

PUBLIC HEARING

before

**ASSEMBLY STATE GOVERNMENT, CIVIL SERVICE, ELECTIONS,
PENSIONS, AND VETERANS' AFFAIRS COMMITTEE**

ASSEMBLY BILL 1308

(Establishes principles for the investment of State pension funds
by The State Investment Council)

and

ASSEMBLY BILL 1309

(Requires divestiture of State's public pension and annuity funds directly
or indirectly linked to the Republic of South Africa)

Held:
September 24, 1984
Room 446
State House Annex
Trenton, New Jersey

New Jersey State Library

MEMBERS OF COMMITTEE PRESENT:

Assemblyman Joseph Charles, Jr., Chairman
Assemblyman Robert D. Franks

ALSO PRESENT:

Assembly Speaker Alan J. Karcher
Assemblyman Willie B. Brown

Donald S. Margeson, Research Associate
Office of Legislative Services
Aide, Assembly State Government, Civil Service, Elections,
Pensions and Veterans' Affairs Committee

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ASSEMBLY, No. 1308

STATE OF NEW JERSEY

INTRODUCED FEBRUARY 23, 1984

By Assemblymen KARCHER, BROWN, THOMPSON, WATSON,
CHARLES, BRYANT and Assemblywoman GARVIN

AN ACT concerning the investment of certain State funds and
amending and supplementing P. L. 1950, c. 270.

1 *BE IT ENACTED by the Senate and General Assembly of the State*
2 *of New Jersey:*

1 1. Section 5 of P. L. 1950, c. 270 (C. 52:18A-83) is amended to
2 read as follows:

3 5. There is hereby established in the Division of Investment a
4 State Investment Council which shall consist of **[10]** 12 members.

5 Within 10 days after the effective date of this act each of the
6 following agencies, namely, the Board of Trustees of the Public
7 Employees' Retirement System, the Board of Trustees of the State
8 Police Retirement System, the Board of Trustees of the Teachers'
9 Pension and Annuity Fund, the Board of Trustees of the Police
10 and Firemen's Retirement System of New Jersey and the Con-
11 solidated Police and Firemen's Pension Fund Commission, shall
12 designate one of their respective members to serve as a member
13 of the State Investment Council herein established. The five mem-
14 bers of the council so selected shall serve as such for a period of
15 one year from the date of their selection and until their respective
16 successors are in like manner selected. **[Each of the remaining**
17 **5]** Five members of the State Investment Council shall be ap-
18 pointed by the Governor for a term of five years and shall serve
19 until his successor is appointed and has qualified; except that of
20 the first appointments to be made by the Governor hereunder, one
21 shall be for a term of one year, one for a term of two years, one

EXPLANATION—Matter enclosed in bold-faced brackets [thus] in the above bill
is not enacted and is intended to be omitted in the law.
Matter printed in italics thus is new matter.

22 for a term of three years, one for a term of four years, and one
 23 for a term of five years, and they shall serve until their respective
 24 successors are appointed and have qualified. The term of each of
 25 the members first appointed hereunder by the Governor shall be
 26 designated by the Governor. *Two members of the council shall be*
 27 *appointed jointly by the President of the Senate and the Speaker*
 28 *of the General Assembly from among the members of the Legis-*
 29 *lature, not more than one of whom shall be of the same political*
 30 *party, and who shall serve during the two-year Legislature in*
 31 *which they are appointed.*

32 At least three of the five members appointed by the Governor to
 33 the council shall be qualified by training and experience in the field
 34 of investment and finance. No member of the State Investment
 35 Council *appointed by an agency or the Governor* shall hold any
 36 office, position or employment in any political party nor shall any
 37 [such] member benefit directly or indirectly from any transaction
 38 made by the Director of the Division of Investment provided for
 39 herein.

40 The members of the council shall elect annually from their
 41 number a chairman of such council. Any member of the council
 42 so elected shall serve as such chairman for a term of one year and
 43 until his successor is, in like manner, elected. The chairman of the
 44 council shall be its presiding officer.

45 The members of the council shall serve without compensation but
 46 shall be reimbursed for necessary expenses incurred in the perfor-
 47 mance of their duties as approved by the chairman of the council.

48 Each member of the council *appointed by an agency or the Gov-*
 49 *ernor* may be removed from office by the Governor, for cause, upon
 50 notice and opportunity to be heard at a public hearing. Any vacancy
 51 in the membership of the council occurring other than by expira-
 52 tion of term shall be filled in the same manner as the original ap-
 53 pointment, but for the unexpired term only.

1 2. Section 6 of P. L. 1950, c. 270 (C. 52:18A-34) is amended to
 2 read as follows:

3 6. The Division of Investment established hereunder shall be
 4 under the immediate supervision and direction of a director, who
 5 shall be a person qualified by training and experience to direct the
 6 work of such division. The director of such division shall be ap-
 7 pointed by the State Treasurer from a list of one or more persons
 8 qualified for such office and submitted to the State Treasurer by
 9 the State Investment Council; provided, that the State Treasurer
 10 may require the submission of an additional list or lists. Each list

11 so submitted by the council shall also contain the qualifications of
 12 each person whose name appears thereon who shall be certified by
 13 the council to the State Treasurer as qualified for the office of di-
 14 rector of such division. The detailed qualifications of each person
 15 so named by the council shall be contained in such certification.

16 Any director so appointed shall serve without term but may be
 17 removed from office (a) by the State Treasurer, for cause, upon
 18 notice and opportunity to be heard at a public hearing, or (b) by
 19 the State Investment Council, if ~~seven~~ *eight* or more members
 20 thereof shall vote for such director's removal from office.

21 Any vacancy occurring in the office of the Director of the Division
 22 of Investment shall be filled in the same manner as the original
 23 appointment.

24 The director of said division shall devote his entire time and
 25 attention to the duties of his office and shall not be engaged in any
 26 other occupation or profession. He shall receive such salary as
 27 shall be provided by law.

1 3. (New section) There is established in the Division of Invest-
 2 ment in the Department of the Treasury a Citizens' Investment
 3 Advisory Committee to consist of six residents of the State to be
 4 appointed for terms of two years as follows: two members to be
 5 appointed by the Governor, two members to be appointed by the
 6 President of the Senate and two members to be appointed by the
 7 Speaker of the General Assembly. Not more than one of each
 8 group of two shall be a member of the same political party. Of
 9 the first six members appointed, one of each group of two shall be
 10 appointed for a term of two years and one for a term of one year.
 11 All members shall serve after the expiration of their terms until
 12 their respective successors are appointed and shall qualify. Vacan-
 13 cies shall be filled in the same manner as the original appointment
 14 but for the unexpired term only. Members shall serve without com-
 15 pensation but shall be entitled to reimbursement for expenses in-
 16 curred in the performance of their duties.

17 The Citizens' Investment Advisory Committee shall organize as
 18 soon as practicable after the appointment of its members and shall
 19 annually select from among its members a chairman and a vice-
 20 chairman. The Division of Investment shall provide the committee
 21 with reasonable administrative, professional, technical and clerical
 22 staff assistance, subject to the availability of funds.

1 4. (New section) The Citizens' Investment Advisory Committee
 2 is empowered to:

- 3 a. Consult with and advise the State Investment Council and the
- 4 Director of the Division of Investment with respect to the work of
- 5 the division and its investment policies and practices;
- 6 b. Conduct studies regarding investment policies and practices
- 7 as it shall determine or as the State Investment Council or the
- 8 Director of the Division of Investment shall request;
- 9 c. Monitor the investment policies and practices of the division
- 10 with regard to compliance with the investment principles specified
- 11 in this act;
- 12 d. Conduct public hearings with regard to the investment policies
- 13 and practices of the division or in conjunction with any study it
- 14 may undertake;
- 15 e. Maintain a continuing review of the investment policies and
- 16 practices of other states and public and private entities; and
- 17 f. Issue reports and make recommendations with regard to the
- 18 work of the Division of Investment and its investment policies and
- 19 practices to the Governor, the Legislature, the State Investment
- 20 Council and the Director of the Division of Investment.

1 5. (New section) It is the fiduciary responsibility of the State
 2 Investment Council to preserve the capital and realize the greatest
 3 possible returns on investment, commensurate with acceptable
 4 standards of risk and prudence, for the pension funds under its
 5 jurisdiction, and this responsibility shall be the primary and under-
 6 lying criteria for its pension investment policies and practices. In
 7 carrying out this responsibility, the council shall establish policies
 8 and practices governing investment decisions for the pension funds
 9 in accordance with the supplementary principles described in this
 10 section. Each pension investment decision shall be made in con-
 11 formity with at least one supplementary principle in each case
 12 where the resulting investment or divestment offers a risk, rate of
 13 return, opportunity or other condition of investment which is equiv-
 14 alent to, or more favorable than, an alternative investment decision
 15 that is not in accordance with the supplementary principle.

16 The supplementary principles governing the investment of pen-
 17 sion funds are as follows:

- 18 a. Investments shall be made with full recognition of their social
- 19 and ethical consequences, and no investment shall be made in a
- 20 security of a public or private entity if the activities of the entity
- 21 serve to undermine basic human rights or dignities, or if the entity
- 22 engages in substantial business in a country which condones or en-
 courages policies which serve to undermine basic human rights or
 23 dignities, or if the entity has been judicially determined to be a

25 violator of any international, federal or state law regarding human
 26 rights, environmental protection, occupational safety and health or
 27 labor relations;

28 b. Investments shall be made in securities which are issued by
 29 public or private entities located within the State of New Jersey;

30 c. Investments shall be directed to the promotion of the economic
 31 development of the State of New Jersey and shall be designed to
 32 have a positive impact on such factors as employment, wages, State
 33 and local tax bases, inter- and intra-state trade and economic
 34 activity, revitalization of urban centers, and the diversity of the
 35 State's commercial and industrial character;

36 d. Investments shall be directed to the promotion of new or ex-
 37 panding businesses within the State of New Jersey;

38 e. Investments shall be directed to the promotion of small busi-
 39 nesses within the State of New Jersey which are owned or con-
 40 trolled by socially or economically disadvantaged individuals as
 41 defined by section 8 (d) of the federal "Small Business Act," Pub.
 42 L. 85-536 (15 U. S. C., sections 637 (a) and 637 (d)) and any
 43 regulations promulgated pursuant thereto;

44 f. Investments shall be directed to the promotion of the avail-
 45 ability of new or rehabilitated housing within the State of New
 46 Jersey for persons of all income ranges; and

47 g. Investments shall be directed to the promotion of alternative
 48 energy resources and systems and energy conservation programs.

