Public plans should not engage in social investing

April 2, 2018

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Divesting stock of arms manufacturers raises a host of problems

Every few years politicians come up with the brilliant idea of using public pension funds to make political statements. The most recent incarnation is proposed legislation that would require the Massachusetts' public pension fund managers to sell the stock of any firearm company that derives more than 15 percent of its revenues from the civilian market. This legislation is supported by the state's Treasurer Deb Goldberg.

The emotional appeal of such a call is powerful in wake of the horrific shooting in Parkland, Florida. But strong arguments exist against using public pension plans to accomplish policy goals, much less simply to make us feel better.

The divestiture of gun stocks by Massachusetts plans – or even by all public plans – is unlikely to impact the price of the stock of these companies. The action may cause a temporary price drop, but as long as some buyers remain they will swoop in, purchase the stock, and make money. And the buyers are out there. The "Vice Fund," which was established in 2002, specializes in only four sectors: alcohol, tobacco, arms, and gambling, and thus stands ready to buy any stocks diverted from standard portfolios.

Most importantly, public pension funds are particularly ill-suited vehicles for social investing. First, adding a new criterion to the investment decision will increase the likelihood of mistakes. While the investment teams for many large public funds are first rate, others are much less experienced. Introducing divestment requirements into such an environment will take the manager's eye off the prize – maximum returns for any given level of risk.

Second, while the divestiture of gun manufacturers alone would have little impact on the returns of public pension funds, it is the first step down a slippery slope. The last round began with Sudan, but quickly spread to Iran and "terror-free" investing. Before that was tobacco and, in Massachusetts, any firm doing business with Northern Ireland. The point is that while divesting a few stocks will have little impact on fund returns, divestiture as standard procedure will sharply increase administrative costs and lead to lower returns.

Finally, the people advocating for divestiture and the stakeholders in the pension fund are not the same people. The advocates for divestiture are either politicians or legislators. The stakeholders are tomorrow's beneficiaries and/or taxpayers. If divestiture produces losses either through higher administrative costs or lower returns, tomorrow's taxpayers will have to ante up or future retirees will receive lower benefits. The welfare of these future actors is not well represented in the decisionmaking process.

The issue of divesture does not arise in the private sector, which is covered by the Employee Retirement Income Security Act (ERISA) of 1974. From the beginning, the U.S. Department of Labor has warned that the exclusion of investment options would be very hard to defend under ERISA's prudence and loyalty tests. Thus, ERISA fiduciary law has effectively constrained social investing in private sector defined benefit plans.

Massachusetts' public plans are not well funded. Based on their assumed returns, the plan for state employees has assets equal to only 65 percent of liabilities and the plan for teachers only 52 percent. These plans have real problems that need to be addressed. Advocating the divestiture of companies that manufacture firearms is a frivolous diversion and could establish a dangerous precedent for further divestiture.