set of equal opportunity guidelines for U.S. companies that are doing business in Northern Ireland. The guidelines stress corporate hiring and promotional practices relative to the Catholic minority [in Northern Ireland]."). The following legislation was introduced in Congress to provide for adherence to the MacBride Principles by U.S. companies and organizations: S. 449, 102d Cong., 1st Sess., §§ 4-5 (1991); H.R. 87, 102d Cong., 1st Sess. § 1 (1991); H.R. 856, 102d Cong., 1st Sess. §§ 4-5 (1991).

30. See COALITION FOR ENVIRONMENTALLY RESPONSIBLE ECONOMICS (CERES), 1990 CERES GUIDE TO THE VALDEZ PRINCIPLES 7-10 (setting forth broad standards followed by corporations that become signatories to Valdez Principles, which represent code of conduct by which investors can determine whether corporation is environmentally responsible). The code, named after the well-known Alaskan environmental disaster in which an Exxon oil tanker ran aground near Valdez, Alaska and spilled millions of gallons of crude oil into Prince William Sound, is designed to "help socially concerned investors . . . choose companies for investments and help companies mobilize internal environmental programs." Barnaby J. Feder, *Group Sets Corporate Code on Environmental Conduct*, N.Y. TIMES, Sept. 8, 1989, at D1, D5 (reporting statements made by Social Investment Forum members); see also Laura L. Castro, *A Matter of Principle: Companies and Environmental Awareness*, NEWSDAY, Sept. 8, 1989, at 13 (describing Valdez Principles and noting that they "can be used by pension funds, college endowments, religious portfolios and individuals to judge investments. . . . They can [also] be used by consumers to determine whether they wish to patronize a company's goods and services . . . [and] by students to screen companies with which they are willing to consider employment.") (quoting Denis Hayes, co-chair of CERES).

31. The Slepak Principles comprise a behavioral code that is intended to lay down voluntary human rights guidelines for U.S. businesses operating in the Soviet Union and the Baltics; legislation implementing the principles was introduced in Congress by Sen. John Heinz (R-Pa.), Sen. Dennis DeConcini (D-Ariz.), and Rep. John Miller (R-Wash.). S. 1018, 101st Cong., 1st Sess. (1989); H.R. 2366, 101st Cong., 1st Sess. (1989). Senator Heinz stated in a hearing before the Senate Subcommittee on European Affairs that "the bill would increase 'business sensitivity' to the importance of human rights considerations in Soviet joint ventures." *Administration Opposes Rights Bill for U.S. Firms Operating in U.S.S.R.*, 6 Int'l Trade Rep. (BNA) 1194 (Sept. 20, 1989). Senator Heinz offered S. 1018 as an amendment to another bill on the Senate floor, but withdrew his amendment without calling for a vote. 135 CONG. REC. S8335-40 (daily ed. July 20, 1989). The bill was not reintroduced in the 102d Congress.

32. See Harvey & Conner, *supra* note 29, at 31 (describing acquired immune deficiency syndrome (AIDS) Principles as "workplace bill of rights requiring corporate endorsers to clearly articulate nondiscriminatory policies regarding people with AIDS or HIV [human immunodeficiency virus] infection"). The AIDS Principles were drafted by the Citizens Commission on AIDS for New York City and Northern New Jersey in February 1988. *Id.*

33. See DOMINI & KINDER, *supra* note 22, at 6 (providing examples of investment screens examining corporate interests in tobacco, alcohol, gambling, asbestos, Agent Orange, munitions, nuclear energy, environmental performance, product safety, worker safety, or trade

SRI is intended "less to draw attention to something than to refuse to profit by it."<sup>34</sup> It is a method of investment marked by an emphasis on separation and avoidance of ethically questionable corporate behaviors.<sup>35</sup> Not all portfolio screening, however, takes the form of separation or avoidance, which are negative screening mechanisms. Positive choice screens have also been developed to identify attractive investments in much the same way that negative screens are used to eliminate undesirable ones.<sup>36</sup> For example, some mutual funds now actively market "companies thought to be socially benign," such as companies that focus on becoming environmentally sound.<sup>37</sup>

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with Communist countries or South Africa); JUDD, *supra* note 5, at 16-58 (reviewing additional screens such as workplace advancement of women and minorities); MILLER, *supra* note 3, at 26-29 (surveying screens for shareholder rights, consumer rights, and product quality).

Some commentators believe that environmental issues will become the most popular screen in the 1990s. See JUDD, *supra* note 5, at 16 ("If a single issue will propel socially responsible investing into the headlines in the 1990s, it is the environment."); MILLER, *supra* note 3, at 28 (stating that "environmentalism leapt to the forefront as the [socially responsible investing] crusade of the 1990s"). A large number of socially responsible funds have adopted environmental screens. These funds include the Calvert-Ariel Appreciation Fund, Calvert Social Investment Fund, Covenant Investment Management, Domini Social Index Trust, Dreyfus Third Century, Green Century Balanced Fund, Muir California Tax Free Fund, New Alternatives, Pax World Fund, Righttime Social Awareness Fund, and Schield Progressive Environmental Fund. SOCIALLY RESPONSIBLE MUTUAL FUNDS, *supra* note 5, at 1-2 (identifying screens used by socially responsible mutual funds based on investment compilations in fund prospectuses).

34. DOMINI & KINDER, *supra* note 22, at 3.

35. DOMINI & KINDER, *supra* note 22, at 3 (asserting that portfolio screening approach to SRI emphasizes refusal to profit from socially irresponsible investments); see also *infra* notes 38-43 and accompanying text (discussing how shareholder activism is based on investment in "bad" companies in order to change corporate behavior).

36. See DOMINI & KINDER, *supra* note 22, at 5 ("The positive approach complements the avoidance approach. Those adopting it seek investments in companies that enhance the quality of life . . ."); see also JUDD, *supra* note 5, at 9 ("If you plan to invest at all, buying the good must go hand-in-hand with avoiding the bad."); MILLER, *supra* note 3, at 31 (describing alternative investing as investment in companies deemed to be promoting valued social goals). The range of positive criteria that may be used by socially responsible investment funds is as broad as the range of negative criteria. See ALPERSON ET AL., *supra* note 1, at 23-62 (identifying positive criteria as including corporate investment in education and efforts to combat AIDS); DOMINI & KINDER, *supra* note 22, at 7 (listing positive investment screens such as involvement in solar energy, alternative energy, recycling, health care, promotion of women and minorities, energy conservation, good record on worker and product safety, favorable environmental record, and efforts to meet needs of elderly or disabled persons); SIMPSON, *supra* note 1, at 54 (identifying positive screens including record of charitable donations, support for affordable housing, and good record of community and employee relations).

37. See, e.g., Jane Bryant Quinn, 'Affinity' Plans Can Help Favorite Causes; Socially Conscious Investing Gels Rolling, ST. PAUL PIONEER PRESS, June 12, 1990, at 7C (identifying companies that actively develop alternative energy sources or new methods of pollution control). The Calvert-Ariel Appreciation Fund is an example of a fund that positively screens companies that are environmentally sound and have secure market segments and strong environmental reputations with customers, competitors, and employees. SOCIALLY RESPONSIBLE MUTUAL FUNDS, *supra* note 5, at 1. The following investment plans also use positive choice screens: Calvert Social Investment Funds (environmental protection, employee relations, women and minority advancement, and product safety screens); Covenant Investment Management (community behavior, product quality and safety record, environmental record, and employee rela-

The second form of SRI is the activist shareholder approach, made famous by Ralph Nader in his campaigns to improve General Motors' safety record.<sup>38</sup> This technique is distinguished by the investor's desire to change company behavior by exercising rights that flow from ownership of the enterprise.<sup>39</sup> The activist shareholder invests in a particular firm *because* the firm engages in objectionable behavior, and the shareholder hopes to change that behavior by convincing the firm that it has ethical obligations to the wider community in which it operates.<sup>40</sup> Unlike the boycott technique outlined above, the activist believes that the best way to effectuate change is to maintain a relationship, albeit a combative one, with the offending organization.<sup>41</sup> The use of this method has increased in

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tions and equal opportunity record screens); Domini Social Index Trust (product quality, environment, corporate citizenship, employee relations, women and minority advancement screens); Dreyfus Third Century (environmental protection, occupational health and safety, and equal employment opportunity screens); Green Century Balanced Fund (environmental record screen); Muir California Tax Free Fund (environment, education, and housing screens); New Alternatives (alternative energy, environmental protection, and resource recovery screens); Parnassus Fund (out-of-favor companies with quality products, employee relations, community participation, and progressive and enlightened management screens); Pax World Fund (life-support products and services, equal opportunity, and pollution control screens); Righttime Social Awareness Fund (employee relations, corporate citizenship, alternative energy, and environmental practices screens); and Schield Progressive Environmental Fund (environmental protection, environmental soundness, and alternative energy screens). *Id.* at 1-2 (identifying positive screens used by socially responsible mutual funds).

38. See DOMINI & KINDER, *supra* note 22, at 192 ("In the early 1970s Ralph Nader and other social reformers, and churches such as the Church of Christ began using shareholder resolutions as instruments of social change, and today remain its most consistent exponents."); SIMPSON, *supra* note 1, at 7-8 (noting that Ralph Nader is credited with starting shareholder activism with his campaign against General Motors); Donald E. Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 421, 423 (1971) (noting that Ralph Nader-inspired "Campaign to Make General Motors Responsible" is generally recognized as giving rise to activist shareholder approach); see also Burton G. Malkiel & Richard E. Quandt, *Moral Issues in Investment Policy*, HARV. BUS. REV., Mar.-Apr. 1971, at 1 (describing efforts to establish corporate shareholders committee that would make recommendations to corporation on improving vehicle safety and decreasing automobile pollution).

39. SIMPSON, *supra* note 1, at 6 (noting that shareholder activism is based on investment in ethically irresponsible companies in attempt to exercise ownership rights and thereby steer company in more ethically laudable direction).

40. See, e.g., DOMINI & KINDER, *supra* note 22, at 8 ("Some ethical investors want to do more than avoid bad companies and invest in good ones. They want to change the bad into the good. For these investors there is the activist approach."); JUDD, *supra* note 5, at 10 (discussing ethical investment techniques and commenting that "[t]he third approach to socially responsible investing, changing the bad into good, is most often employed by church groups, socially conscious institutions, and activist organizations"); MILLER, *supra* note 3, at 33 (describing interventionist corporate investing as "investment in irresponsible rather than responsible companies, with the goal of inducing a change in corporate behavior through stockholder pressure" and direct action); SIMPSON, *supra* note 1, at 6 (stating that socially responsible investing includes active targeting of investments with aim of promoting social change, including investing in "bad" companies in bid to steer them in new direction).

41. See FRED D. BALDWIN, *CONFLICTING INTERESTS: CORPORATE-GOVERNANCE CONTROVERSIES* 68 (1984) (reviewing initial efforts by shareholders to change corporate behavior). For example, a student during the Vietnam War purchased shares of Honeywell stock simply for the purpose of voicing his opinions of company affairs in shareholders' meetings. *Pillsbury v. Honeywell, Inc.*, 191 N.W.2d 406, 408 (Minn. 1971). The student then demanded to

frequency since initial efforts in the 1970s,<sup>42</sup> even though constraints hinder the technique's effectiveness.<sup>43</sup>

see the company's records concerning munitions production. *Id.* at 409. The company refused and the Minnesota Supreme Court upheld the refusal. *Id.* at 413 (affirming rejection of petition for writ of mandamus to compel production of corporate records). In 1970, the Project for Corporate Responsibility similarly attempted to press its own philosophy of corporate responsibility on General Motors through the use of shareholder resolutions. See DAVID VOGEL, *LOBBYING THE CORPORATION: CITIZEN CHALLENGES TO BUSINESS AUTHORITY* 71 (1978) (describing goals of activists that established Campaign GM). The Project also proposed resolutions addressing specific issues such as air pollution. BALDWIN, *supra*, at 66 (noting that seven of nine resolutions originally proposed by Project for Corporate Responsibility addressed air pollution). Two General Motors shareholder resolutions sponsored by the Project were included in proxy statements that would have expanded the board of directors by the addition of a woman, a minority individual, and an environmentalist, and also would have established a Committee for Corporate Responsibility. VOGEL, *supra*, at 78. Although the proposals obtained support from less than three percent of the shares voted and were ultimately rejected, *id.* at 85, General Motors later expanded its board to include a minority individual and established a Public Policy Committee similar in purpose to the Project's proposed Committee for Corporate Responsibility. *Id.*

42. See LOWRY, *supra* note 3, at 26-27 (describing rise in annual number of socially responsible shareholder resolutions from 30 in 1972 to between 100 and 200 during 1976-1988 and to high of 300 in 1990); see also Myron P. Curzan & Mark L. Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 677-78 (1980) (noting that proxy voting on social responsibility issues increased sharply during 1970s).

43. See LOWRY, *supra* note 3, at 27 (admitting that voting strength of socially responsible investors is limited); Curzan & Pelesh, *supra* note 42, at 671-72 (concluding that ability of small investors to affect corporate policies is quite limited, due to enormous holdings of institutional investors). One of the principal obstacles to the effectiveness of the activist shareholder approach is the rules established by the Securities and Exchange Commission (SEC) governing proxy statements and shareholder resolutions. Under SEC rules, a socially responsible shareholder resolution may be excluded if it deals with a matter that is not "significantly related to the registrant's [the corporation's] business," 17 C.F.R. § 240.14a-8(c)(5) (1991), is "beyond the registrant's power to effectuate," *id.* § 240.14a-8(c)(6), "relat[es] to the conduct of the ordinary business operations of the registrant," *id.* § 240.14a-8(c)(7), or deals with substantially the same matter as a prior proposal recently submitted for a vote and rejected by a very wide margin, *id.* § 240.14a-8(c)(12). With respect to the first basis for excluding shareholder resolutions, the SEC has clarified that ethical and social issues will pass muster if there is a nexus between those issues and the business of the corporation. See Robert N. Leavell, *Corporate Social-Reform: The Business Judgment Rule and Other Considerations*, 20 GA. L. REV. 565, 586 (1986) (reviewing development and interpretation of SEC Rule 14a-8).

An earlier version of Rule 14a-8 proved to be quite effective in barring socially responsible shareholder resolutions such as "Campaign GM," see generally Schwartz, *supra* note 38, because under the earlier rule, General Motors was able to block seven of nine reform resolutions sought by the Project for Corporate Responsibility. See Leavell, *supra*, at 583 (noting that proposed shareholder resolutions were excluded under SEC rules); *supra* note 41 (describing proposed resolutions and noting their dispensation). There is speculation that when the SEC modified Rule 14a-8 in 1983, see Amendments to Rule 14a-8 Under the Securities Exchange Act of 1934 Relating to Proposals by Security Holders, 48 Fed. Reg. 38,218, 38,223 (1983), it strengthened the ability of companies to bar resolutions failing to meet higher vote thresholds and may have been responsible for the sudden decline in number of resolutions between 1983 and 1984, when shareholder resolution volume declined from 111 to 48. ALPERS ET AL., *supra* note 1, at 8. Yet, the number of shareholder resolutions voted on climbed to 216 in 1989, after partial reversal of the Rule 14a-8 changes was required by *United Church Bd. for World Ministries v. SEC*. *Id.* The court in *United Church* struck a portion of the final rule amending Rule 14a-8 for failure to provide adequate notice under the Administrative Procedure Act, 5 U.S.C. § 553 (1988). *United Church Bd. for World Ministries v. SEC*, 617 F. Supp. 837, 839-40 (D.D.C. 1985) (concluding that SEC's notice of proposed rulemaking should include agency views and information on which agency views were based). Still, the prospect of fur-

Obviously, socially responsible investors can and indeed do employ both methods simultaneously.<sup>44</sup> There is no reason that an investment portfolio cannot be developed as a result of both avoidance or positive choice screening and expected shareholder activism. This Article focuses primarily on the avoidance or positive choice approach in the private or public pension context, because in that context, the use of screens has become a principal method for implementing social and ethical considerations into investment decisions.