1 6. (New section) The State Investment Council shall annually
 2 adopt and file with the Legislature an investment strategy plan,
 3 which shall set forth plans and procedures by which the council
 4 expects to meet the goals and objectives of the investment princi-
 5 ples described in this act.

1 7. (New section) The State Investment Council shall file with the
 2 Legislature a quarterly report describing its investment trans-
 3 actions of the previous three-month period and the degree to which
 4 the transactions conform to the annual investment strategy plan.

1 8. (New section) The State Investment Council shall adopt rules
 2 and regulations to implement the investment principles specified
 3 in this act and shall bring the pension investments into compliance
 4 with these principles within two years after the effective date of
 5 this act, except that nothing in this act shall be construed to require
 6 the premature sale, redemption, withdrawal or divestment of any
 7 investment in effect on the effective date of this act.

1 9. This act shall take effect immediately.

STATEMENT

This bill sets forth a new investment strategy for public pension funds as recommended in a report to the Legislature by the sponsor on January 25, 1984.

The bill requires the State Investment Council, which guides the Division of Investment in the management of the six State pension funds, to make investments within the State of New Jersey to meet a number of goals whenever the expected rate, risk or terms of the in-State investment are commensurate with those available for other investment opportunities. While the bill establishes the principle that the primary responsibility of the council is to preserve the capital and realize the greatest possible returns on its investments, commensurate with acceptable standards of risk and prudence, the bill nonetheless requires the council to follow a number of supplementary principles when setting investment policy.

In addition to the principles governing investment in New Jersey, the bill also provides that the council refrain from any investment in companies or countries with poor records of compliance with basic standards regarding human rights, employment practices, labor relations, health and occupational safety and environmental safeguards.

The bill also adds two legislators to the 10-member council; establishes a Citizens' Investment Advisory Committee; and requires the council to adopt regulations to implement the new principles and to prepare an annual investment strategy plan.

ASSEMBLY, No. 1309

STATE OF NEW JERSEY

INTRODUCED FEBRUARY 23, 1984

By Assemblymen BROWN, CHARLES, KARCHER, THOMPSON,
WATSON, BRYANT and Assemblywoman GARVIN

AN ACT concerning the investment of certain public funds.

1 *BE IT ENACTED by the Senate and General Assembly of the State*
2 *of New Jersey:*

1 1. Notwithstanding any provision of law to the contrary, no
2 assets of any pension or annuity fund under the jurisdiction of
3 the Division of Investment in the Department of the Treasury
4 shall be invested in any bank or financial institution which directly
5 or through a subsidiary has outstanding loans to the Republic of
6 South Africa or its instrumentalities, and no assets shall be in-
7 vested in the stocks, securities or other obligations of any company
8 engaged in business in or with the Republic of South Africa.

1 2. The State Investment Council and the Director of the Division
2 of Investment shall take appropriate action to sell, redeem, divest
3 or withdraw any investment held in violation of the provisions of
4 this act, except that nothing in this act shall be construed to
5 require the premature sale, redemption, divestment or withdrawal
6 of an investment.

1 3. Within 30 days after the effective date of this act, the Director
2 shall file with the Legislature a list of all investments held as of
3 the effective date of this act which are in violation of the pro-
4 visions of this act. Every three months thereafter, and until all
5 of these investments are sold, redeemed, divested or withdrawn,
6 the Director shall file with the Legislature a list of the remaining
7 investments.

1 4. This act shall take effect immediately.

STATEMENT

This bill requires the divestiture of all investments of the State's public pension and annuity funds which are directly or indirectly linked to the Republic of South Africa. In view of the fiduciary responsibility of the State Investment Council to manage funds in a prudent manner, the bill sets no deadline for divestiture, but requires the council to file quarterly reports on its progress in reaching complete divestiture.

ASSEMBLYMAN JOSEPH CHARLES, JR. (Chairman): Ladies and gentlemen, I would like to welcome you here this morning. My name is Joseph Charles, and I am the Chairman of the State Government Committee. The other member of the Committee, who is here today, is Bob Franks, sitting to my right. Assemblymen Zimmer, McEnroe, and Long are unable to be with us this morning.

As you all know, from reading the notice, today's meeting is the second public hearing which we called to discuss two related bills, which are pending before this Committee.

The first of these bills is A-1308; that is the bill that is sponsored primarily by Speaker Alan Karcher. That bill gives the State Investment Council some general statutory guidance with respect to its policies regarding investment of State pension funds. The bill establishes a prudent-man rule as the primary guideline for the Council's investment decisions. The bill also provides that in choosing among investment options which qualify under the prudent-man criterion, the Council shall apply certain supplementary principles. These principles discourage investment in securities of any public or private entity whose activities undermine basic human rights or which does business in a country which undermines basic human rights. The principles encourage, on the other hand, investment of State pension funds in New Jersey businesses, particularly in situations where such investment would contribute to the State's economic development.

In addition to these provisions providing investment policy, A-1308 would add two legislative members, one from each party, to the current ten member investment council. The bill also provides for the establishment of a Citizens' Investment Advisory Committee of six members. The Governor, the Senate President, and the Assembly Speaker would each appoint two members from different political parties. This Advisory Committee would consult with the Investment Council, reviewing its policies and practices and generally assisting the Council in complying with the investment policy principles I described a moment ago.

The second bill is A-1309. That bill was sponsored by Assemblyman Willie Brown. A-1309 requires the State Investment Council

and the Director of the Division of Investment to divest the pension fund portfolio of investments in banks which have outstanding loans to the Republic of South Africa and to invest no assets in the securities of companies doing business in or with the country of South Africa.

As announced in the notice of this hearing, the Committee's consideration of these bills will be limited to review of the impact of their prospective enactment upon the portfolio of the State's pension funds and upon investment policies and practices of the managers of that portfolio. If you recall at the first hearing on July 10, the scope of the testimony was more general than that. Today, testimony of scope is limited to the impact of divestiture and the investment policy engendered in A-1308 on the State pension funds.

The Committee has arranged to receive testimony from the Chairman of the State Investment Council, Mr. Frank Keleman. We have also arranged today to have an independent expert in pension fund analysis, Dr. Marcy Murningham of Mitchell Investment in Boston.

After these speakers have completed their statements, Committee members will have the opportunity to ask them pertinent questions. As usual the proceedings of this public hearing are being transcribed, and I therefore request that everyone who is speaking for the record, speak directly into the microphones. Just a few of the ground rules — I hope to have this hearing just continue straight through with no break.

I will first be calling Director Keleman to come forward and to give his testimony. Mr. Keleman, if you have some other persons who you would like to be present with you as you testify, you can have them come and testify along with you or sit by you, however you decide.

FRANK K. KELEMAN: It may be necessary to call upon Roland Machold who is Director of the Division.

ASSEMBLYMAN CHARLES: You may bring him forward right now if that would be helpful.

MR. KELEMAN: I don't know if he is here. He is just up the street and he may be joining us very shortly.

ASSEMBLYMAN CHARLES: Okay. After the Director testifies, we will then hear from Dr. Marcy Murningham. That is the limit of the

speakers who will be testifying this morning. A third public hearing will probably be announced at which I hope to wrap up. There may or may not be a third public hearing as such after today. It really depends upon an assessment of the testimony that occurs today and also an evaluation of what was testified to in the first public hearing.

Before we get into the testimony of the Director, I would first like to ask Assemblyman Frank whether he has any comments that he would like to make just by way of starting.

ASSEMBLYMAN FRANKS: Not at this juncture, Mr. Chairman. Thank you.

ASSEMBLYMAN CHARLES: I would like to just inform the audience here today that also sitting up here with us, as a matter of courtesy, is Assemblyman Willie Brown, who is the sponsor of A-1309.

MR. KELEMAN: Thank you. Chairman Charles, members of the State Government Committee, I am Frank Keleman, and I am Chairman of the State Investment Council as opposed to being Director of the Division, Mr. Charles. The Director of the Division is Roland Machold. I am Chairman of the State Investment Council. I thought I would just get the record straight in regard to it.

I have been a member of the State Investment Council for 14 years. In addition, I have managed my own business for many years. I served as director of several corporations, and for many years, served as Chairman of the Cooper Medical Center in Camden. I have been reappointed to the State Investment Council by both Republican and Democratic administrations. I am one of the five nonpartisan gubernatorial appointees to the Council. The Council is evenly balanced between public representatives and representatives of the State administered public pension funds. I am joined on the Council by teachers, policemen, and public employees who represent their particular funds. I appear before you to offer my comments on Assembly Bills 1308 and 1309, which are presently being considered.

The State Investment Council, acting as fiduciaries for the policemen, firemen, teachers, public employees, and judges of New Jersey, opposes Bills 1308 and 1309.

A-1308 would introduce non-financial, political issues into the investment process, materially reduce the fiduciary protection due to pension fund beneficiaries, and open the door to powerful special interests to direct pension investments to their own ends.

A-1309 would sharply reduce investment opportunities. It would potentially reduce investment returns and/or increase investment risks for pension fund portfolios.

The Division of Investment, which formed in 1950, is a consequence of scandals resulting from improper administration of investment funds. Inexperienced political appointees directed investments towards specific investment organizations within the State of New Jersey. At that time, State law did not provide for professional management of State investments and supervision, disclosure, and accountability for the State investment programs. An appraisal of investments at that time indicated that substantial concessions had been made to private parties, that commission fees had been excessive, and that rates of return for State investments had been sharply reduced. An independent government committee was established to review the circumstances surrounding these scandals and to make recommendations to the Governor and the Legislature regarding legislation which would protect public moneys from political interference and mismanagement in the future.

In 1950 legislation was enacted which created the present structure for the management of the State investment programs. The Legislature and the Executive at that time devised an investment structure which was designed to be separate from political influences. The legislation created an independent State Investment Council, which was evenly balanced in numbers between representatives of the general public and representatives of public employee pension funds. The legislation provided that the public members be appointed by the Governor for staggered five-year terms so that no one governor could unduly affect the composition of the Council. Furthermore, the legislation provided that gubernatorial appointees should be experienced in investment and finance. The public employee representatives are appointed annually by the Pension Fund Boards and

provide for direct representation to the Council for teachers, policemen, firemen, and both municipal and State public employees. Finally, the legislation specifically provided that no Council member could hold any office, position, or employment with a political party or could benefit from any transaction of the Division.

