LABOR CENTER REPORTER

Number 153
June 1985

UNIVERSITY OF CALIFORNIA, BERKELEY
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THE FINANCIAL ASPECTS OF DIVESTMENT

by Clair Brown and Micheal Reich

What would be the financial implications if a large stockholder such as the University of California divested fully from companies doing business in South Africa?

Many money managers lacking experience with South Africa-free portfolios believe that the costs could be quite high, while money managers with such experience know the costs can be small or even nonexistent. Analysis of the UC portfolio and of the professional literature on this topic leads to the conclusion that the potential costs, conservatively estimated, would not exceed a very small amount; indeed, by some calculations, the financial benefits may outweigh the costs. The exigencies of prudent fiduciary responsibility clearly do not exclude full divestment from South Africa-related companies.

The divestment process could result in a higher yield, lower risk portfolio if the University used this opportunity to shift some if its assets from equity to bonds and real estate. The University's investment strategy has been criticized by many money managers as being too oriented toward equity, which is 70% to 80% of the portfolio. Since it is arguable whether the current investment strategy pursued by the University is optimal, the financial arguments against divestment become even weaker. Changes in investment strategy that might accompany divestment could improve the performance of the UC portfolio.

Constructing a South Africa-Free Portfolio--According to the Investor Responsibility Research Center (IRRC, the most authoritative identifier of companies operating in South Africa), in December 1984, 31 of the 50 largest and 57 of the 100 largest Fortune companies were operating in South Africa. The total market value of the firms with South African operations constitutes approximately one-half of the total value of the Standard and Poor 500 companies, and one quarter to one-third of the total market value of all traded equities in the United States. In several major industries, such as drugs, international oil and office equipment, all or virtually all of the major firms do business in South Africa.

These very large magnitudes suggest to some that pruning a large fund of its South Africa-related holdings could be accomplished only by substantially constraining the available investments. The results that have been predicted include lower rates of return, with increased investment in companies that are much smaller, more risky and more costly to research, monitor and trade. Therefore, both implementation of divestment and ongoing costs of divestment could be quite high.

These concerns have now been addressed by profesional money managers, both through conjecture and experience of divestment where it has already occurred. Money managers with the greatest experience with South Africa-free funds find that the costs have been miniscule. Such costs, expressed in percentage terms, need not be higher even for multi-billion dollar portfolios. This result can be surprising, but it is true for a very simple reason. The number of large, medium and small firms which do not have any operations in South Africa remains enormous relative to the size and number of holdings in the University's portfolio. For example, divestment of South Africa-related stocks would still leave the following firms available for investment, from the Standard and Poor 500 companies alone: 19 of the top 50, 43 of the top 100, more than 100 of the top 250, and more than 250 of the top 500. These choices are more than sufficient to recreate a portfolio with all the desirable features of a well-structured fund.

What about the exclusion of some major industries implied by a South Africa-free fund? The simple answer is that not every industry must be represented in order to obtain optimal diversification. Modern portfolio theory--as followed by most money managers today--shows how to obtain diversity with even a small number of industries. The results usually track fairly closely the performance of the Standard and Poor 500 index.

The Rate of Return--Let us then review the conjectural studies that ask the question: what would happen to the Standard and Poor index if the South Africa-related stocks were removed and replaced by others? Several such studies were cited by Mr. John Harrington of Working Assets Money Fund in his April 24 presentation to the Anti-Apartheid Convocation at UC Berkeley. Nine such studies are reviewed in a recent report of the IRRC. Although the methodology used varies by study, every study cited finds a higher rate of return for the South Africa-free portfolio ranging from a 6% to a 113% increase in the rate of return over various periods used in the studies (all were between 1972 and 1984).

Risk and Transaction Costs--Some of these studies also find higher risk, or variability, in the South Africa-free funds. The increased risk is not worrisome for several reasons. First, using the standard measures, the increased rate of return more than compensates for the increased risk. Second, the increased risk can be offset by lowering the proportion of the portfolio in equities and increasing the amount in bonds. Third, analysis of risk must include the fact that continuing operations in South Africa presents great risk for foreign-owned companies. In 1982, the Business Environmental Risk Information, a Geneva-based firm that does corporate risk analysis around the world, recommended that firms operating in South Africa de-emphasize South African operations and prepare to shift production elsewhere if possible; protect industrial sites and personnel against violence; and examine the possibility of an orderly withdrawal to avoid financial losses.

To some, notably Wilshire Associates, the possibility of higher transactions costs appears worrisome, especially for portfolios as large as the UC fund. But several considerations again mitigate these worries. First, implementation costs of divestment can be reduced drastically if divestment proceeds in an orderly manner. Second, the research, monitoring and trading costs can be held to what they are now, if they are assumed to be optimal, by considering the size distribution of holdings as one of the criteria in constructing a portfolio. This can be easily done. The much higher transaction costs estimated by Wilshire result from the unusual way they construct a South Africa-free portfolio; they replace each excluded firm with another from the same industry, but of much smaller size. Diversification does not require such a methodology; in fact, better criteria, such as return and risk, should be used. Although some brokerage fees will be incurred in the divestment process, they would account for only a small fraction of the cost of managing the fund and should be insignificant in the overall performance of the portfolio.

Conclusion--The political and moral reasons for full divestment are compelling. And now we know that no financial constraints prevent us from pursuing divestment. In fact, the instability of the South Africa government indicates that full divestment would be the prudent path. Other divestment programs show us how full divestment might be implemented in an orderly manner. For example, the New York City Employee's Retirement Fund, which is worth $8.5 billion, is being fully divested in four phases over a five year period. The first phase of divestment, which is to be completed in fifteen months, covers those companies that operate in a manner which directly supports Apartheid or have not adopted the Sullivan Principles.

Trustees of pension funds need no longer fear the threat of "large and incalculable" losses as a reason for not divesting. Those financial arguments have been shown to be false and misleading.

--Clair Brown & Michael Reich