### *B. SRI Versus Traditional Investing: The Efficient Markets Hypothesis*

Pension plans in the United States, both public and private, now hold approximately \$3732 billion in assets.<sup>45</sup> These assets grow continually and represent a substantial portion of the funds available for capital investments.<sup>46</sup> It is therefore not surprising that the debate over the use of social or political criteria in administering these funds is frequently polarized, particularly when the issue of accepting a lower rate of return or increased risk arises. Indeed, the most contentious issues have to do with the differences in the risk/return ratio between traditional and social investments. The first issue is basic: some proponents of SRI argue that social investing has no extra cost because ethical investments do not require a loss of return at a given level of risk.<sup>47</sup> The second issue is more complex: should social investing by pension funds be allowed even if it does entail a lower rate of return? A discussion of the first question

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ther changes to Rule 14a-8 designed to restrict shareholder activism remains. See Jolie Solomon, *Activists Fear SEC Proxy Rule*, BOSTON GLOBE, May 10, 1992, at 33 (noting that SEC Chairman Richard Breeden and SEC Commissioner Rick Roberts have expressed "interest in restricting social policy ballot initiatives"); Anne Schwimmer, PENSIONS & INVESTMENT AGE, Mar. 30, 1992, at 16 (revealing that corporations have asked SEC to tighten Rule 14a-8 to limit shareholder proposals).

44. See SIMPSON, *supra* note 1, at 5-6 (reviewing portfolio screening and shareholder activism as complementary methods of socially responsible investing).

45. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYS., FLOW OF FUNDS ACCOUNTS, FINANCIAL ASSETS AND LIABILITIES: FIRST QUARTER 1992 6 (1992) [hereinafter FEDERAL RESERVE, FIRST QUARTER 1992].

46. See *id.* (noting that total financial assets of pension plans in first quarter of 1992 were \$15,372.1 billion). Pension funds account for about 24% of total financial assets in the United States. *Id.* By contrast, pension funds accounted for only 3% of total financial assets in 1950, U.S. DEPARTMENT OF LABOR, TRENDS IN PENSIONS 420 (1992), and grew to 14% in 1980. FEDERAL RESERVE, FIRST QUARTER 1992, *supra* note 45, at 5 (noting that pension fund growth has outpaced growth in total financial assets).

47. See, e.g., BRUYN, *supra* note 2, at 12 ("Social investment has outperformed traditional investment designed to maximize profits alone."); LOWRY, *supra* note 3, at 4 (arguing that socially responsible investing "can pay off very handsomely relative to investments and business done solely 'for profit'"); Interview with Joan Bavaria, president of Social Investment Forum, in Eugene, Oregon (May 16, 1986) ("You can definitely have the same performance [from socially responsible investing as from traditional investing], so why not integrate your social values?").

follows, whereas an answer to the second question is set forth in Part III.

A review of the mechanics of traditional investing and of the well-known capital asset pricing model (CAPM)<sup>48</sup> leads inexorably to the conclusion that SRI must involve a less attractive risk/return ratio than traditional investing if capital markets are efficient.<sup>49</sup> Yet, to the extent that capital markets are not efficient, an "inefficiency hypothesis" provides that it may be possible to pursue SRI and still maximize income.<sup>50</sup> To test both the efficient markets hypothesis and the inefficiency hypothesis, some preliminary data on the performance of certain socially targeted investments is included. This data suggests that where social investment funds have outperformed the market, superior performance may be due to the fact that SRI tracks the kinds of speculative "booms" that characterize inefficient markets.<sup>51</sup> Alternatively, SRI screens may be serving as proxy devices for the concepts that underlie traditional portfolio construc-

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48. See *infra* notes 58-62 and accompanying text (describing fundamentals of capital asset pricing model).

49. In efficient markets, prices reflect a forecast of future value based on the market participants' agreement on price information. See EUGENE F. FAMA & MERTON H. MILLER, *THE THEORY OF FINANCE* 335 (1972) (stating that in efficient markets, prices reach equilibrium because of agreement by market participants about implications of all available information for current prices and probability of future prices); see also EUGENE F. FAMA, *FOUNDATIONS OF FINANCE* 133 (1976) ("An efficient capital market is a market that is efficient in processing information. . . . In an efficient market, prices 'fully reflect' available information."). If capital markets are efficient, socially responsible investing will result in higher risk or lower returns because investment decisions based on noneconomic factors will be penalized. See Langbein & Posner, *supra* note 2, at 85-89 (concluding that socially responsible investment portfolio will entail higher risk if capital markets are efficient).

50. Under the "inefficiency hypothesis," prices, which are based on noneconomic considerations, do not perfectly reflect projections of future earnings based on all available information. See Langbein & Posner, *supra* note 2, at 82 (asserting that investments based on public information are not likely to outperform market). The inefficiency hypothesis takes different forms, including the argument that many investors do not base their decisions on information but respond instead to signals or "noise" in the investment system. See Fischer Black, *Noise*, 41 J. FIN. 529, 531-32 (1986) (arguing that many trades of stock are not based on clear information, but rather on "noise" or unsubstantiated rumors regarding future stock performance); David M. Cutler et al., *What Moves Stock Prices?*, J. PORTFOLIO MGMT., Spring 1989, at 9 (concluding that variation in stock prices is greater than what would be expected if investment decisions were based solely on publicly available information); Werner F.M. DeBondt & Richard H. Thaler, *Does the Stock Market Overreact?*, 40 J. FIN. 793, 793 (1985) (stating that stock prices "overreact" to unexpected events and dramatic news); Robert A. Haugen et al., *The Effect of Volatility Changes on the Level of Stock Prices and Subsequent Expected Returns*, 46 J. FIN. 985, 1006 (1991) (maintaining that volatility of stock prices is not related to "real economic events," but rather to stock buyers' emotions or intuitions); Charles M.C. Lee et al., *Anomalies: Closed-End Mutual Funds*, J. ECON. PERSPECTIVE, Fall 1990, at 163 (casting doubt on efficient markets hypothesis by stating that trades based on irrational beliefs can influence price); Robert J. Shiller, *Speculative Prices and Popular Models*, J. ECON. PERSPECTIVE, Spring 1990, at 56-63 (demonstrating that many investment decisions are emotional or intuitive and not based on information, or are responsive to unexpected news and dramatic events).

51. See *infra* notes 141, 142, 144, and 152 (explaining performance of socially responsible funds compared to market).

tion theory.<sup>52</sup>

1. *Some simple economics of portfolio creation*

Those who argue that ethical investment is legal where the financial benefits are equal to those of a similar investment are not making a logical argument. No two investments are the same. One investment will always offer better returns, lower risk or better diversification for the portfolio. If trustees are faced with two potential investments which they judge to be equal on financial grounds but one offers social benefits, then they should split their investments equally between the two to gain additional diversification.<sup>53</sup>

Pension fund managers who engage in traditional investing do so with one objective in mind, which is the protection of pension security through the achievement of the highest possible return on an investment that represents some acceptable level of risk.<sup>54</sup> Thus, the traditional investor really cares about only two issues with respect to a potential investment: risk and return.<sup>55</sup> In developing an entire portfolio, however, the traditionalist tries to eliminate non-systematic risk by diversifying and, at the same time, tries to enhance efficiency.<sup>56</sup> The four concepts of risk, return, diversification, and efficiency constitute the basis of modern portfolio theory.<sup>57</sup>

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52. See LOWRY, *supra* note 3, at 54 (insisting that socially responsible investments may prove more profitable than some traditional investments because SRI eschews short-term profits for long-term gains from investments in stable, growing companies).

53. SIMPSON, *supra* note 1, at 85-86 (quoting Nell Minow of Institutional Investor Services, Inc.).

54. For general background on the economics of pension fund investing, see COTTLE ET AL., *supra* note 14, at 119-76 (describing methods of investment analyses and portfolio construction and management); MCGILL, *supra* note 14, at 434-69 (reviewing regulatory constraints and investment objectives of pension fund portfolio management); MUNNELL, *supra* note 14, at 108 (stating that performance of pension fund investments is traditionally measured by rate of return on fund assets).

55. See, e.g., COTTLE ET AL., *supra* note 14, at 38-47 (stating that determination of acceptable risk and return objectives are "key considerations in making investment decisions"); JOHN J. PRINGLE & ROBERT S. HARRIS, *ESSENTIALS OF MANAGERIAL FINANCE* 144-51 (1987) (maintaining that investment decisions are characterized by balance between risk and rate of return); MARTIN J. SCHWIMMER & EDWARD MALCA, *PENSION AND INSTITUTIONAL PORTFOLIO MANAGEMENT* 93-102 (1976) (noting that "risk is the uncertainty in any investment" and describing risk management approaches available to pension fund managers).

56. See PRINGLE & HARRIS, *supra* note 55, at 142 (stating that fundamental aspect of financial management is that risk can be reduced through diversification). But see Harry M. Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 79 (1952) ("Diversification cannot eliminate all variance . . . in expected returns.").

57. For the seminal work on modern portfolio theory, see Markowitz, *supra* note 56, at 89 (stating general rule that diversification of investment portfolio across industries will lower risk and increase yield). For a general discussion of subsequent work in economics concerning modern portfolio theory, see John Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 REV. ECON. STAT. 13, 19-20 (1965) (finding that diversification is necessary for portfolio optimization); William F. Sharpe, *Capital*



Similarly, the elements of risk and return form the foundation of the capital asset pricing model.<sup>58</sup> The CAPM may be stated as follows:  $r - r_f = \text{beta} (r_m - r_f)$ , where  $r$  is the expected return on any stock;  $\text{beta}$  is the covariance of the stock in the market portfolio;  $r_f$  is the risk-free interest rate;  $r_m$  is the expected return on the market;  $r - r_f$  is the expected risk premium; and  $r_m - r_f$  is the expected market risk premium.<sup>59</sup> Return is essentially an investment's expected profitability, which turns on the likelihood of any given performance scenario. For example, if there is a 50% chance that a particular investment will return 10% this year and also a 50% chance that it will return only 5%, then the expected return is:  $.5(10\%) + .5(5\%) = 7.5\%$ .<sup>60</sup> Risk is a measure of the uncertainty or standard deviation of the return.<sup>61</sup> This means that the value of any potential investment will depend on the future return the investor expects to receive, as well as on the likelihood that the return will be realized.<sup>62</sup>

If investors are rational, a given investment must provide a higher rate of return to compensate for increased risk. Thus, risk and return are positively correlated: more risk, more return; less risk, less return.<sup>63</sup> This relationship enables a manager to determine whether

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*Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. FIN. 425, 436-40 (1964) (maintaining that diversification of investments reduces systemic risk).

58. For a basic discussion of the relationship between risk and return based on the implications of the CAPM, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 136-39 (3d ed. 1988) (describing linear relationship between risk and return under CAPM); WILLIAM F. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* 20-24 (1970) (maintaining that portfolio theory relies on calculation of probability of various rates of return); EZRA SOLOMON & JOHN J. PRINGLE, *AN INTRODUCTION TO FINANCIAL MANAGEMENT* 301-08, 427-35 (1977) (explaining market risk premium basis of CAPM).

59. See BREALEY & MYERS, *supra* note 58, at 134-43 (describing sensitivity calculation for expected market risk premiums under CAPM and stating that "[t]he risk of a well-diversified portfolio depends on the average *beta* of the securities included in the portfolio"); JEROME B. COHEN ET AL., *INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT* 150-57 (1982) (describing development of portfolio with highest risk through calculation of standard deviation of return); David W. Mullins, Jr., *Does the Capital Asset Pricing Model Work?*, HARV. BUS. REV., Jan.-Feb. 1982, at 108 (describing pricing model and discussing formula for calculating expected returns).

60. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 777-78 (1985) (calculating expected portfolio return by using sum of expected returns of portfolio assets).

61. See *supra* note 58 (listing sources that discuss risk and return under CAPM).

62. See PRINGLE & HARRIS, *supra* note 55, at 135-41 (stating that present value of potential investment is based on calculation of both probable returns and variability of outcomes or risk).

63. See COHEN ET AL., *supra* note 59, at 199 ("One of the primary assumptions of the capital asset pricing model is that there is a positive long-run relationship between risk and return and that the relationship tends to be linear.").

The CAPM theory has been much criticized. See, e.g., *id.* at 205 (noting that serious questions have been raised about whether CAPM accurately describes true relationship between risk and return in marketplace); THOMAS R. DYCKMAN & DALE MORSE, *EFFICIENT CAPITAL MARKETS AND ACCOUNTING* 2 (1986) ("The CAPM is a simplistic approach to pricing securities and is not likely to be completely accurate."); BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* 83 (1986) ("Neither the capital asset pricing model

a particular portfolio will be efficient. A portfolio of investments is efficient under either of two conditions: for a given level of return, the portfolio has the lowest possible level of risk; or, for a given level of risk, it has the highest expected return.<sup>64</sup>

Finally, the risk facing an investor will either be systematic or non-systematic.<sup>65</sup> Systematic risk is risk that cannot be eliminated through increased diversification of the portfolio.<sup>66</sup> It is the basic risk associated with changes in the economy over which the investor and other marketplace actors have no control.<sup>67</sup> Nonsystematic risk, however, is risk that can be completely eliminated through appropriate diversification of the portfolio.<sup>68</sup> An efficient portfolio will contain only systematic risk, whereas nonsystematic risk will be entirely eliminated through diversification of the investment portfolio.

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(CAPM) nor any of the other asset pricing models commands universal acceptance as an explanation of the expected return of assets."'). Some critics, however, recognize it as more accurate than alternative pricing models. See Mullins, *supra* note 59, at 112-13 (recognizing imperfections in CAPM but concluding that alternative models have not proved to be superior).

64. See Markowitz, *supra* note 56, at 79 ("The portfolio with maximum expected return is not necessarily the one with minimum variance. There is a rate at which the investor can gain expected return by taking on variance or reduce variance by giving expected returns."); see also WILLIAM J. BAUMOL ET AL., *THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION* 29 (1990) ("Given the choice between two investments with the same expected return, the investor will always select the security with the lower risk."); SHARPE, *supra* note 58, at 26 ("If two portfolios have the same [risk] and different expected returns, the one with the largest return is preferred. If two portfolios have the same expected return and different [risks], the one with the smaller [risk] is preferred.").

65. See PRINGLE & HARRIS, *supra* note 55, at 152 (stating that "the risk of any individual stock can be separated into two components: *nondiversifiable risk* and *diversifiable risk* [or systematic risk and nonsystematic risk, respectively]"); Gordon & Kornhauser, *supra* note 60, at 777 (describing nonsystematic risks as "risks peculiar to the issuer" and systematic risks as "risks to issuers generally").

66. See PRINGLE & HARRIS, *supra* note 55, at 152 ("Nondiversifiable [or systematic] risk is that part of the total risk that is related to the general economy or the stock market as a whole and, hence, cannot be eliminated by diversification. Nondiversifiable risk is also known as *market risk*, or *systematic risk*."); Gordon & Kornhauser, *supra* note 60, at 177 (referring to systematic risk as "nondiversifiable risk"); Langbein & Posner, *supra* note 2, at 80 (noting that systematic risk cannot be reduced through diversification but can by other means).

67. See BREALEY & MYERS, *supra* note 58, at 132 (stating that systematic risk, or "market risk," cannot be eliminated through diversification); COTTLE ET AL., *supra* note 14, at 160 ("[Systematic] risk stems from underlying characteristics of the environment in which security markets operate."); LONGSTRETH, *supra* note 63, at 82 ("By holding a well-diversified portfolio, one can remove issue-specific risks, leaving only the systemic risk of the particular market for which the securities in the portfolio are a proxy.").