For over 34 years, the State Investment Council has performed its mandated duty to the State. It has provided investment objectives and fiduciary standards for all State investments and has carefully monitored the operations and performances of the Division of Investment. It has fulfilled its legal obligations to "centralize all functions related to the purchase, sales, or exchange of securities for the State's diverse funds under experienced and professional management." Furthermore, it has met its requirements, under the law, to engage independent auditors to review the financial statements of the Division each year and to publish each month a complete listing of all transactions which is distributed to the Legislature.

Advocates of A-1308 and A-1309 have asserted that "nobody knows what the Council does and even the Council doesn't know what it does." This statement is clearly inaccurate.

State law also provides that the Council, as fiduciaries, must observe the State prudent person law which provides that the Council must "exercise care and judgment under the circumstances then prevailing which persons of ordinary prudence and reasonable discretion exercise." The Council has resolved, in conformance with Federal law, the Division is bound to make prudent investments for the sole and direct benefit of beneficiaries of the various funds and that the Division must not make any concessions as to rate, risk, or terms which would benefit other parties at the expense of the beneficiaries of the fund.

Court and legal interpretations also require that fiduciaries must provide adequate equity and diversification for investments.

The State prudent person law also requires fiduciaries to make investments "for the purpose of preserving capital and of realizing income." This is reflected in the Council's investment objectives for the pension funds, which are preservation of capital;

realization of earnings sufficient to meet the assumed actuarial rate of return, which presently is six and a half percent, for the major pension funds administered by the State; and the best possible performance within the fiduciary standards set by the Council.

Furthermore, State law by reference requires a pension fund investment meet investment standards set for banks and insurance companies which, for instance, require a minimum bond rating of B-AA or better and which have been interpreted to prohibit high risk equity investments such as start-up and early stage equity investments. These laws and standards are significant because they guide the standards of risks and return for the investment program of the pension funds.

A substantial commitment of funds has been made to fixed income securities in order to realize the necessary income to ensure the realization of the actuarial rate of return. The use of equity investments which provide lower income but the prospect of capital appreciation was virtually prohibited by State law until the late 1960's.

At June 30, 1984, fixed income securities, which include mortgages, constituted 72% of the book value of pension funds and 66% of the value of such assets. Investments in equities constituted the remainder.

It is important to keep in mind these legal and policy objectives in order to analyze the effects that Bill 1308 and Bill 1309 would have on the returns and risks of the pension funds of New Jersey's teachers, policemen, public employees, firemen, and judges.

The performance of the Council and the Division can be measured against several standards. It can be measured against the relative performance of other money managers and it can be measured against the standards and objectives inherent in New Jersey law.

The investment portfolio of the Division can be divided roughly into three parts: Equities, almost all of which are held in Common Pension Fund A; long-term bonds, the significant majority which are held in Common Fund B; and short-term investments which are held in the State of New Jersey Cash Management Fund. At June 30, 1984, the aggregate book value of the pension funds was \$10.2 billion. Of this

amount, \$2.6 billion is in Common Pension Fund A; \$3.9 billion is in Common Pension Fund B; and not quite \$1 billion is in the State of New Jersey Cash Management Fund. The remainder consists of bonds and mortgages held directly by the pension funds. The Council has retained Merrill Lynch to measure the total return and relative performance of the two common funds and uses the Donoghue report to evaluate the relative performance of the State of New Jersey Cash Management Fund. Performance has been reported routinely in the Division's reports for many years.

In fiscal 1983, Common Pension Fund A provided a return of 54.1%, which ranked it in the top 49th percentile of equity managers, and the return of Common Pension Fund B was 36.2%, which ranked in the top 1% of bond managers. Comparable figures for fiscal 1984 are not available from Merrill Lynch at this time. However, another pension fund service which provides performance reports showed that Common Pension Fund A ranked in the 43rd percentile of equity managers in fiscal 1984. The State of New Jersey Cash Management Fund ranked in the top 2% of similar short-term investment funds for both years.

Of greater significance in evaluating the Council's performance is the question of whether the pension funds have met the objectives set by State law and the State Investment Council, namely, the preservation of capital and the realization of the actuarial rate of return. The Council and the Division have met these goals. The pension funds have never suffered a loss of principal or interest on any fixed-income investment and have never held an equity position in any company which went bankrupt. The pension funds have not been affected by such notorious bankruptcies as the Penn Central, W.T. Grant, Braniff Airlines, or others. Secondly, the returns of income have always exceeded the assumed actuarial rates of return. In fact, excess returns over the past seven years have been the principal factor in increasing the funding of the pension fund's projected accrued liabilities from 70% in 1977 to 100% in 1984, as is reflected in the official statement for the New Jersey G.O. Bonds, that were just announced.

Finally, during the 34 year-period of the Council's oversight, there has never been a single scandal related to the investment program and there has been no determination of any conflict of interest or malfeasance in the investment management process. This has been an outstanding achievement and reflects a performance which has not been duplicated in many states.

However, it is not for me to stand in judgment of the Council and its performance. In 1977 the Office of Fiscal Affairs reviewed the Council and the Division and concluded:

"The Council carries out an active policy setting and monitoring role in the State's investment program," and "we conclude that those policies and practices are directed towards the efficient and prudent management of the State's investments."

Furthermore, in 1981, Governor Byrne created a Task Force on the use of State Pension Funds to further economic growth in New Jersey. This group included James Hughes, Executive Director of the New Jersey Economic Development Authority; Peter Shapiro, Essex County Executive; Walter O'Brien, Director of Government Relations of the New Jersey Education Association; Martin Bierbaum, Professor of Urban Planning at Rutgers University; Leonard Johnson, former President of New Jersey Business and Industry Association; and Richard Spies, who served as Chairman of that group, a professor of economics and Associate Provost of Princeton University. The group concluded that:

"We have the impression that the current structure and policies have served the State and the pension fund very well over the years."

In 1983, Governor Kean created a Pension Study Commission, which, among other matters, reviewed the investment policies and practices of the Council and the Division of Investment. The Pension Study Commission report concluded:

"The current structure within which New Jersey's pension investments are made is, in our judgment, both sensible and appropriate for the task and should not be changed in any substantive way. The balance which exists between the accountability of the pension investment fiduciaries to the beneficiaries of the funds with the

insulation from political influence is of decisive importance. It is crucial that the twin pillars of fiduciary responsibility, namely, prudence and loyalty, be maintained. The current structure allows for and facilitates that to a better extent than any other we have seen or considered."

I have summarized the laws which govern State investments, the functions and performance of the State Investment Council, and the conclusions of independent observers in order to clarify public understanding of the State's investment process and to provide a necessary context for a discussion of bills A-1308 and A-1309.

Assembly Bill 1308 would materially change the fiduciary laws related to the Division, would add two legislators to the State Investment Council, would establish a Citizens Advisory Committee, and would add supplementary non-financial criteria for investment. The bill is predicated upon the proposition that there are unfinanced capital gaps in New Jersey which offer the opportunity of "development" investment without sacrifice of risk, return, or other investment terms.

I would like to address certain specific features of the bill and then turn to a discussion of broad assumptions which support the bill.

Bill 1308 would add two legislators to the State Investment Council. The bill does not provide for any investment or financial qualifications for such officials. Furthermore, the addition of elected officials would bring to the Council deliberations the non-financial political issues of the moment, which are likely to change from one legislature to the next and would impede long-term financial planning. Finally, the addition of legislators would dilute the current representation of public pension fund employees on the Council, a balance which was carefully constructed in 1950.

Bill 1308 would also create a Citizen's Investment Advisory Board consisting of two appointees each by the Governor, the Speaker of the Assembly, and the President of the Senate. It appears to me that this Board's responsibilities would supersede the existing responsibilities of the State Investment Council and would exclude the

representation of the public employees, policemen, firemen, and teachers who are the members and beneficiaries of the pension fund systems. The new board would consult with the Council, hold public hearings, conduct studies, monitor investment policies, and issue reports and recommendations. Since its inception, the State Investment Council has successfully performed all of these functions. Furthermore, the Council has consistently demonstrated a willingness to listen to all interested parties with respect to investment matters. The bill further provides that the Council adopt rules and regulations in compliance with "supplementary" investment principles, which in effect transfers the fiduciary oversight and policy-making authority of the Council to the new Board, and the Council's role is entirely compromised.

The proposals are entirely contrary to the intent that the Legislature expressed in the existing law, which is to establish investment programs which are free of political conflict.

Section 5 of Bill 1308 would establish a new prudent person standard for the State's investments, a standard which is entirely different from the standards that apply to all other fiduciaries in the State and the Nation. Prudence must only be "acceptable," but it does not specify to whom the standard is acceptable. No longer would the fiduciary be held to the necessity of exercising "care and judgment" and the common investment standard "which persons of ordinary prudence and reasonable discretion exercise." It also appears that requirements for diversification of investments, which are inherent in State law, and are explicitly stated in Federal law, would no longer be applicable. In fact, Bill A-1308 is explicitly designed to limit investment diversification to the State of New Jersey which would impose on the pension funds the specific risks of the State's economy and inhibit investments in out-of-State industries such as petroleum extraction, timber, automobile manufacturing, regional banks and aerospace and other technology industries which may be located in other parts of the country. Finally, the new prudency standard does not mention the loyalty principle which provided that investments must be made for the "sole and direct benefit of the beneficiaries of the

pension funds." In fact, the purpose of the bill is entirely contrary to the loyalty principle, since it is intended to provide benefits to a wide range of persons who are not pension fund beneficiaries.

To summarize, the Council believes that the proposed prudency standard for the investment of State pension funds is materially defective in this bill and would virtually eliminate the fiduciary protection due to beneficiaries of the State pension funds.

I would like to turn to a brief discussion of the seven specific "supplementary" investment principles as set forth in Bill A-1308.

As sub-paragraph (a), this principle would prohibit investment in entities who undermine human rights, engage in business in countries which violate human rights or has been judicially determined to violate human rights. The definition is so wide that a great many countries in the world could be included in this category, including the United States with Puerto Rico and Nicaragua, Great Britain with Northern Ireland problems, Israel with its West Bank problems, and so forth. The Council is sensitive to social issues and this will be discussed subsequently in this testimony.

Sub-paragraph (b) speaks to investments in public entities would not be advisable, since such entities can issue tax-exempt bonds which would provide significantly lower rates than are available for taxable securities purchased by the pension funds. With respect to private entities, a great many corporations do maintain operations in New Jersey. If this proviso were interpreted to include only companies which are headquartered in New Jersey, the investment universe would be limited to less than 5% of the total available investment universe. Such a limitation would sharply reduce the potential diversification by region and by industry.