68. See BAUMOL, *supra* note 64, at 29 ("*Residual risk* is the risk unique to the specific asset (stock); it is also called unsystematic or diversifiable risk. . . . However, when an investor builds a portfolio of stocks, he [or she] can reduce the unsystematic risk almost to zero."); BREALEY & MYERS, *supra* note 58, at 132 (maintaining that unsystematic risk can potentially be eliminated through diversification); PRINGLE & HARRIS, *supra* note 55, at 152 ("Diversifiable risk is that part of total risk that is unique to the company or industry and that, therefore, can be eliminated by diversification. Diversifiable risk is sometimes also referred to as *unsystematic risk*.").

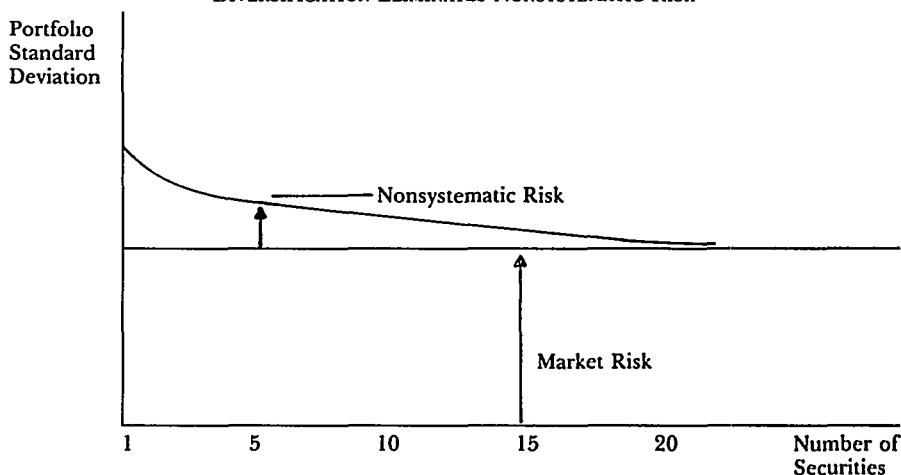
lio.<sup>69</sup> The market will not reward a portfolio that has not eliminated all nonsystematic risk with a high rate of return.<sup>70</sup>

The CAPM and the assumption that markets are efficient are extremely important to the theoretical debate about the costs and desirability of socially responsible investing.<sup>71</sup> At the outset, one should note that the CAPM assumes, *inter alia*, that financial markets are frictionless and that there are no transaction costs.<sup>72</sup> While these assumptions are clearly unrealistic, they do not wholly invali-

69. See SHARPE, *supra* note 58, at 97 ("Efficient portfolios have no unsystematic risk. . . . A portfolio (or security) with unsystematic risk is inefficient.").

70. See Ferris & Rykaczewski, *supra* note 3, at 62 (stating that financial markets will not reward portfolio that bears unnecessary nonsystematic risk that can be eliminated through broader selection of investments); Langbein & Posner, *supra* note 2, at 79 (maintaining that diversifiable risk "is not compensated risk" because "it does not command a higher return than a less risky stock yielding . . . the same expected return"). In contrast, an expert on modern portfolio theory allowed that it was possible for a nondiversified portfolio to obtain high returns. Markowitz, *supra* note 56, at 89 ("It is conceivable that one security might have an extremely higher yield and lower variance than all other securities; so much so that one particular undiversified portfolio would give maximum [yield] and minimum [risk]"). The following figure exhibits the relationship between diversification and the elimination of nonsystematic risk.

FIGURE 1  
DIVERSIFICATION ELIMINATES NONSYSTEMATIC RISK



Diversification can eliminate nonsystematic risk, but it cannot eliminate systematic (market) risk.

Adapted from: RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 134 (3d ed. 1988).

71. See LOWRY, *supra* note 3, at 39-41 (recognizing that performance of socially responsible investments is directly related to validity of efficient market theory).

72. For a discussion of some of the variables of the CAPM, see MICHAEL C. JENSEN, *STUDIES IN THE THEORY OF CAPITAL MARKETS* 5 (1972) (identifying assumptions underpinning CAPM, including frictionless markets where transaction costs are negligible); PRINGLE & HARRIS, *supra* note 55, at 155-56 (listing critical assumptions essential to CAPM theory, including notions that investors are risk-averse and make decisions based on single time period).

date the basic implication of the modern portfolio theory for ethical investing, which is that the inclusion of criteria other than risk, return, diversification, and efficiency reduces the number of potentially attractive investments and thereby diminishes a fund manager's ability to assemble an efficient portfolio.<sup>73</sup>

An important corollary of CAPM, which has been referred to as the "separation theorem," implies that in an efficient market, investors will maximize their incomes by separating investment and consumption decisions.<sup>74</sup> Under this theorem, investors who wish to "do good" should first maximize investment income by positioning themselves on the "efficiency frontier"<sup>75</sup> and then by spending their

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73. See Langbein & Posner, *supra* note 2, at 85 (arguing that portfolio constructed in accordance with social principles will be less diversified than one constructed with optimal strategy of high return portfolio design).

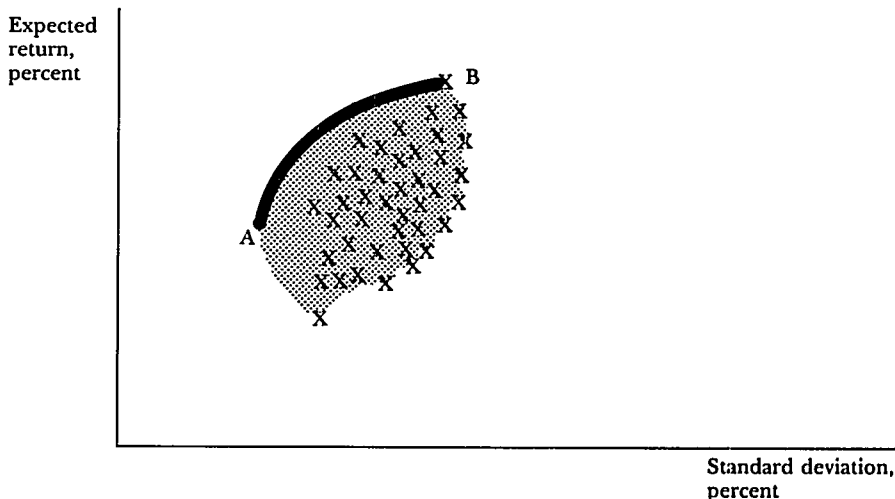
74. See JACK HIRSHLEIFER, *PRICE THEORY AND APPLICATIONS* 436 (1988) (arguing that income maximization in efficient markets results from separation of productive and consumptive decisions); Ferris & Rykaczewski, *supra* note 3, at 61 ("[The separation] principle contends that optimal portfolio management requires a separation between the investor's preferences or tastes and the criteria used by the fund for its investment decision.").

75. See COHEN ET AL., *supra* note 59, at 150-57 (identifying "efficient frontier"); COTTLE ET AL., *supra* note 14, at 170 (maintaining that "efficient frontier" is bounded by calculation of maximum return at each level of risk). As used throughout this Article, "behind the efficiency frontier" refers to the traditional investor's view of where ethical investing and other "beat the market" strategies will place a social investor. A traditionalist would expect to find SRI portfolios behind the efficiency frontier because the efficient markets hypothesis relies on fundamental economic information to predict stock performance and SRI does not. See Langbein & Posner, *supra* note 2, at 88-89 (suggesting that SRI can result in "serious underdiversification" and place investor behind efficiency frontier at given level of risk). Of course, if the market is inefficient and SRI enables an investor to maximize income, then clearly SRI portfolios are not really behind an efficiency frontier. For the sake of simplicity, however, SRI portfolios are referred to in this Article as being behind the efficiency frontier or simply "behind the frontier" even when they represent an income maximizing strategy. Figure 2 provides a visual representation of the efficiency frontier concept.

investment income in a charitable way.<sup>76</sup> If investment income is maximized, investors will have more to spend on charity than would be possible if they positioned themselves inside the efficiency frontier by mixing investment and consumption decisions.<sup>77</sup> If capital markets are efficient, then socially responsible investors are necessarily somewhere behind the efficiency frontier, and the CAPM suggests that they could do better by moving onto or beyond the frontier itself.

FIGURE 2  
THE EFFICIENCY FRONTIER

CAPM suggests that an investor will maximize income by holding a diversified portfolio, which will lie along the efficiency frontier. The efficient markets hypothesis also says that because every stock price reflects the stock's real value, it is not possible to pick and choose stocks according to any "beat the market" philosophy and win consistently.



Each cross shows the expected return and standard deviation from investing in a single stock. The broken-egg-shaped area shows the possible combinations of expected return and standard deviation if you invest in a *mixture* of stocks. If you like high expected returns and dislike high standard deviations, you will prefer portfolios along the heavy line. These are *efficient* portfolios. Whether you want to choose the minimum risk portfolio (portfolio A) or the maximum expected return portfolio (portfolio B) or some other efficient portfolio depends on how much you dislike taking risk.

Source: RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 155 (3d ed. 1988).

76. Note that the CAPM indicates that an investor who wishes to maximize income should hold some combination of a market portfolio and riskless assets such as treasury bills. See LOWRY, *supra* note 3, at 19 (stating that traditional investors do not "mix money and morality," but pursue profit maximization and address social concerns indirectly through charitable contributions). This combination will not be a point on the efficiency frontier, but will lie beyond or in front of the frontier.

77. Consumption here refers to an investor's decision to "buy" the satisfaction that comes from giving to a charitable cause, whether political, environmental, or otherwise. See Ferris & Rykaczewski, *supra* note 3, at 61 ("By maximizing [income] . . . each individual has a greater financial ability to satisfy personal preference or desires.").

One reason that the CAPM suggests SRI will be unattractive is that the socially responsible investor's portfolio is likely to contain a degree of nonsystematic risk that is created by certain ethically, socially, or politically dictated investment decisions.<sup>78</sup> Because the use of negative screens bars investment in certain companies, diversification of the socially responsible portfolio will be constrained, and it may be impossible to eliminate systematic risks.<sup>79</sup> The heightened risks that are expected in a pension fund portfolio developed consistent with social criteria would not be compensated by the prospect of increased returns and would be borne instead by the socially responsible investor.<sup>80</sup>

A pension plan may be organized as either a defined contribution or a defined benefit plan.<sup>81</sup> The risk of uncertain returns to pension funds under different investment strategies varies under these two types of plans. A defined contribution plan is comparable to a savings account because it establishes an individual account for each employee that will be drawn upon that employee's retirement.<sup>82</sup> The plan specifies the rate of contribution into the plan rather than the benefit after retirement, however. For this reason, retirement benefits from defined contribution plans vary according to investment gains.<sup>83</sup>

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78. See Gordon & Kornhauser, *supra* note 60, at 778 (noting that investors generally do not receive greater expected return for nonsystematic risk element).

79. See Langbein & Posner, *supra* note 2, at 85 (concluding that portfolio constructed in accord with socially responsible criteria will be less diversified and will therefore entail more risk than portfolio constructed on principle of profit maximization).

80. See Ferris & Rykaczewski, *supra* note 3, at 62 (noting that great risks are borne by pension plan participants and not by plan trustees or managers when plan indulges in SRI).

81. A defined contribution plan is "a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account." Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1002(34) (1988).

A defined benefit plan is:

a pension plan other than an individual account plan; except that a pension plan which is not an individual account plan and which provides a benefit derived from employer contributions which is based partly on the balance of the separate account of a participant-

(A) for the purposes of section 1052 of this title [setting minimum participation standards], shall be treated as an individual account plan, and

(B) for the purposes of paragraph (23) of this section [1002] and section 1054 of this title [29] [governing benefit accrual requirements], shall be treated as an individual account plan to the extent benefits are based upon the separate account of a participant and as a defined benefit plan with respect to the remaining portion of benefits under the plan.

*Id.* § 1002(35).

82. See Langbein, *supra* note 3, at 5 (detailing operation of defined contribution pension plans).

83. See Langbein, *supra* note 3, at 5 (describing differences between defined contribution and defined benefit pension plans).

In contrast, a defined benefit plan is one in which the plan sponsor promises to pay specified retirement benefits. The plan sponsor, generally an employer, bears the risk if the fund does not perform as expected, because the employer must meet its obligations to the beneficiaries regardless of the actual return on the fund's investments.<sup>84</sup> In the defined contribution context, however, the employee bears the risk that a fund will not perform as expected.<sup>85</sup> At first glance, it might appear that plan participants should be wholly indifferent to the practice of social investing by fund managers in the defined benefit context because it is the plan sponsor who suffers in the event that the investments underperform. This is not the case, however, because underperforming funds are less able to provide cost-of-living adjustments, and fund managers may adopt conservative investment strategies that provide lower benefits to future participants.<sup>86</sup>

In addition, the fact that private pensions are insured via the Pension Benefit Guaranty Corporation (PBGC)<sup>87</sup> does not mean that participants in defined benefit or defined contribution plans should be indifferent to the performance of their funds.<sup>88</sup> The risk borne by defined contribution participants is fairly obvious and is not materially affected by the presence of federal insurance. Similarly, the PBGC's role with respect to defined benefit plans is neither cost-free nor entirely comforting, for two reasons. First, the PBGC assesses premiums based on the riskiness of the plan to be insured: the riskier the plan, the more money PBGC charges to insure it.<sup>89</sup> Thus,

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84. See GREENOUGH & KING, *supra* note 14, at 178 (noting that under defined benefit plan, pension fund commits to make payments based on specified formula, irrespective of pension fund growth).

85. See GREENOUGH & KING, *supra* note 14, at 178 ("Under defined contribution plans, the benefit itself is not precisely stated in advance, but is whatever pension can be purchased at retirement by the funds that have been accumulated on behalf of each plan participant.").

86. See Ferris & Rykaczewski, *supra* note 3, at 61 (concluding that "both present and future pension recipients may be adversely affected by lower fund return in spite of a defined benefits package").

87. ERISA established the PBGC, 29 U.S.C. §§ 1301-1461 (1988), granted it juridical capacity, *id.* § 1303(b), and bestowed upon it extensive investigatory and enforcement powers. *Id.* § 1303(a).

88. *But see* GREENOUGH & KING, *supra* note 14, at 194. William Greenough and Francis King argue that:

The combined effect of the PBGC and the funding standard regulations established by other sections of the Pension Reform Act of 1974 can be expected to do much to improve the capacity of defined benefit pension plans to meet their benefit obligations and to assure participants that their pension plan can keep its promises, even in the event the employer goes out of business.

*Id.*

89. The premiums charged by the PBGC to an employer for each participant in the employer's pension plan depends on whether the plan is underfunded. 29 U.S.C. § 1306(a)(3)(A)-(E) (1988). Where the plan is sufficiently funded, the PBGC will charge the employer \$19.00 annually for each participant in a single employer plan. *Id.*

the presence of nonsystematic risk will be reflected in added costs borne by the plan for insurance to the extent that risk precipitates an underfunding of plans.

Second, there has recently been much speculation about the solvency of the PBGC and many believe that its reserves are vastly outweighed by its liabilities.<sup>90</sup> Thus, even participants in defined benefit plans ought to hope that plan managers eliminate as much risk as possible in assembling a portfolio, because there is reason to wonder whether the PBGC could satisfy all claims in the event of a major plan sponsor failure or reorganization.<sup>91</sup>

In sum, the economic theory of efficient markets and the CAPM strongly suggest that inclusion in the investment calculus of ethical and social factors will limit the pool of investment choices and thereby increase the presence of nonsystematic risk in investment portfolios. This circumstance will manifest itself in reduced investment returns and a loss of income, at a given level of risk, for participants in pension plans, particularly in the defined contribution context.

## 2. *The inefficiency hypothesis*

Despite this discouraging result, the evidence in support of the efficient markets hypothesis is not completely monolithic. Over the past decade, an increasing number of studies have suggested that because capital markets may be subject to inefficient speculative booms,<sup>92</sup> it may actually be possible for non-CAPM strategies such

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§ 1306(a)(3)(A)(i). Where the plan is underfunded, however, the employer will be charged a variable rate of up to \$53.00 annually per participant. *Id.* § 1306(a)(3)(E)(iv)(I).

ERISA covers only defined benefit plans, and not defined contribution plans. *Id.* §§ 1321(a)-(b)(1). All defined benefit plans are mandatorily covered whether the employer pays the required premiums or not. *Id.* § 1321(a). Where a covered plan is terminated either by the employer voluntarily or by the PBGC, and is also underfunded, the PBGC will become the trustee of the plan and will guarantee any nonforfeitable benefits. *Id.* §§ 1322-1322a.

90. See, e.g., Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 65 (asserting that PBGC "finds itself on the brink of financial ruin" because many insured pension plans are underfunded); J. Robert Suffoletta, Jr., Note, *Who Should Pay When Federally Insured Pension Funds Go Broke?: A Strategy For Recovering from the Wrongdoers*, 65 NOTRE DAME L. REV. 308, 313 (1990) (estimating that deficit in all pension fund claims may soon reach \$10 billion); Edwin McDowell, *U.S. Moves on Pan Am Pensions*, N.Y. TIMES, July 25, 1991, at D8 (stating that PBGC had assets of \$3.3 billion and liabilities of \$5.1 billion at end of fiscal year 1990).

91. See, e.g., McDowell, *supra* note 90, at D1 (reporting that in wake of Pan American World Airways' (Pan Am) bankruptcy, PBGC determined that some of Pan Am's flight engineers may receive reduced benefits because Pan Am's Cooperative Retirement Income Plan is approximately \$800 million underfunded and airline's defined benefit plan for flight engineers is approximately \$40 million underfunded).

92. See DeBondt & Thaler, *supra* note 50, at 793 (noting stock prices' tendency to overreact upon surfacing of unexpected news or occurrence of dramatic geopolitical events); H. Nejat Seyhun, *Overreaction or Fundamentals: Some Lessons from Insiders' Response to the Crash of 1987*, 45 J. FIN. 1363, 1386-87 (1990) (concluding that stock price shifts in months before



as SRI to succeed at income maximization. In this regard, it is important to keep in mind that a hypothesis of market inefficiency implies that the separation theorem does not hold<sup>93</sup> and that SRI and other "beat the market" strategies that operate from behind the efficiency frontier may maximize income in direct contrast with the expectations of the CAPM.<sup>94</sup>

In support of this "inefficiency hypothesis," the economist Michael Jensen wrote more than ten years ago that despite his belief that the efficient markets hypothesis was backed by strong empirical evidence, economics was beginning to present new evidence that was inconsistent with that hypothesis.<sup>95</sup> Since then several others, most notably Robert Shiller,<sup>96</sup> have also concluded that there is now evidence available that questions the theoretical and empirical underpinnings of the efficient markets hypothesis.<sup>97</sup> For example,

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1987 market crash, during crash, and in subsequent months were based more firmly in over-reaction to trends than in fundamental values changes); Jeremy Stein, *Overreactions in the Options Market*, 44 J. FIN. 1011, 1012 (1989) (presenting evidence that price volatility of options market exceeds rational expectations).

93. See HIRSHLEIFER, *supra* note 74, at 436 (stating that separation theorem only applies where markets are efficient).

94. See *supra* notes 49-52 (suggesting that SRI could outperform market if markets are inefficient and CAPM is invalid).

95. See Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978) (asserting that economics was "entering a stage where widely scattered and as yet incohesive evidence is arising which seems to be inconsistent with the [efficient market] theory").

96. Shiller, *supra* note 50, at 56-63 (demonstrating that many investment decisions are premised on emotion or intuition and are not based on objective information).

97. See, e.g., Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591, 592 (1986) (asserting that "existing evidence does not establish that financial markets are efficient in the sense of rationally reflecting fundamentals").

The literature on the inefficiency of capital markets is now substantial. See, e.g., DYCKMAN & MORSE, *supra* note 63, at 8 (stating that markets reflect inability of unsophisticated investors to process information and make correct decisions); Black, *supra* note 50, at 531-32 (arguing that many stock trades are not based on clear information and are therefore inefficient); Cutler et al., *supra* note 50, at 9 (asserting that little variation in stock prices can be explained based solely on publicly available investment information); DeBondt & Thaler, *supra* note 50, at 793 (stating that stock prices react irrationally to unexpected world events); Werner F.M. DeBondt & Richard H. Thaler, *Further Evidence on Investor Overreaction and Stock Market Sensationality*, 42 J. FIN. 557, 579 (1987) (suggesting that price shifts are tied to seasonal shifts and firm sizes); Haugen et al., *supra* note 50, at 1006 (maintaining that volatility of stock prices is unrelated to real economic events); Simon M. Keane, *Paradox in the Current Crisis in Efficient Market Theory*, J. PORTFOLIO MGMT., Winter 1991, at 30 (noting sharp criticism of efficient market hypothesis that arose in financial circles after 1987 market crash and 1989 stock price volatility); Allan W. Kleidon, *Anomalies in Financial Economics: Blueprint for Change*, 59 J. BUS. 5469, 5487 (1986) (stating that anomalies in stock prices cannot be accommodated by existing efficiency theories); Lee et al., *supra* note 50, at 163 (casting doubt on efficient markets hypothesis by stating that stock trades based on irrational beliefs can influence price); Bruce N. Lehmann, *Fads, Martingales, and Market Efficiency*, 105 Q.J. ECON. 1, 25 (1990) (examining security prices and concluding that efficient markets hypothesis should be rejected as inadequate to predict prices); Edward M. Miller, *Bounded Efficient Markets: A New Wrinkle to the EMH*, J. PORTFOLIO MGMT., Summer 1987, at 12 (suggesting that changes to efficient markets hypothesis are needed to reflect market realities); John O'Brien & Sanjay Srivastava, *Dynamic Stock Markets with Multiple Assets: An Experimental Analysis*, 46 J. FIN. 1811, 1811 (1991) (finding strong evi-

Professors Andrei Shleifer and Lawrence Summers have noted that investors tend to "chase the trend" by buying stocks after they rise and selling them after they fall.<sup>98</sup> By chasing trends rather than investing on the basis of fundamental information, investors create speculative booms or "bubbles" that move prices away from fundamentals. Instead of counteracting this essentially false change in prices as would happen under CAPM theory, arbitrageurs actually participate in chasing trends because such an investment strategy is profitable for short periods.<sup>99</sup> The participation of arbitrageurs only exacerbates the boom, however.<sup>100</sup>

Professors Shleifer and Summers suggest that such a boom scenario makes it easier to explain the market crash of 1987. Under standard finance theory, argue the professors, the October 1987 crash reflected either a large increase in risk premiums because of the weakness of the economy or a large decrease in future growth rates of dividends.<sup>101</sup> There is no evidence, however, that risk increased or dividend growth decreased.<sup>102</sup> The crash, therefore, can be attributed to a collapse of positive feedback strategies, of which chasing trends is one example.<sup>103</sup>

This creation of speculative bubbles is a form of investment via

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dence against efficient markets hypothesis but concluding that tests do not support absolute rejection of theory); Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSP., Spring 1990, at 19 ("[T]he stock in the efficient market hypothesis—at least as it has traditionally been formulated—crashed along with the rest of the market on October 19, 1987. Its recovery has been less dramatic than that of the rest of the market."); Stein, *supra* note 92, at 1012 (presenting evidence that price volatility of options market exceeds rational efficiency-based expectations); Jack L. Treynor, *Market Efficiency and the Bean Jar Experiment*, FINANCIAL ANALYSTS J., May-June 1987, at 50 ("Market efficiency is a premise, not a conclusion. The finance literature offers no proof of market efficiency . . ."); Langdon B. Wheeler, *The Oscillation of Systems: The Missing Link Between Price Volatility and Market Efficiency*, FINANCIAL ANALYSTS J., July-Aug. 1989, at 7 (proposing revision to efficient markets hypothesis in attempt to reconcile conflict between price volatility and market efficiency). But see Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1607-10 (1991) (arguing that empirical studies of market efficiency are valuable despite disagreement among economists over plausible conclusions).

98. See Shleifer & Summers, *supra* note 97, at 28 (observing that trend chasers follow "positive feedback strategies" in which stock price levels and stock purchase volumes are correlated).

99. See Shleifer & Summers, *supra* note 97, at 28 ("[I]t may pay arbitrageurs to jump on the bandwagon themselves. Arbitrageurs then optionally buy the stocks that positive feedback investors get interested in when their prices rise. When price increases feed the buying of other investors, arbitrageurs sell out near the top and take their profits.").

100. Cf. Shleifer & Summers, *supra* note 97, at 28 ("The effect of arbitrage is to stimulate the interest of other investors and so to contribute to the movement of prices away from fundamentals.").

101. Shleifer & Summers, *supra* note 97, at 28.

102. Shleifer & Summers, *supra* note 97, at 28 (observing that after 1987 crash, stock price volatility "indeed jumped up but came back down rapidly as it usually does").

103. Shleifer & Summers, *supra* note 97, at 28 ("Positive feedback trading, exacerbated by possible front-running by investment banks, can also explain the depth of the crash once it had started.").

the use of "popular," or non-CAPM, models. Professor Shiller examined the use of popular models in the context of the 1987 stock market crash in the United States and Japan, the real estate booms in the late 1980s, and periodic "hot" markets for initial public stock offerings.<sup>104</sup> He notes that what he calls the rational expectations model, which is equivalent to the efficient markets hypothesis, is problematic because it assumes "that people know (or behave as if they know) the true model that describes the economy."<sup>105</sup> He asserts that popular models, which economic actors use to form investment expectations, are not the same as models used by economists.<sup>106</sup> Professor Shiller concludes that certain speculative booms and crashes such as the stock market crash in October 1987 can be explained in large part by the phenomenon of many investors using popular non-CAPM models to make investment decisions.<sup>107</sup>

Finally, Professor Summers examined statistical tests frequently used by economists to assess the efficiency of capital markets and concluded that the tests are not powerfully descriptive.<sup>108</sup> He noted that there is no evidence to suggest that efficient financial markets rationally reflect fundamental investment information.<sup>109</sup> Importantly, he described his results as casting doubt on the efficient markets hypothesis.<sup>110</sup>

As the foregoing examples indicate, a substantial amount of theoretical and empirical work in economics now suggests that the nearly universal support enjoyed by the efficient markets hypothesis has eroded.<sup>111</sup> The implication of this development is significant to the debate over the validity of ethical investing. If capital markets are not efficient then the separation theorem, which posits that in-

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104. See Shiller, *supra* note 50, at 56-63 (demonstrating that pricing in speculative real estate and stock market booms and crashes may be unrelated to fundamental economic information).

105. Shiller, *supra* note 50, at 55.

106. Shiller, *supra* note 50, at 55.

107. See Shiller, *supra* note 50, at 64 (suggesting that popular pricing models may prove more accurate than efficient markets hypothesis in predicting behavior of markets).

108. See Summers, *supra* note 97, at 593-98 (reviewing statistical tests of market efficiency).

109. See Summers, *supra* note 97, at 592 (examining statistical tests of speculative market efficiency and concluding that "existing evidence does not establish that financial markets are efficient in the sense of rationally reflecting fundamentals"); see also O'Brien & Srivastava, *supra* note 97, at 1837 ("We found that the markets are generally inefficient from the point of view of full information aggregation.").

110. See Summers, *supra* note 97, at 592 (stating that his results "call into question the theoretical as well as empirical underpinnings of the Efficient Market Hypothesis"); see also Haugen et al., *supra* note 50, at 1006 (noting that "[e]xcessive volatility of volatility which we observe [in stock prices] only serves to raise further questions regarding our ability to account fully for the behavior of stock prices through current financial markets paradigms").

111. See *supra* note 97 (reviewing criticisms of efficient markets hypothesis' validity).

come is maximized by separating investment and consumption decisions,<sup>112</sup> does not apply, and SRI itself may be a vehicle for income maximization.<sup>113</sup> In an inefficient market, investors can take advantage of speculative booms created by an irrational increase in demand for certain investments. If ethical investors participated in booms through social investing, they could maximize investment income while engaging in consumption in direct contravention of the separation theorem. In other words, the predictions of the CAPM notwithstanding, investors could, from "behind the efficiency frontier," both do good and do well at the same time.

### 3. *Data on state specially targeted portfolio investments and certain private funds*

Because SRI has been performed over a long period of time and has gained considerable attention and support among public entities such as politicians and unions, data regarding SRI's actual performance in certain instances can be assembled. This section contains the available data with respect to public pension funds. In addition, the section briefly surveys the claims of certain private investment funds to extraordinary performance despite the predictions of the CAPM and the efficient markets hypothesis.

One means of resolving the continuing controversy over whether SRI negatively affects fund performance is to put aside theory, which on balance favors opponents of SRI, and to set about measuring the performance of various funds. In other words, this is one dispute that appears amenable to empirical resolution. Assessing performance, though, is not a simple task. Some hurdles that must be overcome include the construction of appropriate benchmarks and timescales and the problem of measuring the performance of one investor against another.<sup>114</sup> In her recent survey of SRI, Anne Simpson concluded that the ethical criteria, investment management, and benchmarks employed will all affect the outcome of any analysis of ethical investment.<sup>115</sup> At least one scholar has stated that the available evidence does not entirely support social investing.<sup>116</sup>

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112. See *supra* note 74 and accompanying text (explaining separation theorem and its implications for socially responsible investments).

113. See *supra* note 47 (reviewing assertions by proponents of socially responsible investing that economic growth and returns under this kind of investing compare favorably to traditional market performance).

114. SIMPSON, *supra* note 1, at 86.

115. SIMPSON, *supra* note 1, at 96.

116. Joel Chernoff, *War of Conscience Tugging at Pension Funds*, PENSIONS & INVESTMENT AGE, Nov. 27, 1989, at 3 (quoting Associate Dean Bernard Jump, Jr. of Maxwell School of Citizenship and Public Affairs at Syracuse University).

The following is a schematic summary of the performance of some of the better-known social investment mutual funds during 1991 and 1992.<sup>117</sup> Data about the performance of the Standard & Poor's (S & P) 500,<sup>118</sup> the Dow Jones Industrials,<sup>119</sup> and the average of all mutual funds is included for comparison.

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117. The Social Investment Forum provided this comparative data. Pax World Fund, organized in 1970, describes itself as devoted to "mak[ing] a contribution to world peace" by investing in firms with fair employment practices and sound environmental policies in non-war related industries, and by avoiding the liquor, tobacco, and gambling industries. PAX WORLD FUND, QUESTIONS AND ANSWERS ABOUT PAX WORLD FUND (1990). The Calvert Social Investment Fund actually consists of four different portfolios, each devoted to companies that "support their workers, provide opportunities for women and minorities, and deliver safe products and services in ways that sustain our natural environment." CALVERT GROUP, CALVERT SOCIAL INVESTMENT FUND: COMMONLY ASKED QUESTIONS (1989). The Fund will not invest in companies that engage in business activities with oppressive regimes, such as that in South Africa, or manufacture weapons systems, or produce nuclear energy. *Id.* The Parnassus Fund describes itself as following a "contrarian" policy of investing in stocks that are undervalued because they are considered disfavored by the financial community. *See* THE PARNASSUS FUND, WHY IS THE PARNASSUS FUND DIFFERENT FROM ALL THE OTHER MUTUAL FUNDS ON THE MARKET TODAY? (defining contrarian as "the art of buying what other people don't want"). The New Alternatives Fund concentrates on environmentally oriented energy investments and favors recycling, clean water, cogeneration, and reducing the greenhouse effect while disfavoring tobacco, gambling, weapons, and nuclear energy. NEW ALTERNATIVES FUND, WHY INVEST IN NEW ALTERNATIVES? 5 (1989). The Dreyfus Third Century Fund is a common stock fund that avoids investments with South African ties and seeks out companies that protect the environment and the health and safety of workers, that produce safe products, and that support equal opportunity. THE DREYFUS THIRD CENTURY FUND, INC., PROSPECTUS 3 (1990); THE DREYFUS THIRD CENTURY FUND, QUESTIONS AND ANSWERS (1989). The Calvert-Ariel Appreciation Fund seeks to invest in companies that take steps to preserve the environment, and will not invest in companies that do business in South Africa. CALVERT GROUP, CALVERT-ARIEL APPRECIATION FUND: AN ENVIRONMENTALLY SOUND INVESTMENT (1989).