Regarding sub-paragraph (c), the Council would be pleased to invest in companies which promote economic development in the State, with the proviso that such investments must meet the risk and return standards set by law. The Council's view of New Jersey investment is discussed further on in this report.

In regard to sub-paragraph (d), the Council would be delighted to invest in expanding businesses within New Jersey, again provided that they met the risk and return standards set by law. However, we believe that new businesses would be too risky for State pension funds. Figures provided by Capital Publishing Company, which maintains records for venture capital industry, indicate that, on average, 40% of all professionally managed ventures fail, and that returns, if any, are usually delayed five to seven years. It appears to us that such individual investments would violate any reasonable standards requiring preservation of capital and income.

Regarding sub-paragraph (e), the Council would be delighted to invest in businesses controlled by economically disadvantaged persons, providing the investments met the risk and return standards set by law.

Regarding sub-paragraph (f), the pension funds presently hold over \$1.3 billion of mortgages and mortgage-backed securities. Almost all of these are U.S. Government supported GNMA, FHLMC, FNMA, VA or FHA securities. The Division has an active dialogue with the New Jersey housing industry, and would be prepared to participate in any pool of mortgages with appropriate risk and return characteristics. However, all mortgage pools, whether guaranteed by the Government or backed by conventional mortgages, require income tests for mortgages. To do otherwise would invite default and the loss of invested principal.

And last, in regard to sub-paragraph (g), again, the Council would be pleased to make such investments in alternative energy sources, providing the investment met the fiduciary standards set by law.

It is notable that exclusive observance of these standards could preclude investment in securities of the U.S. Government and its agencies, which constitute about 40% of the pension fund holdings, as well as investment in virtually all major American corporations.

I would now like to turn to some of the comments made by Speaker Karcher before the Committee. In his remarks he challenged anyone to tell him that there is any public exposure, public participation, or public discussion about the investment policies of

the State. This is an easy challenge to answer. For over 34 years the Division has published monthly transaction reports showing all transactions, commissions, and vendors. This report is distributed to the Legislature, the Executive, and to the general public. The report is distributed to the public upon request and without charge. At present, the report is distributed to over 300 members of the public. Furthermore, the Division's books are audited every year by independent auditors, and the Council issues annual reports for the Division and various other funds under the supervision of the Council. All of these reports are provided to the public at large. Furthermore, all meetings of the State Investment Council are publicly advertised and are open to the public. Finally, all Council regulations are published in the New Jersey Register and are subject to the legislative review process. I should note that in the 14 years that I have served on the Council, no legislator has attended our meetings and, to my knowledge, none have ever spoken to any member of the Council or any member of the staff of the Division.

Finally, I would like to take issue with the statement that the pension funds are the greatest "we" have. In my view, the assets of the pension funds do not belong to anyone but the policemen, teachers, firemen, judges, and public employees who are beneficiaries of those funds. Each of those funds is a separate entity, under the direct supervision of their respective pension fund boards. These boards consist of members elected by their respective memberships, as well as public appointees. I hope you take note of the letters from each of the major pension fund boards, attached hereto as Appendix 1, which are unanimous in their opposition to Bills A-1308 and A-1309.

I would like to turn now to a discussion of other issues raised by Mr. Karcher and other speakers at the previous hearing and in public statements.

The first of these issues is the question whether or not there is a "capital gap" in New Jersey for "development" investments which cannot find financing but which offer comparable risks and returns of the marketplace. If there were such investments in New Jersey, certainly the Council and the Division would be interested in

reviewing them. However, none came forward when the opportunity was presented in recent hearings of the Pension Study Commission. Furthermore, it may very well be that none exist, since the premise poses a "catch-22" situation. A 1981 report by Governor Byrne's Task Force on the Use of State Pension Funds to Further Economic Growth in New Jersey, which is attached to this report as Appendix 2 aptly described this situation:

"Any investment offering a competitive return at an appropriate level of risk should be able to attract the necessary funds without any special consideration from the State Pension funds; if, on the other hand, the investment cannot attract such funds, then, almost by definition, it must be offering a return that is not competitive, and pension funds committed would involve the kind of implicit subsidy we said earlier was inappropriate."

The issue of the "capital gap" was also addressed in 1981 by Governor Byrne's Task Force, which specifically discussed investments in State and municipal agencies, housing instruments, direct loans to New Jersey businesses, and venture capital, and other equity investments. The report concluded that capital markets already appeared to serve New Jersey in these areas, and, lacking empirical evidence to the contrary, the report stated:

"It is clear that we are generally skeptical about whether significant new investment opportunities really do exist to encourage further development, without compromising the primary objective of the pension funds. As a general rule, we believe that the normal capital markets are usually the best vehicle for meeting the various capital needs in the State, without any special underwriting from State pension funds."

The "capital gap" issue was addressed again in 1984 by Governor Kean's Pension Study Commission. The Investment Subcommittee of this commission reviewed "socially mandated" investments, which provide concessions in rates and terms for the social purposes, and "socially sensitive" investments, which assume that social goals can be combined with investment goals when "all other things are equal": that is, that such investments can be made without sacrifice or return,

risk, or other terms, which is the premise that underlines Bill A-1308. The Commission found that there was a lack of quantitative support for socially sensitive investments and that certain mortgage programs which had been made on this premise in various states were all concessionary. The Commission concluded:

"In summary, on the issue of social investment, the subcommittee believe that only economic considerations should be taken into account in the investment process, except in those cases where non-economic criteria have a bearing upon economic considerations and in those few, simple cases where it is clear from the outset that all other things are equal.' Socially dictated investment is a violation of the fiduciary trust which the subcommittee believes is a foundational element of public policy. Socially sensitive investment is generally inappropriate because there are so few cases in which investments taking non-economic criteria into account can be made without sacrifice."

Pages 300 through 303 of the Commission's report on investment, which deal specifically with "socially sensitive" investments, are attached hereto as Appendix 3, and the rest of the report is included by reference.

Professor Richard R. Spies, Associate Provost of Princeton University, who served as a member of both the Byrne and the Kean commissions, wished to have an opportunity to speak before this committee at its July meeting. Unfortunately, the committee's schedule did not permit him to speak at that time and his teaching duties do not permit him to appear before you today. However, he has prepared testimony, which is attached hereto as Appendix 4, which speaks to Bills A-1308 and A-1309. In his testimony, he notes, in part:

"First, I believe that investment decisions which are based in part on secondary objectives such as the in-state economic development or South African divestment always -- and I emphasize the word always -- result in some compromise in the primary objective of achieving the best overall economic return consistent with approval levels or risk. The second point I would like to make is to urge you to consider carefully the very real costs -- in terms of the time and

expense of fund administration and in terms of lower long-term investment returns -- of introducing short-run political considerations into the investment process. In my judgment, the current structure of the State Investment Council represents an excellent balance between the need, on the one hand, to permit public accountability and encourage socially responsible behavior, and, on the other hand, the advantages of an investment process which is independent of local political and business pressures."

In summary, I believe that the existence of a "capital gap" for "development" investment under fair market terms is not documented and may not exist. However, the Council is always willing to review specific investment proposals which address these gaps and to consider them favorably if they meet fair market terms.

I would like to turn next to the issue of whether or not the provisions of Bill 1308 would provide investments which offer "a risk, rate of return, opportunity or other condition of investment which is equivalent to, or more favorable than, an alternative investment decision that is not in accordance with the supplementary principles." Other commentators have already spoken to this issue in general, as I have already noted. However, a review of the specific supplementary principles indicates that concessions are inherent in the principles. The principles appear to sharply increase the prospective risk of the pension fund portfolios by excluding investment in the highest quality U.S. Government and corporate debt securities and the equities of successful and stable corporations which are not in New Jersey. Risk is increased by directing investments to smaller businesses and new enterprises and by eliminating income standards for mortgages. Diversification is reduced by limiting the economic exposure of the pension funds to only one State in the nation, precluding investment in successful enterprises which may be indigenous to other areas.

Furthermore, there is empirical evidence that investment directed towards the "Supplementary" Principles can result in loss of income and principal. The Urban Loan Authority was established in 1969, with the purposes, among other considerations, of developing urban areas, providing employment, funding new and expanding business

and mitigating the effects of discrimination. The loans were to be made to persons who were qualified to run their businesses and who could not find other funding -- in other words, to fill a capital gap for viable businesses. Unfortunately, the press reported that the default rate on the loans was 81% and that political considerations and management adversely affected investments. The authority was closed down in 1978.

The Economic Development Authority of the State is also provided with the ability to guarantee loans and make loans, all with a view to the viability of the enterprise, relieving unemployment and social distress, enhancing pollution control, rehabilitating industry and helping business expansion. However, the authority reports that since 1974, 29 out of 175 of the direct loans and guarantees are in default and that the authority has lost \$4 million on its loan and guarantee programs.

Thus, based on a review of the terms of the "supplementary" investment principles and a comparison of these principles with the investment guidelines of other State agencies, the Council believes that the "supplementary" principles would not permit investments which are "equivalent to or more favorable than" alternative investments. Furthermore, if there were true markets for such investments, the direction of so much capital into these limited areas without competition would only reduce the returns further. Finally, in my view, the appropriation of State moneys to fund social objectives for State agencies is perfectly proper, but appropriation of the savings of public employees for such purposes is a violation of trust. In addition, any sacrifice of income or principle would increase the payments required by the taxpayers to fund the pension plans.

I would like to state definitively that the Council is truly delighted to make investments which benefit the New Jersey economy, provided such investments meet the fiduciary standards provided by law and fair terms in the marketplace. Furthermore, the Council does take note of social concerns because such concerns often have financial implications. Conversely, it is apparent to us that a good corporate citizen is usually a good investment.

The following is a quote from the report of the Pension Study Commission:

"The State Investment Council policies already allow parochial interests in the form of 'New Jersey first' decisions to guide investments in those cases where all other things are equal; for example, in the competitive bidding of certificates of deposit of equal quality and maturity. Moreover, there are a number of cases in which non-economic criteria bear upon the economic criteria used in making investment decisions. On a number of occasions, the Division has voted a proxy against management in situations where it believed that management's recommendations would have an adverse economic impact on the company. These proxy votes have been made in a number of areas which are identified as 'socially sensitive' areas. Non-economic criteria do play an important part in the Council's decision-making process, but only insofar as they bear upon the valid economic factors which have to do with prudent decision-making. The commission endorses the current decision-making process of the Council in this regard because it allows for relevant considerations of a non-economic character to be taken into account without compromising the fiduciary integrity of the Council."