118. *See* SUMNER N. LEVINE, THE FINANCIAL ANALYST'S HANDBOOK 88-89 (2d ed. 1988) (explaining that Standard & Poor's 500 (S & P 500) is generally used as indicator of trends in stock market). The S & P 500 index tracks 500 stocks, including 400 industrial companies, 20 transportation companies, 40 utilities, and 40 financial companies, that are chosen for their representativeness of the broader stock market so that the index theoretically highlights trends on the broader market. *Id.* Some stocks influence the market more than others, so the index attempts to compensate for this by giving more influential stocks greater weight in market forecast calculations. *Id.*

119. *See* RICHARD S. WURMAN ET AL., THE WALL STREET JOURNAL: GUIDE TO UNDERSTANDING MONEY & MARKETS 32 (1989) (noting that Dow Jones Industrials is index designed to measure stock market movements of 30 major industrial companies). A movement up or down in the stock price of one of these indicator companies will theoretically be a reflection of an analogous movement in the broader market. *Id.* at 32-33.

**TABLE I**  
**SOCIALLY RESPONSIBLE MUTUAL FUND PERFORMANCE**

Percentage Appreciation of Total Reinvested Monies

Assets (\$mil)	Fund Name	Individual Fund 1 year ending 6/30/92	Average Performance of Group 1 year ending 6/30/92	Individual Fund 5 years ending 6/30/92	Average Performance of Group 5 years ending 6/30/92
255	Calvert-Ariel Growth (closed to new sales)	10.07%	14.05% (94 small co growth funds)	81.77%	49.25%
130	Calvert-Ariel Appreciation	7.31	14.05 (94 small co growth funds)		49.25
44	Calvert Social Bond	13.29	14.57 (633 fixed funds)		53.81
58	Calvert Social Equity	4.46	11.99 (271 growth funds)		48.16
387	Calvert Social Managed Growth	9.01	13.42 (72 balanced funds)	42.50	54.46
6	Domini Social Index Trust	12.21	12.93 (228 growth & income funds)		49.52
444	Dreyfus Third Century	5.78	11.99 (271 growth funds)	57.22	48.16
8	Muir California Tax Free Fund	11.84	11.29 (66 CA municipal funds)		51.43
24	New Alternatives	2.28	0.88 (23 natural resources funds)	43.20	13.20
39	Parnassus	21.82	11.99 (271 growth funds)	34.95	48.16
368	Pax World	6.93	13.42 (72 balanced funds)	61.59	54.46
6	Righttime Social Awareness	4.49	14.74 (21 specialty funds)		43.34
3	Schild: Progressive Environmental	-17.19	-9.09 (6 environmental funds)		

Information provided by the Social Investment Forum

Source: *Lipper Fund Listings*, BARRON'S, July 27, 1992, at M24-M56.

	Dow Jones Industrials		17.66		64.42
	S & P 500		13.39		59.02
	Average All Mutual Funds (2990 total)		12.89		47.50

Source: *Fixed Income Funds, 2nd Quarter Results*, BARRON'S, July 27, 1992, at M23.

TABLE 2  
 SOCIALLY RESPONSIBLE MUTUAL FUND PERFORMANCE

Percentage Appreciation of Total Reinvested Monies

Assets (\$mil)	Fund Name	Individual Fund 1 year ending 6/30/91	Average Performance of Group 1 year ending 6/30/91	Individual Fund 5 years ending 6/30/91	Average Performance of Group 5 years ending 6/30/91
248	Calvert-Ariel Growth (closed to new sales)	0.53%	4.86% (87 small co growth funds)		36.81%
48	Calvert-Ariel Appreciation	8.96	4.86 (87 small co growth funds)		36.81
30	Calvert Social Bond	10.19	9.28 (545 fixed funds)		40.64
37	Calvert Social Equity	5.15	5.17 (267 growth funds)		51.07
305	Calvert Social Managed Growth	7.11	7.79 (65 balanced funds)	42.10%	51.34
260	Dreyfus Third Century	11.01	5.17 (267 growth funds)	77.10	51.07
21	New Alternatives	5.94	-3.94 (19 natural resources funds)	61.77	66.12
22	Parnassus	3.82	5.17 (267 growth funds)	33.66	51.07
179	Pax World	14.79	7.79 (65 balanced funds)	63.92	51.34
6	Righttime Social Awareness	6.49	3.04 (31 specialty funds)		45.54
4	Schild: Progressive Environmental	-11.41	8.57 (5 environmental funds)		

Information provided by the Social Investment Forum

Source: *Lipper Fund Listings*, BARRON'S, Aug. 12, 1991, at M20-M51.

	Dow Jones Industrials		4.64		84.70
	S & P 500		7.38		75.55
	Average All Mutual Funds (1880 total)		5.22		47.65

Source: *Fixed Income Funds, 2nd Quarter Results*, BARRON'S, Aug. 12, 1991, at M18.

For the year ending on June 30, 1991, eight of the SRI funds outperformed the Dow Jones Industrials; four outperformed the S & P 500; and seven outperformed the average for all mutual funds. For the five-year period ending on the same date, none of the funds outperformed the Dow Jones; one outperformed the S & P 500; and three outperformed the average for all mutual funds. For the year ending on June 30, 1992, one of the funds outperformed the Dow Jones Industrials; one outperformed the S & P 500; and two outperformed the average for all mutual funds. For the five year period ending on the same date, one of the funds outperformed the Dow Jones index; two outperformed the S & P 500; and three outperformed the average for all mutual funds.

These results are consonant with the efficient markets hypothesis to the extent that as a group, the SRI funds do not appear to "beat" the traditional market consistently. It is impossible to account precisely for the funds' varied performances, but the fact that some funds outperformed the market may be further evidence in support of the inefficiency hypothesis.<sup>120</sup> In other words, certain SRI techniques may unconsciously follow speculative booms in the market. The above-listed data for several of the funds supports such an interpretation.

Private funds are not the only source of data demonstrating the effect of SRI on profitability. Many state and local governments have considerable experience with the investment of public pension fund monies into "targeted investments." Targeted investments are generally restricted to a particular geographic area, usually a state or municipality, and are often intended to foster home ownership or to create jobs for specific groups of workers, typically unionized employees, in that geographic area.<sup>121</sup> Measuring the performance of these investments is complicated because it is difficult to determine whether, but for the investment, jobs would have been created or homes purchased. In addition, a public fund cannot consider itself a success at increasing home ownership or creating jobs if it makes loans that would have been made by other entities in the target area. That is, if public pension funds are indeed investing in projects that non-SRI investors are not, then those investments are probably accompanied by a high level of risk.<sup>122</sup> If, on the other hand, the level

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120. See *supra* notes 92-113 and accompanying text (discussing inefficiency market hypothesis).

121. The following state statutes explicitly authorize targeted investments: ARK. CODE ANN. §§ 24-3-414(b), (d) (Michie 1987) (specifying that not less than 5% nor more than 10% of state-sponsored investments shall be Arkansas related); CAL. GOV'T CODE § 20205.7 (Deering Supp. 1992) (giving priority to investments related to residential realty within state); COLO. REV. STAT. § 24-51-206(1) (1988); CONN. GEN. STAT. ANN. § 3-13d(a) (West 1988); FLA. STAT. ANN. § 215.47(2)(a) (West 1989); ILL. ANN. STAT. ch. 108 1/2, ¶ 1-113 (Smith-Hurd Supp. 1992); IND. CODE ANN. § 5-10-1.7-2 (West 1989); IOWA CODE ANN. § 12.44 (West Supp. 1991); KY. REV. STAT. ANN. § 61.650(3) (Michie/Bobbs-Merrill 1986); MASS. GEN. LAWS ANN. ch. 32, § 23(d) (West Supp. 1992); MICH. COMP. LAWS ANN. § 38.1133(3)(e) (West 1985); MISS. CODE ANN. § 25-11-121(1) (1990); MO. ANN. STAT. § 105.689 (Vernon Supp. 1992) (establishing 3% minimum and 5% maximum for state-sponsored investment in small businesses with over 50% of assets or employees in state); N.H. REV. STAT. ANN. § 100-A:151-b (1990) (encouraging investment in home mortgage market for members and state citizens up to 10% maximum); N.Y. RETIRE. & SOC. SEC. LAW § 177(7)(b) (McKinney 1987); OHIO REV. CODE ANN. § 145.11 (Anderson 1990); see also TEX. CONST. art. 16, § 70(g) (stating that all state-sponsored investments "shall be directly related to the creation, retention, or expansion of employment opportunity and economic growth in Texas").

122. See Kathleen Paisley, *Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions*, 4 YALE L. & POL'Y REV. 188, 199 (1985) (stating that targeted local investments serve legitimate political goals but subject fund participants to increased risk or lower returns).



of nonsystematic risk involved in these investments is comparable to that of other funds, then it is hard to believe that these specially targeted investments would not have been made anyway.

At a recent conference entitled "Economically Targeted Investments by Public Pension Funds" held at Albany Law School, Elizabeth Holtzman, Comptroller of New York City, reviewed the performance of specially targeted investments by public funds in New York.<sup>123</sup> New York City's five pension funds are valued at approximately \$38 billion,<sup>124</sup> and about two percent or \$800 million of these funds have been allocated for specially targeted investments, with a goal of four percent to be reached in the near future.<sup>125</sup> Comptroller Holtzman insisted that although targeted investments earn a market rate of return, the capital provided by the funds should be invested in areas not otherwise served by the markets.<sup>126</sup> She proffered the following example:

I had a very moving moment . . . that related to a . . . targeted investment program of the comptroller's office. In December, 1990, I was able to hand Sandra and Santiago Torres the key to a newly rehabilitated apartment on 115th Street in Harlem. It was the 25,000th apartment made available through a targeted investment program of three New York City pension funds . . . .<sup>127</sup>

At a theoretical level, it is hard to understand how these investments could consistently earn a market rate of return, as Comptroller Holtzman claimed they do, if they involve committing capital in ways and places that the market considers less than maximally profitable. In New York, however, the participants' principal is not in jeopardy because organizations such as the Small Business Association, the State of New York Mortgage Association, the Government National Mortgage Association, the Federal National Mortgage Association, and others act as insurers for the city's targeted investments.<sup>128</sup>

While Comptroller Holtzman's assessment of the New York experience is strong on anecdote, it lacks concrete data to support the claim that equal or higher returns are possible without an increase in nonsystematic risk. Indeed, if Holtzman's description of the New

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123. Elizabeth Holtzman, The Center for New York City's Targeted Investment Programs, Remarks at the Government Law Center of Albany Law School (Mar. 1, 1991), in *ECONOMICALLY TARGETED INVESTMENTS BY PUBLIC PENSION FUNDS* 29, 29 (Government Law Center of Albany Law School ed., 1991).

124. *Id.* at 33.

125. *Id.* at 34.

126. *Id.* at 34-35.

127. *Id.* at 39.

128. *Id.* at 34.

York experience is taken at face value, it leads to the conclusion that public pension monies can be used in conjunction with government programs to engage in political philanthropy at no cost. This is simply illogical if the efficient markets hypothesis holds true. Publicly targeted investment may be a successful strategy, however, at least for a while, if the efficiency hypothesis is not always an accurate description of the way markets function.

A number of individuals and organizations have taken the position that greater control by unions over public and Taft-Hartley<sup>129</sup> pension funds should be encouraged because such control would lead to an increase in specially targeted investments.<sup>130</sup> Perhaps the best known proponents of this view are Jeremy Rifkin and Randy Barber, who argued forcefully in 1978 in favor of increased union domination of pension investment decisions.<sup>131</sup> This idea, since expounded by others,<sup>132</sup> is nearly the same as that described by Comptroller Holtzman. The major difference is that the unions favoring this tactic expressly seek increased political power<sup>133</sup> and understand "specially targeted" to mean investments that would increase their present wage-earning capacity by directing capital toward unionized projects and companies.<sup>134</sup>

129. See 29 U.S.C. § 186(c)(5)(B) (1988) (codifying § 302(c)(5)(B) of Taft-Hartley Act) (authorizing creation of pension funds that are jointly administered by employer and union).

130. See Paul J. Wessel, *Job Creation for Union Members Through Pension Fund Investment*, 35 BUFF. L. REV. 323, 362-63 (1986) (concluding that union pension funds are "largely untapped resource" that can be used to create union jobs and preserve union power); Deborah G. Olson, *Keeping Capital and Jobs at Home*, 8 NOVA L. REV. 583, 596 (1984) (promoting U.S. worker control over pension investment decisions and capital assets as means to arrest incidence of capital flight to countries where workers are paid lower wages than in U.S.).

131. See RIFKIN & BARBER, *supra* note 14, at 10-13 (summarizing proposal that unions should end corporate and bank use of pension funds to cripple organized labor activities).

132. See AFL-CIO, INVESTMENT OF UNION PENSION FUNDS iii (1980) (encouraging union participation in pension fund management in order to increase employment, advance "social purposes such as worker housing and health centers," assist workers in asserting their rights by increasing cooperative action, and exclude investment in companies with policies hostile to workers' rights); AFL-CIO, PENSIONS: A STUDY OF BENEFIT FUND INVESTMENT POLICIES 3 (1980) (surveying investment practices of benefit funds for 10 large industrial companies and noting that funds "often heavily invested in non-union firms and firms with high overseas employment," thereby hurting long-term interests of fund beneficiaries); Joel H. Siegal, *Power in the Nineties: An Analysis of the Management of Pension Funds for the Attainment of Union and Public Interest Goals*, 1987 DET. C.L. REV. 673, 697 (concluding that union control over pension funds could provide organized labor with "potentially the most powerful instrument for social change in the country").

133. See Siegal, *supra* note 132, at 697-98 (arguing that economic power base of unions can be used to influence "socio-economic policies in favor of the ideals and philosophies espoused by organized labor").

134. See Wessel, *supra* note 130, at 354 (finding significant shift toward investments with guaranteed use of union labor by construction union pension funds seeking to maintain union membership). For example, investment by union pension funds in unionized companies and companies that do not have extensive overseas operations is a blatant attempt to create and preserve union jobs. There is nothing objectionable about organizations acting to enhance the well-being of their members. Pension investments, however, are supposed to provide for

This political tactic, masquerading as "investment analysis," has sparked a vigorous debate.<sup>135</sup> For instance, the recent revelation of the Kansas Public Employees Retirement System pension fund's dismal investment performance is likely to trigger a badly needed reassessment of the attractiveness of SRI and special targets such as housing. Essentially, the Kansas fund invested aggressively in "backyard" targets that were designed to generate benefits close to home.<sup>136</sup> Specifically, in 1985, the fund began investing in Kansas businesses that were unable to get credit elsewhere.<sup>137</sup> Unfortunately, these investments increased the risk assumed by the fund to such an extent that the fund became unprofitable.<sup>138</sup> In fact, state auditors have suggested that the Kansas fund's losses may soon reach \$200 million.<sup>139</sup> This result can be explained by the fund's apparent gross departure from basic diversification principles of investment.<sup>140</sup> It is important to understand that the evidence in support of the inefficiency hypothesis is not a simultaneous attack on the principle of diversification: there is no evidence that the diversity principle is unsound. On the contrary, Kansas' experience should reaffirm diversity's central role in portfolio creation.

Although somewhat limited, the available evidence on SRI by private funds, public employee union funds, and Taft-Hartley funds suggests that the rosy scenario of comparable gain without increased nonsystematic risk is likely only when the market is not functioning efficiently. Some funds have performed well and others have not.<sup>141</sup> The inefficiency hypothesis provides a reason to be-

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future income, not current wages. Of course, not all noneconomic value choices involve objectionable self-dealing of this kind. See generally *infra* notes 176-210 and accompanying text (discussing legality of socially responsible investing and difficulty of distinguishing permissible noneconomic investment criteria from impermissible self-dealing).

135. Compare RICHARD BLODGETT, *CONFLICTS OF INTEREST: UNION PENSION FUND ASSET MANAGEMENT* 50-51 (1977) (applauding targeted investment of union pension funds in home construction industry that created jobs for union members) with EDWIN VIEIRA, JR., 'SOCIAL INVESTING': ITS CHARACTER, CAUSES, CONSEQUENCES, AND LEGALITY UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 12-14 (1983) (criticizing union pension fund investment in construction, manufacturing, and other traditional union industries that have dwindling investment in modern high technology businesses with higher economic potential).

136. James A. White, *Back-Yard Investing Yields Big Losses, Roils Kansas Pension System*, WALL ST. J., Aug. 21, 1991, at A1.

137. *Id.* at A4.

138. *Id.* It is interesting to note that except for the many types of mortgage insurance available in New York state, this description of backyard investing would apply to the kinds of investments made in New York that Comptroller Holtzman described. See *supra* notes 123-28 and accompanying text (presenting successful New York experience of backyard investment in low-income apartment rehabilitation).

139. White, *supra* note 136, at A1.

140. See *supra* notes 56, 65-69 (discussing effect of diversification on portfolio's amount of risk and return).

141. See *supra* Table 1 accompanying notes 117-19 (showing that Parnassus Fund outperformed market in 1992 whereas Calvert Social Equity Fund, Dreyfus Third Century Fund,

lieve that those funds that have outperformed the S & P 500 might continue to do so in the future.<sup>142</sup> In an efficient market, however, one would expect to see more crises of the magnitude facing the managers and participants of the Kansas fund, because it cannot be true that specially targeted investments will be as attractive as traditional investments. If the rate of return is comparable for both, it must be because the level of diversifiable risk is relatively high for the targeted investments.<sup>143</sup>

#### 4. *Are some screens proxies for modern portfolio theory choices?*

In spite of the fact that the data provided above is generally inconclusive, it is hard to ignore the more concrete fact that, at least in the short run, some socially responsible funds have performed very well.<sup>144</sup> Assume for a moment, however, that a given social or political fund is able to match or better the performance of the S & P 500.<sup>145</sup> Would this mean that the reduced investment pool available to SRI investors did not increase nonsystematic risk or lead to a lower return? Possibly not. Careful examination of many of the screens employed by SRI managers suggests that in some cases a screen may operate as a proxy for the kind of inquiries about risk that a traditional fund manager would make.<sup>146</sup> As a result, it may be true under certain political conditions that companies with socially responsible business practices will outperform their less responsible counterparts.<sup>147</sup>

Consider the case of a fund that avoids South Africa-related in-

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New Alternatives Fund, Pax World Fund, Righttime Social Awareness Fund, and Schield Progressive Environmental Fund performed poorly); see also *supra* Table 2 accompanying notes 117-19 (showing that Calvert-Ariel Appreciation Fund, Calvert Social Bond Fund, Dreyfus Third Century Fund, and Pax World Fund outperformed market in 1991 whereas Parnassus Fund performed poorly).

142. See *supra* notes 92-113 and accompanying text (discussing theoretical and empirical support for inefficiency market hypothesis); see also *supra* Tables 1, 2 accompanying notes 117-19 (showing that Parnassus Fund outperformed S & P 500 in 1992 and that Calvert-Ariel Appreciation Fund, Calvert Social Bond Fund, Dreyfus Third Century Fund, and Pax World Fund outperformed S & P 500 in 1991).

143. Paisley, *supra* note 122, at 199.

144. See *supra* Table 1 accompanying notes 117-19. Note that the average performance, measured in percentage appreciation of total reinvested monies, of the Calvert-Ariel Growth Fund (81.77) and the Pax World Fund (61.59) each exceeded the S & P 500 average (59.02) over the five-year period ending in 1992. *Id.*

145. Of course, this assumption is not necessarily inconsistent with the CAPM and the efficient markets hypothesis because in the short run, a pension plan manager practicing SRI is more likely to outperform the market.

146. See, e.g., Valerie A. Zondorak, *A New Face in Corporate Environmental Responsibility: The Valdez Principles*, 18 B.C. ENVTL. AFF. L. REV. 457, 484 (1991) (finding that corporate management's adherence to ethical principles may improve corporate credibility, attract investment, and strengthen company competitiveness).

147. Judd, *supra* note 5, at 13.

vestments. In October 1989, *Pensions & Investment Age* reported that South Africa-free portfolios outperformed other investment portfolios over a long period of time.<sup>148</sup> One explanation for this result is the apparently superior investment abilities of the managers of funds that screen out companies with ties to South Africa.<sup>149</sup> Another equally plausible explanation is that as the political furor over South Africa intensified during the 1980s, the South Africa screen became a proxy for avoiding a high risk investment. In other words, economic and social turbulence attending the imposition and lifting of international sanctions on South Africa discouraged even traditional investments in corporations with ties to that country.<sup>150</sup>

The South Africa experience suggests that the more popular support a screen has and the more compliance it generates, the more likely it is to serve as a proxy for avoiding an investment that would also be unattractive on traditional grounds. As more foreign companies disinvested in South Africa and the nation's economy deteriorated, the independent desirability of investing there also declined.<sup>151</sup> Therefore, because of the efforts of divestment proponents, South Africa may now be an unattractive place to invest regardless of one's views about apartheid.

The same dynamic may be at work in the case of funds that have used positive screens to invest in environmentally conscious, or "green," companies. The Parnassus Fund, as one example, might continue to outperform the Dow Jones Industrials<sup>152</sup> if "green" is in fact a proxy for unusually prudent management and more efficient production processes. Also, if being environmentally conscious increases a company's attractiveness to consumers, which being a signatory to the Valdez Principles may achieve,<sup>153</sup> then environmental consciousness may also translate into increased demand for a company's product and better stock performance. It is important to note, however, that any particular screen's advantage will disappear as soon as a dynamic of this type becomes clear to traditional investors. In an efficient market, this is the only sense in which SRI may enable an investor to do good and do well at the same time.

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148. *South Africa-Free Portfolios*, *supra* note 3, at 40.

149. *South Africa-Free Portfolios*, *supra* note 3, at 40.

150. *Businesses Avoid South Africa Ties*, *supra* note 7, at C8.

151. See Ann-Catherine Blank, Comment, *The South African Divestment Debate: Factoring "Political Risk" into the Prudent Investor Rule*, 55 U. CINN. L. REV. 201, 215 n.63 (1986) (finding unrest in South Africa lowered profit projections for companies doing business in that nation).

152. See *supra* Table 1 accompanying notes 117-19 (showing that Parnassus Fund (21.82) outperformed Dow Jones Industrials (17.66) for one year period ending 6/30/92).

153. See *supra* note 30 (describing origin and purpose of Valdez Principles).

## II. PENSION FUNDS, SRI, AND THE LAW

A. *The Basic Legal Framework for Pension Investing*1. *Pre-ERISA*

Prior to 1974, the year ERISA was enacted,<sup>154</sup> the common law of trusts, the Taft-Hartley Act,<sup>155</sup> and portions of the Internal Revenue Code delineated the permissible scope of trustee behavior with respect to pension investment decisions.<sup>156</sup> State common law doctrine required trustees "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."<sup>157</sup> This prudent man or prudent person<sup>158</sup> rule was first articulated in the United States in the famous case of *Harvard College v. Amory*.<sup>159</sup> In addition, the common law imposed on the trustee a duty of loyalty and prohibited self-dealing and conflicts of interest.<sup>160</sup> The fiduciary could not enter

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154. Employment Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 646 (codified as amended in scattered sections of 5, 18, 26, and 29 U.S.C.).

155. Taft-Hartley Act, Pub. L. No. 80-101, 61 Stat. 136 (1947) (codified as amended in scattered sections of 29 U.S.C.).

156. See Charles M. Dyke, Note, *Warren v. Society National Bank: Fiduciary Duties and Recovery of Damages for Breach Under ERISA*, 41 DEPAUL L. REV. 515, 533-34 (1992) (discussing pension plan regulation by means of tax deductions and deferments available to qualified benefit plans).

157. RESTATEMENT (SECOND) OF TRUSTS § 227 (1959); see also *infra* note 159 and accompanying text (explaining Massachusetts Supreme Court case of *Harvard College v. Amory* that introduced prudent person standard to American jurisprudence).

158. The prudent man standard is occasionally referred to in popular literature as the "prudent person" standard or the "prudence rule." See, e.g., H. Ward Classen, *Judicial Intervention in Contractual Relationships Under the Uniform Commercial Code and Common Law*, 42 S.C. L. REV. 379, 411-14 (1991) (discussing reasonably prudent person standard); Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. REV. 87, 90, 105 (1990) (invoking prudent person principle and prudence rule); Michael W. Melton, *Demythologizing ESOPs*, 45 TAX L. REV. 363, 389 n.128 (1990) (citing prudence rule).

159. 26 Mass. 446 (1830). Francis Amory had been designated to manage a sum of \$50,000 for the benefit of Harvard College and Massachusetts General Hospital, but he lost \$20,000 of the trust corpus through unprofitable investments. *Id.* at 446-51. Harvard sued on the ground that Amory had been imprudent in choosing to invest the money in manufacturing and insurance stocks that were riskier than public securities and other investments. *Id.* at 459-61. The Massachusetts court found in favor of Amory, noting that a trustee is required to exercise sound discretion and act as a reasonably prudent and intelligent person in managing the financial matters of the investment fund. *Id.* at 461.

160. See, e.g., *Pickering v. El Jay Equip. Co.*, 700 P.2d 134, 140 (Idaho Ct. App. 1985) (discussing common law duty of loyalty); *Goldman v. Rubin*, 441 A.2d 713, 720 (Md. 1982) (commenting on standard of duty of loyalty and conflict of interest); *Riley v. Rockwell*, 747 P.2d 903, 905 (Nev. 1987) (discussing problems concerning conflict of interest); *Bank of Nevada v. Speirs*, 603 P.2d 1074, 1077 (Nev. 1979) (describing concerns and problems with practice of self-dealing), *cert. denied*, 449 U.S. 994 (1980); *Bartlett v. Dumaine*, 523 A.2d 1, 13 (N.H. 1986) (commenting on need to avoid conflict of interest); *Estate of McCredy*, 470 A.2d 585, 597 (Pa. Super. Ct. 1983) (discussing possible problems with duty of loyalty, self-dealing, and conflict of interest where trustee had interest in securities purchased for trust); *Wheeler v. Mann*, 763 P.2d 758, 759-60 (Utah 1988) (finding that situation where trust assets were invested in companies managed by trustee offended principles of self-dealing and duty of

into transactions with the trust or compete with the trust res.<sup>161</sup>

The Taft-Hartley Act, which governs pension plans established jointly by a union and one or more employers in multi-employer plans, requires that the trust be "for the sole and exclusive benefit of the employees of such employer, and their families and dependents."<sup>162</sup> The Act permits employer contributions to the fund only when various conditions designed to avoid diversion of funds to the union or its officers are satisfied.<sup>163</sup>

The third major source of pre-ERISA law governing the behavior of fiduciaries is the Internal Revenue Code, which has a similar "exclusive benefit" rule to that of the Taft-Hartley Act. An employer's plan will not qualify for tax exempt status unless it is maintained for the exclusive benefit of employees or their beneficiaries.<sup>164</sup> Generally, courts have not stringently enforced the IRS exclusive benefit rule.<sup>165</sup> Indeed, the IRS itself has declined to penalize investments that generate collateral benefits for others, so long as the primary purpose of an investment is to benefit employees and their beneficiaries.<sup>166</sup>

## 2. *The fiduciary standards of ERISA*

The passage of ERISA represented the culmination of years of congressional hearings and aggressive lobbying by a variety of parties that expected to be affected by the Federal Government's first

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loyalty); *Wilkins v. Lasater*, 733 P.2d 221, 227 (Wash. Ct. App. 1987) (describing situations where duty of loyalty is breached).

161. See, e.g., *Pickering*, 700 P.2d at 140 (holding that competing with trust beneficiary violates trustee's duty of loyalty); *Estate of McCredy*, 470 A.2d at 598 (discussing potential conflict of interest where trustee had substantial personal interest in securities purchased for trust); *Wheeler*, 763 P.2d at 760 (finding that trustee's investment of trust assets in companies he managed and substantially owned violated duty of loyalty); *Wilkins*, 733 P.2d at 227 (stating that trustee generally breaches duty of loyalty by leasing trust land for self).

162. 29 U.S.C. § 186(c)(5) (1988) (codifying § 302(c)(5)(A) of Taft-Hartley Act). The Act also requires that union pension funds be administered by equal numbers of representatives of labor and management, although there are provisions for the designation of mutually acceptable third party representatives. *Id.* § 186(c)(5)(B).

163. See 29 U.S.C. § 186(c)(5)(B) (1988) (requiring detailed written agreement governing trust payments, equal representation of employers and employees in administration, and annual audit of trust fund as conditions on fund's acceptance of employer contributions).

164. I.R.C. § 401(a) (1988). An employer whose plan qualifies is entitled to deduct contributions to the plan as ordinary and necessary business expenses. *Id.* § 404(a). In addition, the participant may defer payment of taxes until receipt of benefits. *Id.* §§ 402(a)(1), 403(a)(1).

165. See *Shelby U.S. Distribs., Inc. v. Commissioner*, 71 T.C. 874, 885 (1979) (finding that incidental benefit to third party did not justify disqualification of plan); see also *Wessel*, *supra* note 130, at 333 ("Since 1974, the [I.R.C.] has not been invoked by courts to impose fiduciary standards separate from ERISA, but its detailed requirements for qualification still apply.").

166. See generally James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340, 1347-48 (1980) (discussing Internal Revenue Service's broad application of exclusive benefit rule).

attempt to comprehensively regulate private pensions.<sup>167</sup> ERISA's fiduciary standards, however, are clearly rooted in the common law and pre-ERISA regulatory schemes already described. ERISA defines a "fiduciary" as anyone with discretionary authority or control with respect to a pension plan's assets or management.<sup>168</sup> Thus, plan trustees, investment managers, and those supplying advice in exchange for compensation are clearly considered fiduciaries under ERISA.<sup>169</sup>

As fiduciaries, trustees, investment managers, and investment advisors are governed by both the general ERISA standard of section 404<sup>170</sup> and the "prohibited transaction" rules of section 406.<sup>171</sup> Section 404(a) provides a statutory formulation of the prudent person rule in pension management.<sup>172</sup> There is general agreement that Congress intended this rule to be somewhat more flexible in the ERISA context than as applied through the common law.<sup>173</sup>

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167. See Camilla E. Watson, *Broken Promises Revisited: The Window of Vulnerability for Surviving Spouses Under ERISA*, 76 IOWA L. REV. 431, 433-35 (1991) (recounting history of passage of ERISA).

168. 29 U.S.C. § 1002(21)(A) (1988) (codifying ERISA § 3(21)(A)). The Act provides:

[A] person is a fiduciary with respect to a plan to the extent (i) he [or she] exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he [or she] renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he [or she] has any discretionary authority or discretionary responsibility in the administration of such plan.

*Id.*

169. *Id.*

170. See *id.* § 1104(a) (establishing prudent person standard of care for pension plan fiduciaries, including investment diversification requirement and trustee's duty of loyalty to pension beneficiaries).

171. See *id.* § 1106 (establishing general prohibition on transactions between pension plan and fiduciary or party in interest and on transfers of property to pension plan by party in interest).

172. *Id.* § 1104(a) (codifying ERISA § 404(a)). The statutory formulation of the prudent person rule in pension management states:

a fiduciary shall discharge his [or her] duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent [person] acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this subchapter.