We are often asked how much of the Division's investments are in New Jersey. Unfortunately, it is not possible to give a meaningful answer to this question. About 40% of the pension fund investments are direct or indirect obligations of the U.S. Government. About 13% of the total investments consist of Government-backed mortgage pools. In the latter case, we used to make a special accounting of pools serviced by New Jersey savings and loan associations and mortgage bankers, but we found that these firms had expanded their operations into other states, and that the mortgaged housing was often elsewhere. The Council does monitor the number of New Jersey employers who are included on the Council's "Approved Common and Preferred Stock and Convertible Securities List." At the present time, there are 270 companies on this list. Of these companies, 68% have been identified as New Jersey employers. This percentage is probably low, since corporations may provide employment to anonymous subsidiaries. The

non-New Jersey employers appear to be regional banks, utilities and technology companies, railroads, and retail chains, which have been added by the Council to provide diversification. If A-1308 is enacted it could exclude as much as 95% of the companies on this list, leaving only those which have their headquarters in the State.

Finally, most of the Division's investments are made in secondary markets, where the Division's funds are transferred to unknown sellers. Even in the case of direct investments, a local corporation may well use the Division's investment to finance out-of-state plants and equipment.

One of the primary social concerns which has been addressed by the Council over the years is the provision of mortgage funding for housing in New Jersey. The Division does purchase substantial amounts of U.S. Government guaranteed mortgage pools. All are purchased by competitive bidding and New Jersey mortgage bankers are always given preference in the case of a tie bid. However, if we do not purchase such securities, someone else will, and so we are not adding to the funds available for mortgage investment. All the the Division's mortgage purchases must conform to fiduciary standards set by the Council, which set quality and risk parameters and require fair market pricing. With these standards in mind, in 1982 we carefully reviewed a New Jersey mortgage program called Jerseyshares, which would have provided a \$1 billion pension fund investment in a pool of conventional New Jersey residential mortgages. Notwithstanding the obvious public appeal of such a program, we had to decline the investment. The program provided a two percent rate concession below the market rate available for high quality GNMA mortgage packages, and the pension funds would have suffered a loss of income which in present terms would have been about \$160 million on the proposed investment of \$1 billion. This shortfall would have been borne by the taxpayers over time.

By contrast, the Council subsequently reviewed a complicated in-State mortgage program developed originally for the state of Minnesota, and we agreed that the plan was feasible and fair, and that it would be appropriate for the pension funds to invest in a similar plan in New Jersey.

Furthermore, the staff of the Division is presently working with the New Jersey Builders Association on an innovative program to develop pools of collateralized mortgage obligations which would provide fair market rates and invite investment by the Division.

The Division has never made investments in companies which had truly flouted social conscience, such as JP Stevens, which battled unionization for many years. In such a case a poor citizen is also a poor investment from a financial point of view.

The Division is also very careful to evaluate social issues in the voting of its proxies. It reviews information published by all interested parties and has met with numerous social activist groups. The Division has consistently supported shareholder proposals to limit sales to the South African military or government. Similarly, the Division has supported shareholder proposals to require standards for the marketing of infant formula in the Third World. In all cases, it appeared that such stockholder proposals could have a significant positive financial effect on the companies.

In 1979, the Corporate Data Exchange published a Social Audit of Pension Funds. The report reviewed the equity holdings of major pension funds throughout the United States, and identified their investments in corporations which were deemed to be social violators. Such corporations were deemed to be non-unionized, OSHA violators, EEO violators, or active in South Africa. In that study, New Jersey was ranked first out of 20 state pension funds included in the study, with the lowest percentage of investments in such socially objectionable companies. The relevant table published by the Corporate Data Exchange is attached as Appendix 5.

It appears that the proposed bill would require large classes of securities to be liquidated. If the bill is construed to exclude all obligations of the U.S. Government and its agencies, as well as companies which are not headquartered in New Jersey, then as much as 95% of the pension fund portfolios would have to be liquidated. At June 30, 1984, the market value of all pension fund holdings was about \$1.1 billion less than the cost of the holdings. Consequently, any such liquidation would result in substantial losses, which under the

premises cited above could approach \$1 billion. Any losses of this magnitude would immediately increase the unfunded liabilities of the pension plan systems. These are funded over 40 years, so that the cost to the taxpayers of \$1 billion in losses would be \$25 million per year. The bill does provide for a two-year period to accomplish the liquidation, but even after two years, substantial amounts of the low coupon bonds would have to be liquidated. These bonds were purchased many years ago before current high interest rate levels and before the Division was permitted by law to diversify into equities.

Furthermore, the proceeds of the liquidation would have to be reinvested according to the "Supplementary" Principles, and the additional risks of such reinvestment, together with lesser diversification of the portfolios, could impose additional costs to the taxpayers over time.

As fiduciaries for the State public employee pension fund, the State Investment Council recommends against the enactment of Assembly Bill 1308. The bill would radically change the prudence law which relates to the investment of State pension plans and would greatly reduce the fiduciary protection for the savings and retirement benefits of public employees in New Jersey. Furthermore, control of investment policy would be shifted from a Council representing the beneficiaries and the public, to two legislators, the President of the Senate, and the Speaker of the Assembly. Such a shift would entirely exclude the direct representation of teachers, policemen, firemen, and public employees who are beneficiaries of the pension plans. Finally, as of June 30, 1984, the mandated liquidation of ineligible securities could have a cost of as much as \$1 billion, a cost which would have to be passed on to the taxpayers over time.

However, the Council welcomes the renewed interest of the Legislature in pension investment issues, and even if the bill is not enacted, would like to meet regularly with the appropriate committees of the Legislature to discuss pension investment issues. Furthermore, we would welcome any members of the Legislature to our meetings, and would be pleased to set up special meetings of the Council to discuss investment matters.

I would like now to deal with Assembly Bill 1309, which would require divestiture of the State Pension Fund from banks that have outstanding loans to South Africa and companies that engage in business in South Africa. This bill brings political issues into the investment process and could have serious adverse financial effects on investment risks and returns, retirement security of pensioners and the taxpayers of the State.

All members of the State Investment Council, as well as employees of the Division, are horrified at the behavior of the South African government, as is being reported daily in the newspapers. We as individuals believe apartheid is a ghastly political system which is ultimately doomed to failure.

However, State and national fiduciary law does not permit us to introduce subjective non-financial judgments into our investment decisions. As the son of a Hungarian immigrant, I might harbor prejudices against any company that does business with Russia. Similarly, Director Machold is a Quaker, and as a pacifist, he might resist investments which make armaments. However, the law does not permit us to exercise subjective judgments.

Similarly, it is not for the Council to make judgments as to whether the people of South Africa will be helped or hurt by such divestment or whether divestment would have any influence on the government of South Africa. These organizations and persons can speak for themselves.

However, we do make judgments as to the financial significance of a company's operations in South Africa and the potential financial effects on the company as a whole of a company's activities in South Africa.

Before proceeding with an analysis of Bill A-1309, care should be taken to define what it means to "invest" in South Africa or to "engage in business" in South Africa. The Division of Investment makes no direct investment in South Africa. All investments of the Division are made in government or private entities in the United States with the sole exception of less than two percent of the portfolio of Canadian governmental debt. Furthermore, virtually all

purchases of securities are made in secondary markets and the funds of the pension fund are merely transferred to another unknown investor in the secondary market. To our knowledge, no pension fund moneys flow directly, or even indirectly, to South Africa.

Nevertheless, American corporations do engage in commerce throughout the world, and may directly or indirectly "engage in business" in South Africa. No major corporation has a material portion of its business in South Africa. The Securities and Exchange Commission requires disclosure of any material business in a foreign country, and material is defined as at least 10% of sales, assets, or income. We know of no major United States company which meets this level. However, many corporations "engage in business" either directly or indirectly with South Africa, since corporations can operate through foreign affiliates or even independent third parties. The definition of "engaging in business" is unclear in the bill. For the purpose of our analysis we have used a list provided by Investor Responsibility Research Center, sometimes called IRRRC, a nonprofit organization supported by various church and education groups. This list consists of companies with subsidiaries or affiliates in South Africa. This list numbers about 400 corporations, but of necessity, it may omit many other corporations which either intentionally or inadvertently "engage in business" with South Africa through intermediaries. Any legislation or policy statement should carefully define "engage in business" in South Africa in such a way that targeted companies can be unequivocally identified.

As was noted before, the IRRRC list of companies with affiliates or subsidiaries in South Africa numbers about 400. Of these, 104 are companies whose securities are either held by the Division or are eligible for purchase by the Division. Such holdings could consist of stocks, bonds, or commercial paper. A list of 103 companies is attached as Appendix 8. The Division has holdings in securities in 69 of the 103 companies on the list. At June 30, 1984, the book value of the holdings in these companies was just short of \$2 billion, or 20% of the total book value of the pension funds.

A-1309 would have three potential adverse effects on the State and the State Pension Funds:

First, the exclusion of the companies on the IRRC list also excludes companies which are major New Jersey employers. All of the companies mentioned above are New Jersey employers. The aggregate holdings of the companies active in both South Africa and New Jersey is identical. In percentage terms, of all the Division's holdings of companies active in South Africa, 100% are also New Jersey employers. These companies include Johnson and Johnson, American Cyanamid, CPC International, Ingersoll Rand, Merck, Schering Plough, Corning Glass, DuPont, Exxon, FMC, General Electric, General Motors, Heublein, AT&T, Marriott, IBM, McGraw Hill, Minnesota Mining, Mobil, The New York Times, Owens Illinois, Pennwalt, Perkin Elmer, Philips Petroleum, Raytheon, R.J. Reynolds, Squibb, Texaco, Union Carbide, United Technologies, Westinghouse, and Xerox. All of these companies employ at least 1,000 people in New Jersey or are headquartered in the State. Furthermore, many of these companies are known as good corporate citizens.

Personally, it is difficult for me to believe that our State would take an official action which would blacklist a company such as Johnson & Johnson, which has done such an outstanding job in assisting the renovation of New Brunswick. As a citizen of the State, I am concerned that if this bill sends out a message to these companies that they should not invest in South Africa, it might also send a message that they should not invest in New Jersey.

Second, a forced divestiture of the pension fund holdings of companies engaged in business in South Africa would incur immediate losses to the pension funds, losses which would have to be borne by the taxpayers over time. For example, using market prices as of June 30, 1984, the net realized loss, which would be added to the pension funds' unfunded liability, would have been \$65.3 million. This addition would be amortized over the 40-year funding period for the pension funds and would cost the taxpayers about \$1.6 million each year for 40 years. These losses would be realized in large part on low-coupon bonds which were purchased many years ago before the current high levels of interest rates and before the Division was permitted by State law to make substantial commitments to equities. Furthermore, some of these

securities mature in the next century, so that any sale before maturity would realize a loss if high interest rates persist.

Third, the elimination of companies which engage in business with South Africa would sharply limit investment alternatives available to the pension funds, and consequently potential long-term investment returns would be limited. Although there are many other companies in which to invest, the excluded companies represent over 50% of the market value of the S&P's 500, which provides a broad proxy for the stock market. The disinvestment requirement would inhibit investment in preeminent and dynamic companies, companies which offer the highest quality debt securities, attractive equity securities which will at times provide superior returns to the pension funds, and the highest rated short-term corporate investments.

A diversion of State pension funds to smaller domestic companies might be able to provide a high return at times, but only with the assumption of increased risks, reduced diversification, and increased transaction costs. In Fiscal Year 1983, stocks of smaller companies provided outstanding returns; however, in Fiscal Year 1984, such stocks did very poorly and stocks of larger international companies with South African affiliations did much better. In a portfolio as large as our pension funds, it is not possible to switch easily from one type of stock to another, and wide diversification is required to maximize investment opportunities over time and to minimize investment risk. Assembly Bill 1309 would limit portfolio diversification by excluding potential investment in over three-fourths of the equity markets for companies in the drug, chemical, international oil, industrial equipment, automobile, and office equipment industries.

A prohibition against investment in companies which do business in South Africa would also increase the risk of our bond portfolio, which constitutes two-thirds of the market value of the pension portfolios. If the law were enacted, the Division would be precluded from investing in 52% of the top rated AAA and AA industrial debt obligations. Finally, a prohibition against corporate issuers of commercial paper who engage in business in South Africa would eliminate

75% of the P1 rated issuers, and moneys diverted to treasury bills would provide lower returns.

Assemblyman Willie Brown wrote in The New York Times that a South Africa free portfolio could provide better returns for the pension funds. He cited Franklin Research and an economist from Shearson American Express. Furthermore, he referred to the experience of other state pension funds which have passed divestment legislation. In addition, Dr. Marcy Murningham of Mitchell Investment Management Company related the experience of the State of Massachusetts, which divested \$91 million of affected securities.

After reviewing these statements, I believe that they barely touch upon the issues which are raised by divestiture. Furthermore, I have reservations regarding the qualifications of those who have advocated divestiture, insofar as large-scale investment portfolios are involved.

Up to this date, no material has been presented to this Committee from Franklin Research, and the firm is not listed in The Directory of Pension Funds and Their Investment Managers. The same problem exists regarding Dr. Murningham's firm.

Mr. Moffett from Shearson American Express characterizes himself as an investment advisor and money manager. However, he has not indicated the size of portfolios he advises or manages. Now, Shearson is one of the largest money managers in the country, both directly and through its subsidiaries, Boston Company, Balcor, Bernstein McCauley, and IDS, but Mr. Moffett has no responsibility for Shearson's professional money management. His testimony does raise the issue of the effect upon returns of divestiture, and he discusses transaction costs, but only in terms of commissions and not in terms of market impact. He touches lightly on the question of additional risk, and cites a number of other studies to support his views, none of which pertain to the portfolios of the State of New Jersey, nor have been made available for our review. We inquired of his firm whether he was a spokesman for Shearson and received a letter from Shearson setting forth the firm's official view regarding divestiture. I quote from that letter:

"We believe that a forced restriction of portfolio purchases and forced divestment of restricted securities could seriously impair the ability of money managers to effectively manage, thereby placing them at a disadvantage in the marketplace. We estimate that one-third of the universe of corporate bonds and a high percentage of the universe of equities that we would potentially recommend to pension plans would be eliminated. The result is that our universe would be substantially reduced, curtailing opportunity, and probably causing liquidity problems at the time of purchase and sale. Under these circumstances, we anticipate that a deviation in performance from nonrestricted portfolio managers could result. It is important that we act responsibly, and we respectfully suggest that restricting portfolio managers and money managers will probably yield poorer results for large portfolios compared to those which are unrestricted." The letter in question here is attached to this report as Appendix 10.

The experience of other states in evaluating the effects of South African divestment is also of great interest to the Council. Several other states, including Massachusetts, Connecticut, and Nebraska, have passed legislation requiring divestiture. In addition, the cities of Washington and Philadelphia have passed divestiture legislation. In the case of Washington, the City commissioned a lengthy report from Meidinger Asset Planning Services, and the conclusions of that report will be discussed subsequently in this testimony.

It should be noted that the pension funds of New Jersey are many times as large as the funds of Massachusetts, Connecticut, Washington, or Philadelphia, and that any disadvantages of divestment will be magnified. In the case of the City of Washington, the amount of potential divestment by New Jersey would be 25 times as great as the \$80 million divested by that City.

Appendix 11 attached hereto provides a listing of legislative actions in other states on South African divestiture bills. The appendix shows that a South African divestiture bill was defeated in Illinois and reported out of committee unfavorably in Maryland. Furthermore, the legislation died in committee in 17 other states and

is still pending in 11 other states. Also, a voter initiative failed in California.

The State Investment Council believes that divestment cannot be effected without significantly changing the prospective return, risk, diversification, and liquidity of the pension fund portfolios. Furthermore, on balance, these changes would be adverse to the pension fund beneficiaries.

In our analysis of the effects of South African divestment, the very size of the New Jersey pension funds, together with the necessity of diversifying the pension fund holdings, dictates that we consider whole universes of securities and not individual stock and bond transactions. The analysis is not as simple as saying that the elimination of 400 companies will still leave another 5,600 companies for investment. Unfortunately, the 400 excluded companies dominate the aggregate markets for equities, and provide the great majority of high quality short-term and long-term debt investments. Furthermore, their securities offer less risk and lower transaction costs.

We have been provided an academic analysis of divestment by Wilshire Associates; this is attached as Appendix 7. An analysis of the New Jersey equity portfolio prepared by Trinity Investment Management Corporation is attached as Appendix 6, and excerpts from an analytical work provided by Meidinger Asset Planning Services, Inc., which was prepared for the City of Washington, are attached as Appendix 9.

Wilshire Associates is the most respected quantitative analytical investment consultant in the country. Their clients include the States of California, Oregon, Virginia, and Maine, and over 200 corporations, universities, and foundations. In addition, Wilshire directly manages over \$1.4 billion of state pension fund moneys.

Trinity Investment manages \$250 million of accounts, including a \$10 million South Africa free fund for Michigan State University.

The Meidinger Report is significant, since it is the only substantial professional analytical report which, to our knowledge, has analyzed a public pension fund to evaluate the effects of divestment.

All three firms conclude that divestment from companies engaging in business in South Africa would have adverse financial impacts on portfolios as large as the public employee pension funds of New Jersey.

I would like to summarize briefly for you the remarks of these firms, without resorting to the complex investment jargon of the investment world. Wilshire Associates, a leading consultant on the quantitative analysis of investment universes, has prepared an article on the financial effects of South African divestment. This article has not yet been published, but I think it will be published in the Financial Analyst Journal next month. They have kindly permitted me to use this article in my presentation. The article, as I mentioned before, is attached as Appendix 7. In brief, it indicates that:

(1) Using the weighted market value of common stocks, a South Africa free investment universe would eliminate over 50% of the market value of the S&P's 500 companies and 35% of the market value of the Wilshire 5,000 companies;

(2) Investment opportunities would be reduced by over 75% in industries such as industrial equipment, drugs, office equipment, international oils, chemicals, and automobiles;

(3) To try to maintain diversification in the industries in (2) above, GE would have to be replaced by Dover, Kodak by Xidex, IBM by Commodore, Exxon by Murphy Oil, etc;

(4) A universe of smaller, riskier companies could produce the same or higher return over the long term, but the returns would be more volatile. In the year ended June 30, 1984, the largest 500 stocks were down 6.6%, but the second largest declined 15%;

(5) The risk, measured by volatility, of a SAF portfolio would be 8% greater than the S&P's 500;

(6) The risk, measured by industry diversification of a SAF portfolio would be 3% greater than the S&P's 500;

(7) The risk, measured by incremental industry concentration, of a SAF universe would be at least 2% greater in the telephone, utility, and domestic oil industries than in the S&P's 500;

(8) The risk, measured by Value Line's safety ratings, would be 16% greater in a SAF portfolio than in the S&P's 500;

(9) The transaction costs, including commissions and market impact, for a portfolio of our size, would rise from 4.6% to 7.3% of the aggregate value of transactions, an increase of 2.7%. Last year, the Division of Investment executed \$2.9 billion of stock transactions for the pension funds, and the incremental transaction costs of a SAF universe would have been \$78 million by that calculation; and,

(10) Higher research, administrative, and custodial costs could be expected for a South Africa free universe of stock.

Regarding bonds, they point out that:

(1) The universe of available corporate debt rated BAA or better would decrease by 35% in a SAF portfolio;

(2) The corporate debt issuers with ratings of AA and AAA would be reduced by 52% in a SAF portfolio; and,

(3) If higher quality government debt is used to replace ineligible corporate debt, then lower yields will result.

Regarding cash management, they point out that:

(1) In a South Africa free portfolio, the number of eligible highest rated P1 rated companies would be reduced by 78%; and,

(2) In a SAF portfolio, the CD's of 77 banks would be ineligible, which would reduce competition and prospective returns.

Wilshire concludes its analysis with the following statement:

"Divestiture restrictions on companies that do business in South Africa can have substantial impact on investment management activities of large portfolios. In general, the effect will be to increase investment risk, reduce investment and diversification opportunities, and increase the costs of research, trading, and administration. The larger the fund, the greater the impact to be expected."

Trinity Investment Management has managed a \$9.6 million South Africa free portfolio for Michigan State University, and the portfolio has had outstanding returns. Consequently, we asked Trinity whether their experience could be applied to the portfolios of the State of New Jersey. Their reply, in the form of two letters, is attached as Appendix 6.

I will not quote their quantitative analysis, other than to note that their work confirms the analysis prepared by Wilshire. They have also provided an interesting analysis which confirms the negative impact on transaction costs by calculating the sharp increase in trading days and related market exposure for the stocks in a SAF portfolio.