*Id.* § 1104(a)(1) (codifying ERISA § 404(a)(1)).

173. See *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983) (stating that flexible ERISA prudence rule takes circumstances into account and does not establish rigorous "prudent expert" standard of common law); see also Samuel D. Cheris, *Making Responsible In-*



Specifically, the Department of Labor has rejected the common law approach to examining a particular investment for prudence only in terms of relative risk and has followed analysis of the investment as part of the entire portfolio.<sup>174</sup> But, as in the common law, an ERISA fiduciary is also bound by a duty of loyalty and must behave "solely in the interest of the participants and beneficiaries" in the administration of a pension fund.<sup>175</sup>

### B. *Is SRI Illegal?*

These twin obligations of the ERISA fiduciary, the duties of loyalty and of prudence, form the crux of the debate concerning the propriety of ethical investing. Opponents of SRI argue vigorously that SRI practitioners violate these two duties whenever a trustee favors a social cause over the beneficiaries' financial gain.<sup>176</sup> SRI supporters, on the other hand, insist either that SRI involves no financial sacrifice and therefore no breach of the duties of loyalty or prudence exists, or they argue that small losses in exchange for the satisfaction of ethical investing are permitted under ERISA.<sup>177</sup>

Although decided in 1971 and therefore predating ERISA, the case of *Blankenship v. Boyle*<sup>178</sup> is nonetheless a useful starting point for legal analysis of this issue. The court in *Blankenship* applied the common law duty of loyalty to enjoin a type of social investing.<sup>179</sup> In the case, a group of pension fund trustees, dominated by a coal union, deposited plan assets into a union-owned bank in a non-interest bearing account, and also invested sums in public utilities to try to force the utilities to purchase union-mined coal.<sup>180</sup> These actions were a kind of social investment in that the trustees considered factors other than risk, return, diversification, and protection of pension assets in deciding what investments to make.<sup>181</sup> The court

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*vestment Decisions in Light of the Evolving Prudent Person Rule*, 14 EST. PLAN. 338, 340 (1987) ("Congress adopted the [ERISA prudence standard] after hearing extensive testimony which demonstrated that the [common law] prudent person rule was far too rigid for judging managers of employee benefit funds.").

174. See Hutchinson & Cole, *supra* note 166, at 1356 (explaining Department of Labor's position that "[t]he fiduciary will be considered . . . to be in compliance when he [or she] considers not only the possibility of capital gain or loss and probable investment income, but also such criteria as diversification [and] liquidity").

175. 29 U.S.C. § 1104(a)(1) (1988) (codifying ERISA § 404(a)(1)).

176. See, e.g., Langbein, *supra* note 3, at 16 (arguing that duty of loyalty and prudent person rule are violated whenever pension plan trustee "sacrifices the beneficiary's financial well-being for any cause").

177. See, e.g., Zondorak, *supra* note 146, at 482 (stating that socially responsible investing is competitive alternative that no longer necessitates profit sacrifice).

178. 329 F. Supp. 1089 (D.D.C. 1971).

179. *Blankenship v. Boyle*, 329 F. Supp. 1089, 1095 (D.D.C. 1971).

180. *Id.* at 1095-96, 1105-06.

181. See *supra* notes 45-52 and accompanying text (comparing SRI's variety of decision-

enjoined the trustees from operating the pension fund for the benefit of the union or the coal miners<sup>182</sup> and remarked that this was a "clear case of self-dealing" by the union and management representatives.<sup>183</sup> The court in *Blankenship* expressly recognized that the challenged investment practices had benefited the workers in that they were better off with a union that had enhanced its own power via these social investments.<sup>184</sup> The case can therefore be interpreted as hostile to the notion that fiduciaries may trade long-term pension security for short-term political gains.<sup>185</sup>

There is considerably less consensus regarding the interpretation of *Withers v. Teachers' Retirement System*,<sup>186</sup> in which the beneficiaries of a municipal pension fund challenged the propriety of the fund's trustees' decision to buy highly speculative city bonds as part of a plan to help the city avoid bankruptcy.<sup>187</sup> Like many public employee pension plans, this municipal plan was not fully funded, and its most significant asset was the city's contractual liability to pay benefits from future tax revenues.<sup>188</sup> The fund's trustees testified that in the event of bankruptcy, city payments to the pension fund would probably cease because other obligations would assume priority.<sup>189</sup> The purchase of bonds was therefore made in conjunction with several other municipal employee funds.<sup>190</sup> The city bonds were so risky, however, that their purchase would not have met traditional standards of prudence.<sup>191</sup> In addition, the size of the purchase at \$2.53 billion was so substantial as to violate normal diversification principles.<sup>192</sup>

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making criteria with traditional efficiency-based investing methods that require investment decisions to be made solely on basis of risk, return, diversification, and protection considerations). This kind of social investment is quite similar to current proposals to limit investments to unionized firms. See *supra* notes 130-34 and accompanying text (discussing targeted investment of union pension funds).

182. *Blankenship*, 329 F. Supp. at 1113.

183. *Id.* at 1106.

184. *Id.* at 1112.

185. See Ronald B. Ravikoff & Myron P. Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CAL. L. REV. 518, 521 (1980) (conceding that *Blankenship* indicates trustees "may not pursue nontraditional objectives to the detriment of traditional investment goals"). In spite of this observation, Ravikoff and Curzan argue that existing case law can be interpreted to permit SRI and that the prudent person rule also gives trustees some latitude in this respect. *Id.* at 546.

186. 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

187. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1250 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

188. *Id.* at 1251.

189. *Id.* at 1252.

190. *Id.* at 1250.

191. *Id.* at 1255 (finding that extremely low bond rating and general unmarketability would have made purchase fall outside scope of prudent investment strategy).

192. *Id.* at 1250, 1255.

Plaintiff retirees argued that by taking into account the city's threatened bankruptcy, the trustees had violated their duty of exclusive loyalty to the pension plan's beneficiaries.<sup>193</sup> The court rejected the argument that the trustees' objective was to come to the rescue of the city.<sup>194</sup> The court distinguished *Blankenship* by stating that the trustees' investment policies in that case incidentally aided pension beneficiaries through job creation, whereas the sole consideration of the trustees in *Withers* was preservation of the pension fund assets.<sup>195</sup> The court emphasized that pursuant to statute the city played a crucial role as the ultimate guarantor of the payment of pension benefits to fund participants.<sup>196</sup>

Some have interpreted *Withers* as standing for the proposition that a fiduciary may compromise the prudent person rule under certain circumstances.<sup>197</sup> Others, notably Professor Langbein, take the position that the purchase in *Withers* was "justifiable under the traditional wealth-maximizing standards of trust-investment law."<sup>198</sup> What seems clear is that the court in *Withers* expressly approved of *Blankenship* and did not see its decision as undermining that opinion in any way.<sup>199</sup>

In trying to assess the legality of SRI, it is useful to examine the Federal Government's treatment of the issue as well as that of the courts. For example, Ian Lanoff, former administrator of the Office of Pension and Welfare Benefit Programs in the Department of Labor under the Carter administration, has taken the position that "economic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards."<sup>200</sup> This means that in the view of the Department of Labor, the ERISA prudence standard requires a fiduciary to make investment decisions based on economic and financial merit rather than on social issues such as promotion of job security for the fund's

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193. *Id.* at 1255.

194. *Id.* at 1256.

195. *Id.*

196. *Id.*

197. See BRUYN, *supra* note 2, at 9 (citing *Withers* for proposition that nontraditional investment decisions are acceptable as long as they do not involve self-dealing by fiduciaries); Ravikoff & Curzan, *supra* note 185, at 523 (finding that *Withers* permits sacrifice of traditional investment goals of adequate return and trust corpus safety only if parties receive "other benefits").

198. Langbein, *supra* note 3, at 19.

199. See *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1256 (S.D.N.Y. 1978) (distinguishing *Blankenship* because aid to pension beneficiaries in that case was primary rather than incidental investment goal), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

200. Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 LAB. L.J. 387, 392 (1980).

participants.<sup>201</sup> Otherwise, fiduciaries risk violating their duties of care and loyalty that are implicit in the ERISA standards.<sup>202</sup> Lannoff's strict interpretation of the duty of loyalty and the prudence rule does not completely foreclose all social investing, however. He concedes that "ERISA provides sufficient flexibility to permit consideration of incidental features of investments which are equal in economic terms."<sup>203</sup>

The notion that SRI is permitted only as an incidental feature of otherwise traditional investment considerations suggests that SRI is legal only when practiced in its mildest forms. This means that screens operated in such a way as to exclude large numbers of companies or even entire industries probably run afoul of the prudence rule<sup>204</sup> and possibly of the diversification requirements of ERISA as well.<sup>205</sup> In addition, funds that make positive investment choices based solely on social and political criteria, such as the existence of equal employment opportunity programs or a unionized workforce, are also likely to violate the fiduciary standards of ERISA.<sup>206</sup> The reality is that if SRI is permitted under any circumstances, as it is, it may only be practiced without fear of liability when the screens, whether positive or negative, have a *de minimus* effect on the performance of an investment portfolio.

Pension fund monies are simply not regulated in such a way as to permit the trade-off that certain SRI investors apparently wish to make: the exchange of future retirement income security for current benefits. It does not matter whether the current benefits take the form of wages, jobs, or personal satisfaction that comes from taking a political stand. While some of the opposition to SRI appears to come from those whose primary agenda is at political odds with much of the left-leaning social investing community,<sup>207</sup> this cannot be said of all SRI critics.<sup>208</sup> In addition, ethical investors, in

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201. *Id.* at 389.

202. *Id.* at 389, 391.

203. *Id.* at 392; *see also* Brock v. Walton, 794 F.2d 586 (11th Cir. 1986) (finding that trustees who made loans to plan participants below prevailing interest rate did not violate ERISA, which specifies that loans must be made at reasonable rates).

204. *See supra* notes 172-74 and accompanying text (noting that ERISA prudence rule requires fiduciary to consider capital gain and loss as well as probable investment income, diversification, and liquidity when making investment decisions).

205. *See* 29 U.S.C. § 1104(a)(1)(C) (1988) (requiring diversification of investments in order to spread risk and providing limited exception for circumstances under which it is "clearly prudent not to do so").

206. *See supra* notes 172-75 and accompanying text (discussing general fiduciary standards of ERISA).

207. *See infra* notes 212-35 and accompanying text (discussing opposition to SRI arising from fear that investment decisions will become politicized).

208. *See, e.g.,* Jeffrey A. Teper, *The Cost of Social Criteria: Investors Should Weigh a Program's Expense, Benefit*, PENSIONS & INVESTMENTS, May 13, 1991, at 34 (arguing that institutions com-

part because of an inability to define their activities with precision, must concede that *Blankenship*-type schemes properly belong in the category of alternative investing strategies.<sup>209</sup>

The fiduciary rules incorporated into ERISA were drafted partly in response to extensive testimony about union and employer abuses such as the inclusion in investment decisionmaking of non-traditional criteria that resulted in arrangements placing the pension monies of employees at substantial risk.<sup>210</sup> Theoretically, it is not possible to distinguish the kind of self-dealing exemplified in *Blankenship* from, for example, the choice to invest in environmentally friendly companies made by pension fund trustees. In each instance, the relative economic merits of the investment are overshadowed by some other concern. As a result, ERISA is read to prohibit all but the mildest forms of social investment because the different forms of investment are indistinguishable.

Should the practice of SRI in the 1990s lead to an increased incidence of dramatic losses such as those of the Kansas backyard in-

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mitted to investing on basis of social criteria must be aware of risks and costs incumbent in using these criteria to inform investment decisions, and noting that institutions that do not take such factors into account may be investing irresponsibly).

209. See MILLER, *supra* note 3, at 31 (commenting that alternative investing is investment in companies deemed to be promoting valued social goals).

210. For example, in the 1960s, the F.W. Woolworth Co. pension plan was heavily invested in real property. *Private Welfare and Pension Plan Study: Hearings on S.2 Before the Senate Subcomm. on Labor*, 92d Cong., 1st Sess. 727 (1971) (testimony of Robert G. Zimmerman, assistant secretary and assistant treasurer, F.W. Woolworth Co.). In fact, 26.72% of the plan was invested in real estate previously owned by Woolworth and in mortgages on property owned at the time by Woolworth. *Id.* The value of the properties purchased from Woolworth by the trust pension plan was returned to the plan in monthly leases with Woolworth. *Id.* at 728. The mortgages on properties owned by Woolworth, and on which the plan granted a mortgage, had terms scheduling payment over 25 years. *Id.* at 728. One Senator commented:

I take it if Woolworth were to collapse . . . the fund would then be in a position of having tenants on all the real estate it owns simultaneously being unable to make further payments. . . . You would have 26 percent of your assets which in an instant became not income producing and up for sale, in a distress condition.

*Id.* at 729 (statement of Sen. Cummings).

In a similar situation, a pension plan of a medium-sized manufacturing company had amassed more than \$10 million in funds and had invested more than 99% of the fund in the employer's own stock. *Private Welfare and Pension Plan Legislation: Hearings on H.R. 16462, 1046, and 1045 Before the House Subcomm. on Labor*, 91st Cong., 1st & 2d Sess. 594 (1970) (statement of I.W. Abel, president, United Steelworkers of America). Additionally, the trustees of the fund, who were officers of the company, had been borrowing money to purchase the stock. *Id.*

In another example, the retirement fund of Winn-Dixie Stores, Inc., held the following mix of assets: 41% bonds, 37% common stocks, 20% rental properties, and 2% mortgages. See *Private Welfare and Pension Plan Study: Hearings on S. 2 Before the Subcomm. on Labor*, 92d Cong., 1st Sess. 862, 867 (1971) (testimony of James Cameron, vice chairman, profit sharing committee, Winn-Dixie Stores, Inc.) (testifying that "common stock of Winn-Dixie Stores, Inc., rental properties under lease to Winn-Dixie Stores, Inc., or its subsidiaries, and loans secured by mortgages on properties under lease to Winn-Dixie Stores, Inc." comprised 28% of company's retirement fund).

vestment program in the 1980s,<sup>211</sup> courts may have to directly confront the question whether there are any circumstances under which a fund may engage in pure ethical investing. At the moment, and with the events in Kansas in mind, the exclusion of all but incidental consideration for noneconomic criteria seems reasonable.

### III. LIVING WITH SRI AS AN INCIDENTAL CONSIDERATION

Socially responsible investment is less-than-optimal investment.

If it were optimal, we would all be doing it anyway.<sup>212</sup>

[T]he issue of "social responsibility" has more and more come to be seen as one in which a trade-off is involved . . . between acting responsibly and acting profitably. . . . In fact, because of several profound economic changes in the past few years, social responsibility and profitability may now be more compatible than ever before.<sup>213</sup>

Those who oppose SRI seem to do so because they are concerned by the opportunity for self-dealing, as exemplified in *Blankenship*, or because they are strongly opposed to politicizing investment decisions.<sup>214</sup> On the other hand, supporters of ethical investing are generally of the opinion that politics are properly injected into investment decisions when there is no resulting cost.<sup>215</sup> When SRI is costly, meaning that it results in a lower rate of return, there is less consensus among supporters over its propriety. As explained above, ERISA neither permits<sup>216</sup> nor prohibits<sup>217</sup> all forms of SRI. However, two questions remain: what circumstances will satisfy the "incidental consideration" that ERISA appears to permit those inclined to participate in SRI?<sup>218</sup> And, should ERISA be amended to

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211. See *supra* notes 136-39 and accompanying text (discussing significant losses in Kansas Public Employees Retirement System pension fund investments).

212. SIMPSON, *supra* note 1, at 3 (quoting Alastair Morton, former chief executive of Guinness Peat group in United Kingdom and presently chair of Eurotunnel).

213. RICHARD PARKER & TASMIN TAYLOR, *STRATEGIC INVESTMENTS: AN ALTERNATIVE FOR PUBLIC FUNDS* 2 (1979) (emphasis deleted).