They also provide an interesting analysis by ranking the aggregate market values of all of our eligible stocks and dividing these weightings into 13 equal categories, which in effect creates the same statistical profile as a deck of playing cards. By eliminating companies associated with South Africa, the pension funds would lose the use of 17 cards, including half of the Aces, Kings, Queens, and Jacks, and would have to compete against other investment managers who had access to a full deck. I, for one, would hate to play poker under those conditions.

In answer to our question about the Michigan State portfolio, Trinity replied as follows:

"We are both proud and pleased that we have been able to serve MSU so well.

"But, we would be professionally negligent, if not downright misleading, if we were to tell you -- or let you infer -- that we would have done as well with New Jersey's \$3.5 billion in equities as we have managed to do with Michigan State's mere \$9.6 million.

"Quite the contrary. In our judgment, based on our day-to-day experience of identifying undervalued stocks within the limited South Africa free universe, and then going into the market to buy them, we are convinced that what we have been able to do with Michigan State University's portfolio could not be translated into much larger portfolios, such as the New Jersey portfolio.

"I don't have to tell you that when you manage billions of dollars in an equity portfolio it is much more complicated than simply finding undervalued stocks that are going to outperform the S&P's 500."

Meidinger was asked by the City of Washington to do an in-depth study of divestment of South African-related securities from the City's pension funds. They published a 144 page report, which I

will spare you; however, I have attached hereto, as Appendix 9, the pages which summarize their conclusions.

Their study confirms the conclusions of Wilshire Associates regarding risk, return, diversification, and transaction costs. Their final conclusion is set forth below:

"We believe that imposing the restrictions of the proposed South African law would be detrimental to the investment managers' ability to meet their objectives, would cause the Fund to be more volatile and hold securities of lower overall quality, could reduce future Fund performance and, consequently, cause the District to have to increase contributions (taxes) and/or reduce its ability to improve benefits in the future.

"From that standpoint, we recommend that the Board oppose the enactment of the law because of the implications for the Fund's investment program."

The Council has reviewed South African investment issues on numerous occasions. South African issues are raised annually on proxy voting, and the Council has consistently supported shareholders' resolutions against the sale of a company's products to the South African military and police. We believe that this decision is both a good financial decision and a good social decision.

The Division does review whether or not companies eligible for investment have subscribed to the Sullivan principles, and a company which is a Sullivan subscriber is regarded as a better corporate citizen and a better investment prospect.

Furthermore, on June 30, 1984, the pension funds had holdings in two extractive companies which had activities in South Africa. Our obligation was paid off on one, and the other, Newmont Mining, was sold. The sale was based on both financial reasons and concerns for the company's minority holdings of a mining company in South Africa, particularly since Newmont was not a Sullivan signatory.

Finally, the pension funds at the present time have no holdings of any company which is identified with South Africa which is not also a New Jersey employer.

The State Investment Council is charged by law with the fiduciary oversight of the investment of State-administered pension funds. The nature of their fiduciary responsibility is defined in both State and national law.

The Council has evaluated material presented to this Committee, including the appendixes attached hereto. The Council recommends against the enactment of Assembly Bill 1309.

In the Council's opinion, the divestment of pension fund holdings in corporations which engage in business in South Africa would have an adverse financial effect upon the asset holdings of the State pension funds. We believe that investment returns, particularly in investments in long-term and short-term debt securities, could be adversely affected. Furthermore, we believe that transaction costs for the purchase and sale of securities could be significantly higher, due to the prospective increased market impact of trading in more volatile and less liquid securities of corporations with smaller capitalizations.

Finally, we believe that divestiture would increase the investment risk of the equity portfolio of the pension funds. In the event of divestiture, the Council believes that even if equity returns can be maintained without incurring substantial additional risk, the additional transaction costs and the prospective replacement of corporate debt issues with obligations of the United States government would have an adverse affect on the pension funds of at least \$50 million annually.

Let me emphasize that the conclusions of the State Investment Council are based upon a financial evaluation of the effects of divestiture on the pension funds administered by the State of New Jersey, and the Council does not, in any way, condone the political system or the government of South Africa.

Thank you. I'm sorry that I have been so long.

ASSEMBLYMAN CHARLES: Well, that's okay, because I am going to impose on you a little bit. What I would like to do now is hear from Dr. Marcy Murningham. Following her testimony, I would ask that both she and yourself be available for some questions from Assemblyman

Franks, Assemblyman Brown, and me; also, Speaker Alan Karcher, who has joined us at the table. I think that way we can expedite the hearing. Perhaps many of the questions I would put to you, or that the others would put to you, will be addressed in the remarks of Dr. Murningham, and maybe her testimony will more sharply focus on some of the questions that we should perhaps put to both of you in connection with this issue. So, I ask that you remain until she has testified, and then I will call for questions from those at this table. Thank you very much, Mr. Keleman.

The next witness we will hear from is Dr. Marcy M. Murningham, Coordinator of Research, Mitchell Investment Management Company, Inc. Her responsibilities in this capacity are to examine corporate practices in the area of social responsibility. She has been involved with public policy and institutional behavior as a practitioner and scholar for the past 10 years. Dr. Murningham?

DR. MARCY M. MURNINGHAN: Thank you. Mr. Chairman and members of the Assembly State Government Committee: My name is Marcy Murningham and I am the Coordinator of Research — as you have heard — for the Mitchell Investment Management Company, Inc., an investment advisory firm based in Cambridge, Massachusetts.

I am happy for the opportunity to appear before you again as you continue to gather information this morning regarding the proposed divestiture and reinvestment legislation. I would like to briefly review the Commonwealth of Massachusetts' experience with the divestiture of state public pension funds with firms doing business in or with South Africa, even though I recognize that the Commonwealth's experience is with funds which are certainly much smaller than the New Jersey holdings. I acknowledge the point that was made previously; I think it is an important point to recognize. In doing so, however, I would also like to touch upon some of the assumptions and criticisms which typically underlie the design of the divestiture policy, and which have already been touched upon this morning as well. Without pretending to fully recognize the special dilemmas and subtleties affecting the management of New Jersey's public funds, I hope that my remarks serve a useful purpose in that they help to clarify some of your deliberations.

My intent is to demonstrate that the application of certain ethical considerations to investment policy need not have a detrimental effect on return, risk, diversification, and other standards of prudence. While greater care and caution may be necessary to carry out divestiture in a successful manner -- perhaps requiring the provision of necessary supplementary resources to investment divisions -- it can be done. In broader terms, I cannot resist noting that professional execution of a legislatively-determined policy is what we were all taught to expect from a properly functioning government.

To divest or not to divest is a question charged with beliefs about moral and ethical responsibility and is made more complex by competing claims of consequences. I think you are to be congratulated for seeking to take a stand against the injustice and iniquitous deeds occurring far beyond New Jersey's borders. Your challenge is to weave moral truth into the fabric of this State's investment policies without compromising or sacrificing your immediate responsibilities to people who have worked hard to serve the public interest. I am confident that you can meet this challenge and believe that government and the public interest are well-served by your deliberations.

In January of 1983, as many of you know, Massachusetts became the first state in the United States to ban investment of state pension funds in firms doing business in or with the Republic of South Africa. Included in the provisions of the law was the stipulation that divestiture occur over a three-year time period. While it turned out that divestiture occurred more rapidly than that -- deterioration in bond market conditions led to the investment decision to divest and reinvest all South Africa-related securities within one year of the law's passage -- this phase-in provision helped the state treasurer's office to maintain its prudence standards while adhering to the South Africa free policy. Giving investment managers ample time to dispose of existing excluded holdings was an important feature of the bill. Within the investment community, such a provision preserves the discretion necessary to make sound financial judgments. I note that a similar open-ended time frame is contained in the proposed legislation.

Prior to the passage of the divestiture bill, there were several legislative attempts in Massachusetts which were unsuccessful. By 1982, however, it became clear that there were moral and economic arguments persuasive enough to generate bipartisan support for the bill. In early January, 1983, the divestiture law was passed by a nearly unanimous House and Senate.

Adding to the impressiveness of this vote was the fact that it was an overwhelming override of outgoing Governor Edward J. King's veto the previous December. The state legislators did not agree with Governor King's contention that divestiture conflicted with the Commonwealth's fiduciary responsibility, and that a voluntary course of action was more desirable. They were more persuaded by the efforts and endorsements of over 100 labor, religious, and civic organizations, the impressive array of testimony provided at well-attended hearings, the support of the legislative leadership, and the conscientious work of the bill's cosponsors, state Senator Jack H. Backman and then state Representative Melvin H. King. On January 3, 1983, the Senate voted 23 to 5 and the House voted 233 to 2 to override the Governor's veto, thus enacting Chapter 669 of the Acts of 1982.

Affected by the 1983 law were stocks and bonds purchased before an earlier ban on South Africa-related investments went into effect. Budget amendments passed by the Massachusetts legislature have, since September 1, 1979, imposed South Africa free restrictions on new purchases. Therefore, the 1983 bill affected approximately \$91 million of teacher and state employees' retirement funds invested at that time in 43 banks and companies represented in the portfolio.

Rather than extending the "round trip" divesting and reinvesting process over the three-year period provided for in the legislation, the state treasurer's office moved quickly after the bill's passage. Within the first nine months of 1983, more than 75% of the \$91 million worth of investment -- primarily affecting fixed income securities -- affected by the Act were sold. Current coupon Government National Mortgage Association (GNMA) issues were purchased to replace those which were divested. By the end of 1983, all South Africa-related securities were sold by the Massachusetts State Employees' and Teachers' Annuity Funds.

I should point out here that the imposition of South Africa free restrictions on pension fund management was not the only change in statutory rules governing investment policy in Massachusetts. Last year, the general court passed legislation designed to revamp the funding and investment policies of the Commonwealth. This law, which was the product of a select committee chaired by Harvard professor and former United States Secretary of Labor John T. Dunlop, granted the state's investment committee broader latitude in the range of investments that could be made. Implementation of Chapter 661 of the Acts of 1983 served to buttress the provisions of the divestiture bill because, among other things, it removed certain financial investment restrictions which constrained the funds from achieving positive investment results.