214. See, e.g., Langbein, *supra* note 3, at 9-12 (finding that SRI subjects pension trustees to political demands because investment of that type is "intrinsically standardless"). Langbein also criticizes the use of union pension funds to create jobs because this "violates the primary policies of pension law" by sacrificing retirement income of plan beneficiaries through investment in economically less attractive investments. *Id.* at 11-12.

215. See, e.g., Blank, *supra* note 151, at 208-09 (stating that socially responsible investments should be encouraged as matter of policy if they do not increase risk or decrease trust income).

216. See *supra* notes 204-06, 210 and accompanying text (discussing ERISA prohibition on social investment except as incidental consideration).

217. See Lanoff, *supra* note 200, at 390 (concluding that ERISA prudence standard permits consideration of social implications after determination that potential investments are equally economically viable); see also *supra* notes 172-75 and accompanying text (discussing ERISA fiduciary standards).

218. See *supra* notes 200-04 and accompanying text (noting that incidental consideration

explicitly permit trustees to engage in more aggressive SRI at the expense of plan beneficiaries' future pension benefits?

### A. *Inconsequential SRI*

The "incidental consideration" standard, if it can be treated as such, has two obvious drawbacks, one theoretical and the other practical. The theoretical problem is that giving a small amount of consideration to noneconomic criteria, or opting for SRI only when it involves no sacrifices to the portfolio in terms of risk or return, is the capital market equivalent of being a "little bit pregnant." It is not hard to imagine two investment choices that offer the same return, with one being a traditional investment and the other an ethical investment. It is also not hard to imagine two investment choices, one for the ethical investor and the other for the traditional investor, that appear to be equally risky. The difficulty lies in imagining two such choices, one for the SRI adherent and one for the traditionalist, that simultaneously present the same risk/return profile.<sup>219</sup>

Suppose, however, that two such investments could be found. Is this the moment for the kind of incidental consideration that ERISA permits? Perhaps, except that under these circumstances it will be difficult to determine who is practicing SRI and who is motivated by traditional considerations. This distinction will not really matter, however, because whatever differentiates the ethical investment from the unethical one is evidently not significant enough to affect the efficient market's assessment of the investments' attractiveness. In any event, there will probably be few instances in which the only characteristic distinguishing two investments is that one satisfies a particular set of political or social criteria and the other does not.<sup>220</sup>

The practical problems with implementing the incidental consideration standard arise in the more numerous cases in which a distinction of the type just mentioned is small but measurable. For example, in *Brock v. Walton*,<sup>221</sup> the United States Court of Appeals for the Eleventh Circuit determined that pension plan trustees did not violate ERISA when they charged interest rates below the pre-

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standard means that SRI is only permitted as incidental feature of otherwise traditional investment considerations).

219. Keep in mind that traditional investors are not "unethical," but are better described as "apolitical." These investors will pursue an investment that would also attract a socially responsible investor if it is otherwise economically satisfactory.

220. See *supra* note 53 and accompanying text (stating that no two investments are identical when evaluated in terms of profit potential, risk, and diversification).

221. 794 F.2d 586 (11th Cir. 1986).

vailing market rate on loans to plan participants.<sup>222</sup> ERISA generally prohibits plans from making mortgage loans to participants unless they bear a reasonable rate of interest.<sup>223</sup> In this instance, the plan lent the mortgage funds at two and one-eighth points below the prevailing market rate.<sup>224</sup> The court noted that "reasonable" interest and "market" interest are not synonymous,<sup>225</sup> and stated that the rate charged was not so low as to be completely unjustified, nor was it violative of ERISA's prudence standard.<sup>226</sup> Additionally, the court in *Brock* affirmed the district court's finding that ERISA's exclusive purpose standard is not violated when "a party other than a plan's participants and beneficiaries" benefits from a transaction with the plan.<sup>227</sup>

Thus, while small deviations from the exclusive purpose standard and the single-minded pursuit of financial return at an acceptable level of risk are clearly permitted, it is hard to say how large this universe of nearly equal investment choices is. The incidental consideration standard provides no guide as to how wide the gap between the reasonable return on an SRI investment and market return may be before ERISA is offended.

### *B. Proposals for Permitting More Aggressive SRI*

This Article has considered the practice of SRI under two circumstances: first, in the instance in which competing investments are equal, in the sense that they both fall on the efficiency frontier,<sup>228</sup> and second, in the instance in which competing investments are nearly equal.<sup>229</sup> ERISA permits the consideration of noneconomic factors in either of these two cases.<sup>230</sup> There is no reason to believe that there will be many times in which two investments can be said to be equal, however. The size of the pool of nearly equal investments will depend entirely on how much deviation from market standards is permitted.

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222. *Brock v. Walton*, 794 F.2d 586, 588 (11th Cir. 1986).

223. 29 U.S.C. §§ 1106(a)(1)(B), 1108(b)(1) (1988) (codifying ERISA §§ 406(a)(1)(B), 408(b)(1)).

224. *Brock*, 794 F.2d at 587.

225. *Id.*

226. *Id.*

227. *Id.* at 586, *aff'g* *Donovan v. Walton*, 609 F. Supp. 1221, 1245 (S.D. Fla. 1985).

228. See *supra* note 75 and accompanying text (defining efficiency frontier as state of investor who has maximized income by holding diversified portfolio that eliminates risk).

229. See *supra* notes 221-27 and accompanying text (discussing investment of fund assets at slightly below market rate of interest).

230. See *supra* note 203 and accompanying text (noting that ERISA provides sufficient flexibility to permit consideration of some noneconomic factors when making investment decisions).



A third class of situations exists that may well encompass most of the choices faced by ardent ethical investors. This third group consists of choices that, in an efficient market, are expected to involve significant costs in terms of either risk or return to the ethical investor. ERISA clearly does not permit this kind of investing, although there is reason to believe that it nonetheless takes place.<sup>231</sup> An issue to consider is whether ERISA should be amended to allow aggressive SRI, and if so, under what circumstances this type of SRI should be permitted.

In considering the feasibility of allowing participants to opt for a socially responsible investment portfolio, Professors Langbein and Posner have suggested that if beneficiaries are informed of the increased risks and costs of such a portfolio, the investment scheme might satisfy ERISA.<sup>232</sup> The rationale behind this cautious proposal appears to be that the investment plan would "lack that element of involuntary imposition on the beneficiary" that ERISA seeks to avoid and that ethical investing of pension funds invariably involves due to the funds' collective nature.<sup>233</sup> The dissonance between trustees and participants is really an agency cost problem,<sup>234</sup> and opt-out procedures seem a sensible way to address the problem.

Another possibility is that in a defined contribution plan, aggressive SRI may be permissible with or without the consent and knowledge of the beneficiaries where the expected return on an ethical investment equals that of a competing traditional investment and the ethical investment is independently insured by the fund for the added risk.<sup>235</sup> Requiring social investors of pension assets to obtain

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231. See *supra* note 136-39 and accompanying text (discussing Kansas pension fund situation).

232. See Langbein & Posner, *supra* note 2, at 104-07 (finding ratification model of SRI, which informs beneficiaries of risks and costs of investments and allows them to opt into plan, to be feasible in pension context having low administrative costs, so long as investment criteria are precisely defined).

233. Langbein & Posner, *supra* note 2, at 106. Langbein and Posner describe SRI as "economically sound because the consumption benefits of social investing . . . are, in economic analysis, as real as investment benefits." *Id.* at 107.

234. See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308-10 (1976) (discussing agency cost theory). Agency costs arise in any agency relationship because agents and principals have an inherent conflict of interest. Jonathan R. Macey, *Private Trusts for the Provision of Private Goods*, 37 EMORY L.J. 295, 315 (1988). "Agents have incentives to shirk and to divert the resources of the [trust] toward their own ends, while the principals, due to collective action and free rider problems, often find it costly to curtail such conduct." *Id.* Agency costs are especially high in a trust relationship because "the objectives of the trust are not as clearly specified as those of [a] corporation [that] exists as a contractually created legal entity whose purpose is to maximize profits." *Id.* at 315-16. Because trust objectives are more varied, developing legal standards to monitor trustees and lower agency costs is more difficult. *Id.* at 316.

235. Cf. *supra* notes 123-28 and accompanying text (discussing low-income apartment re-

insurance would satisfy those concerned with SRI's increased non-systematic risk and the likelihood of further demands on the already beleaguered Pension Benefit Guaranty Corporation.<sup>236</sup> It would also, however, add to the cost of social investing.

When the expected return on an ethical investment is lower than that of a traditional investment, obtaining the express consent of the participants appears to be the only sensible mechanism available to avoid pension plan disputes. In effect, obtaining consent permits participants to "purchase" the current satisfaction that comes from SRI with future pension benefits.

As for defined benefit plans, it is hard to imagine why an employer, who bears the risk if the investments do not perform as expected, would want to assume additional costs in order to satisfy the consumption desires of its employees. There is no obvious reason to prohibit SRI, however, when the expected return is comparable to other investment choices and the increased risk is compensated through the purchase of insurance.

### CONCLUSION

The debate over ethical investing should be about the kinds of choices available to plan participants as they try to reconcile their politics with a desire to create and preserve capital for retirement. Of course, such a debate properly takes into account the fact that measures leading to a decrease in private pension accumulations will likely affect Social Security and other potential sources of income for the elderly. Supporters of SRI have therefore done a disservice to the debate by insisting that SRI is essentially costless without explaining that only under the inefficient markets theory could this be true. This Article has shown that we should expect SRI to lead to increased costs and lower returns or alternatively to higher nonsystematic risk in an efficient market.<sup>237</sup> Indeed, the more aggressively SRI is practiced, the more one would expect ethical investing to be economically unattractive.<sup>238</sup>

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habilitation investments undertaken by New York City, which appear to exemplify this mechanism).

236. See, e.g., David T. Cook, *Squeeze Goes on at Pension Guarantee Agency*, CHRISTIAN SCI. MONITOR, Dec. 6, 1983, at B3 (describing financial problems of Pension Benefit Guaranty Corporation); Douglas Frantz & Robert A. Rosenblatt, *Unhealthy Pension Plans Pose Gamble for Workers*, L.A. TIMES, Nov. 13, 1989, at A1 (outlining risks accompanying underfunded pension plans); Nancy L. Ross, *Pension Payment Deferral Requests Rise*, WASH. POST, July 6, 1982, at D7 (reporting on numbers of companies that cannot make payments under pension plans).

237. See *supra* notes 78-80 (suggesting that under capital asset pricing model SRI results in greater nonsystematic risk).

238. See *supra* notes 74-77 and accompanying text (concluding that SRI prevents investors from achieving efficient portfolio of investments).

Even on an intuitive level, this result is not surprising, because if SRI were truly costless, one would expect to see a great many SRI practitioners.<sup>239</sup> And if SRI were costless, the only points of contention would be the propriety of particular screens and competing ethical views. In fact, concern that it is theoretically impossible to distinguish the search for "green" companies, for example, from the pro-union activities condemned in *Blankenship*, generates much of the criticism of SRI.

This does not mean that ethical investing should be prohibited under all circumstances. ERISA does not require this,<sup>240</sup> and common sense and basic fairness suggest the contrary. Individuals should not be forced to make investments they find morally unacceptable. SRI practiced by the individual investor does not raise this concern. In the pension context, however, one cannot avoid the agency cost problem by presuming knowledge or consent of plan participants to any social or political agenda of plan trustees.<sup>241</sup> The stakes—future retirement income—are high and the opportunities for abuse seem limitless, so some constraints are needed.

Yet, ERISA's current inconsequential standard<sup>242</sup> is overly restrictive. When a plan provides a mechanism for informing participants of expected additional costs and/or added risk, it is hard to justify limiting SRI to choices nearly comparable to traditional investments. Alternatively, when a plan includes insurance against added risk as the price it pays to secure a return competitive with other investments, there is likewise no reason to prohibit ethical investing.

Supporters of SRI appear to have ignored the strongest source of theoretical support for the oft-heard proposition that SRI is cost-free. Significantly, the SRI critique developed by Professors Langbein and Posner assumes that capital markets are efficient and that the CAPM remains unchallenged.<sup>243</sup> These assumptions are not true, however. Evidence now reveals that capital markets are not always efficient.<sup>244</sup> Accordingly, the separation theorem does

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239. Many supporters of SRI object to this conclusion and point out that an investor might, for example, be a racist who approves of and wants to support the South African apartheid government. Acting on these views in the creation of a portfolio, however, would be just another form of ethical investing. In economic terms, the traditionalist is simply nonpolitical, not immoral or politically conservative.

240. See *supra* notes 203-04 and accompanying text (concluding that ERISA allows SRI in its mildest forms).

241. See *supra* note 234 (discussing agency costs in trust context).

242. See *supra* notes 200-03 (noting that Federal Government has concluded that ERISA permits SRI as "incidental consideration" of traditional investments).

243. Langbein & Posner, *supra* note 2, at 76.

244. See *supra* notes 92-113 and accompanying text (providing empirical and theoretical evidence supporting inefficiency market hypothesis).

not apply, and SRI could in fact be an income maximizing strategy. In other words, in an inefficient market, a social investor may maximize income by following various speculative booms, in spite of the fact that a traditionalist would view this choice as being behind the efficiency frontier.<sup>245</sup> Therefore, non-CAPM strategies such as SRI may succeed where traditional approaches fail.<sup>246</sup> Alternatively, the fact that certain screens are superior proxies for ascertaining information useful to all investors may account for the instances in which SRI funds outperform the market. For example, the search for "green" companies may actually be a search for especially well-managed companies.

The mounting evidence in favor of the inefficiency hypothesis unquestionably bolsters the case for SRI. Nonetheless, backyard investment schemes of the Kansas variety are undoubtedly illegal under ERISA and ought to remain so. The diversification principle remains valid, however, and there is no evidence that backyard schemes are so hostile to this principle that they warrant an explicit ban.

Socially responsible investing has existed for a long time and is being practiced by a sufficiently broad variety of plans that its impact cannot be ignored. For example, although it is difficult to gauge the precise impact of various investments, institutional and individual investors' widespread refusal to maintain economic ties with the apartheid regime in South Africa has clearly played a role in the changes taking place in that nation.<sup>247</sup> Although some political changes remain elusive and the future is by no means certain, these investors helped to create a climate in South Africa that was conducive to reform.<sup>248</sup> The same can probably be said of other ethical investing campaigns. Rather than destroying SRI, frank acknowledgement of its expected costs and risks in an efficient market

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245. See Richard A. Booth, *The Emerging Conflict Between Federal Securities Law and State Corporation Law*, 12 J. CORP. L. 73, 88 (1986) (stating that investing on basis of "hunches" based on noneconomic factors may cause substantial changes in stock prices and therefore constitute rational, profit-seeking investment strategy); see also *supra* notes 92-94 and accompanying text (discussing SRI in terms of efficiency frontier).

246. See *supra* Tables 1, 2 accompanying notes 117-19 (presenting tabulated evidence that some social investment funds outperformed market average, Dow Jones Industrials, and S & P 500); see also *supra* notes 49-51 and accompanying text (discussing efficient markets hypothesis and finding that superior performance of SRI supports inefficiency hypothesis).

247. See *supra* notes 6-7 (describing internal social and political changes in South Africa and lifting of economic sanctions by international community).

248. See, e.g., Chris Black, *Divestment Debate Rekindled: Apartheid Foes Say Pressure Must Be Kept on South Africa*, BOSTON GLOBE, Feb. 11, 1990, at A21 ("People inside South Africa, black and white, were the major force [behind ending apartheid]. But they would be the first to say the external boycott was very important." Indeed, [National Publicity Secretary for the United Democratic Front] Lekota characterized the role of external economic pressure as 'crucial' . . .") (quoting Robert Zevin, economist and senior vice president, US Trust Co.).

should enhance SRI's attractiveness to pension plan participants and their beneficiaries. In addition, the inefficiency hypothesis only supports the longstanding contention of SRI aficionados that profitable investment can take place behind the efficiency frontier.