I would like to make two points concerning the Commonwealth's experience with divestiture. The first is that during the two years prior to the Act's passage, the state's pension funds began selling South Africa-related securities. Approximately one-third of the South Africa-related portfolio was divested during 1981 and 1982. This was prior to the Act's passage. Without commenting on the intent of the investment committee's action -- it might have been in response to changing market conditions resulting in the lackluster performance of blue chip equity holdings at that time, it might have been in response to the greater attractiveness and availability of other financial vehicles such as mortgages and mortgage-backed securities, it could have been in response to the continued uncertainty in the economic climate and fluctuations in interest rates, or it might have been as a result of the anticipated passage of the divestiture legislation -- the point is, there was a sale of approximately \$40 million of securities, resulting in an income gain to the fund of approximately \$10 million. Whatever the intentions or motives of the investment committee, the point to be made here is that the Commonwealth was already embarking on a divestiture path. One concludes that this path was taken, not just for political and ethical reasons, but for economic and financial ones as well.

The second point to be made is that the Massachusetts pension funds were not adversely affected by divestiture. In spite of claims made by staff within the state treasurer's office that enactment of divestiture legislation lost the portfolio \$14 million -- due to the sale of bonds with a face value of \$78 million and the purchase of bonds with a face value of \$64 million -- there were, in fact, positive effects on the retirement systems. The pension funds enjoyed a \$16 million gain, unadjusted for inflation, and improved the quality of its holdings. Because I think a similar situation exists in New Jersey, I would like to take a moment to describe what happened.

As you know, bonds yield two types of income: (a) an annual coupon dividend; and (b), a payment that is received when the bond reaches maturity. According to figures prepared by the Federal Reserve, since 1960 corporate bonds have represented a sizeable proportion of the assets of many public funds, although the aggregate percentage of corporate bond holdings declined to roughly 38% in 1983. In recent years, public funds experienced poor performance in their debt securities because they had accumulated large stores of low-coupon bonds, purchased in the late 1960's and early 1970's, which depreciated in price when interest rates soared. These low-coupon bonds serve as an albatross on fund performance, and unless investment restrictions were liberalized -- as they were changed, referenced earlier, in this State -- to permit the purchase of corporate equities or other instruments, these low-coupon bonds often continue to be an albatross. There is a form of "bond swapping," however, which can be utilized, as was the case in Massachusetts with divestiture.

Since coupon income is taxable for taxpaying entities, many taxpaying groups will pay a premium for so-called deep-discounted bonds. This is because the appreciation in the value of the bond when it reaches maturity is taxed at the lower capital gains tax rate. Public pension funds are, however, tax-exempt institutions. As such, they do not benefit from the lower tax rates. In fact, there are no apparent reasons for tax-exempt entities to continue to hold deep-discounted bonds, as the annual income stream and redemption value are likely to be lower than that produced by nondiscounted, high-yield bonds.

In Massachusetts — and a similar situation appears to exist in New Jersey, given the high proportion of portfolio holdings in bonds — the pension funds, given market conditions, were holding bonds which were selling at well below par value. Through the sale of these deep-discounted bonds and using the proceeds to purchase higher-yielding bonds with similar maturity dates, the Massachusetts pension funds were able to improve the annual income stream as well as the quality of their portfolio holdings. The average weighted coupon purchased was higher than that which was sold. In addition, the average quality rating of the issues purchased was AAA, whereas the average quality rating of the issues sold was AA2, or third quality.

For the record, the treasurer's office reported earlier this year, in correspondence to Governor Michael Dukakis' office, that the net so-called paper loss incurred was \$11.7 million rather than \$14 million as was reported earlier, that this drop in value was due primarily to market conditions and not to divestiture, and that the bonds sold in 1983 would be worth 8% less in 1984, given further deterioration in the bond market. Through the sale of corporate bonds and purchase of United States agency securities — which was the primary method employed to implement the divestiture policy — the Massachusetts pension funds achieved a \$1.6 million per year improvement in the cash flow, based upon the \$64 million face value of the securities which were purchased. This represents a total income increase, before inflation, of up to \$30 million — an additional \$16 million more than the \$14 million drop in value — over the life of the bonds. If weighting for inflation, the amount of new money flowing into the retirement system is worth about \$8 million, although we know that that will fluctuate.

From what I can tell, there appears to be a similar situation in New Jersey's portfolio. Based upon reports from the Division of Investment, New Jersey's portfolio contains roughly \$1.4 billion in par value of corporate bond holdings. An analysis of the companies represented in these holdings shows that 33 or 34 are South Africa-related, representing bonds with a total face value of approximately \$635.5 million, a little less than 50% of the face value

of the total corporate bond holdings. Within this category of South Africa-related bonds, roughly \$135.5 million, or about 20%, have an interest rate below 7.5%. Current interest rates average between 11% and 13%. Of these bonds, approximately \$116.6 million can be considered discount bonds. In other words, it appears that within the category of South Africa-related bond holdings, about 19% are discount bonds. Should these bonds become replaced with a purchase of higher yield, South Africa free bonds, there could be improvement in the annual income stream to the fund. The quality rating of these bonds might be improved as well. In fact, given the predictions of many analysts that interest rates are likely to go up after the November presidential election, this may be an opportune time for such a transaction.

After reviewing the Commonwealth's experience with divestiture, I would now like to turn to some of the underlying premises pertaining to investment policy and divestiture and address some of the criticisms typically generated. My words should be taken in the spirit of reflection rather than representing a complete review of New Jersey investment practice. My perspective on the Garden State is from afar and I recognize that comparing investment patterns in each state presents a difficult task, given differences in the legal environment, funding status, plan characteristics, and the retirement board's interpretation of fiduciary responsibility. Nevertheless, there are some points I would like to make concerning the impact of the proposed bills upon the State's portfolio.

The core issue, of course, is the question of whether or not the application of nonfinancial considerations to public fund investments will result in any financial impairment. Still, should divestiture or other restrictions be imposed on large portfolios, will fund managers be able to continue their current risk/reward strategies to fund future benefits? Or, would some revision in investment strategy -- implying, perhaps, some revision in existing investment policy -- be required? We must remember, too, that the money does not belong to the trustees or the plan's sponsors, but rather to the members of the system.

At a broader policy level, there are other questions which are raised. What role does the public interest play in the investment decision-making process? Indeed, how should questions of ethics, morality, and public interest be defined and adapted to investment practice or to investment results? What attendant disclosure and accountability requirements are necessary? Do plan participants have a right to know about, or play a part in, financial management of these assets? What about the general citizenry? Should they play a role as well?

The immediate issues I want to address concern prudence standards and fiduciary responsibility, levels of risk and return, diversification, transaction costs and liquidity, and management style.

The first issue is the prudent person standard. Turning to the immediate questions of prudence standards, most of what public pension fund managers do is governed by a prudent person rule as well as, and this is true in Massachusetts as well as New Jersey, other kinds of restrictions, statutory restrictions or internal policy restrictions. In recent years, there has been a movement away from rigid prohibitions and toward more liberal restrictions on allowable investments. Even with these changes, certain traditional guidelines remain concerning investment choices and strategy. As with any sector in our society, it takes a while before new ideas become embedded in common practice.

Fortunately, the prudence standard is not an a priori measure. Rather, it reflects a prevailing view of prudence in society which varies from time to time. Since congressional passage of the Employee Retirement Income Security Act of 1974, prudence standards were further changed.

Instead of investments being evaluated according to some universal rational investor, ERISA allows investments to be evaluated according to their role in the total portfolio and according to the special characteristics of the plan. This allows for greater diversity in portfolio management strategy. In other words, investments which may seem to be excessively risky on their own may be quite acceptable and prudent as part of a well-diversified portfolio.

While ERISA does not apply to public pension plans, it strongly influences state and local definitions. In addition, recent court and regulatory interpretations indicate a recognition of the need to evaluate risk in terms of an overall investment strategy. This development is particularly relevant to state retirement officers who worry about compromising fiduciary responsibilities. In other words, current prudence standards need not be violated as a result of applying exclusionary criteria to investments. There is more latitude allowed concerning the type of assets that can be included in a prudently-constructed portfolio, a necessary precondition to the introduction of social policy considerations.

The second issue is the issue of risk and return. Another guideline and concern governing investment strategy and the divestiture debate is the appropriate level of risk and return. The rule of thumb is that higher risk usually produces higher return, and that public fund managers should accept higher risk only in exchange for a greater return. For several reasons, however, public funds are constrained from taking unlimited risk. Fund managers recognize that one way of alleviating risk across the entire portfolio is through a diversification of assets such as through the inclusion of alternative investments, including mortgage pools, commercial real estate, venture capital, or participation in the options and commodities markets.

To get technical for a moment, there are two measures of portfolio risk used by investment analysts. The sensitivity of a portfolio to changes taking place in the marketplace, usually represented by the Standard and Poor's 500, is described in terms of a "beta coefficient." The level of diversification among assets with different patterns of return, compared to the degree of diversification represented in the market, is described in terms of R-squared. The market, as represented by the Standard and Poor's 500, has a beta of 1.0 and an R-squared of 1.0. Guiding portfolio managers is the principle that a portfolio with a beta of greater than one is more volatile than the market, while a portfolio with a beta less than one is less affected by market movement.

These measures have been used by some analysts to predict the impact of divestiture on portfolio performance. Since by definition divestiture means the exclusion of companies doing business in or with South Africa, levels of risk and return need to be examined as they pertain to a universe of companies free of South Africa connections.

Since most companies on the typical divestiture list -- provided, as has already been mentioned this morning, by the Investor Responsibility Research Center or by the United States Consulate General in Johannesburg -- are concentrated within certain industries and represent over half of the capitalization of the Standard and Poor's 500, a challenge in creating a South Africa free universe is to include companies within certain industrial groupings which represent positive investment opportunity without incurring excessive levels of risk. Similarly, other industries, such as utilities, railroads, telephone, real estate, and energy extraction, are proportionately more highly represented in a South Africa free universe. Within these industries are companies with less of a worldwide market. As such, some say, they possess more risk characteristics which, in the view of many investors, are not as present in large international companies.

Put more simply, one interpretation of the portfolio effect of a divestiture policy is that it would increase the level of risk and, by implication, reduce the rate of return to the fund. According to some analysts using quantitative measures -- and Wilshire Associates has done this recently -- the market risk or beta of a South Africa free universe of companies is higher. One view determines it to be 8% higher than the Standard and Poor's 500. Additional estimates place the diversification risk level for the South Africa free universe at 3% higher than the Standard and Poor's 500, an admittedly modest differential since the alternative universe is also well diversified.

Other interpretations conclude differently on the issue of risk. Financial analysts from U.S. Trust, Shearson Lehman/American Express, the Boston Company, and the Council on Economic Priorities conclude that the beta coefficient of a South Africa free universe is proportional to the general market response. In other words, they say the risk level is average.

As with most statistical studies of controversial issue, results can be interpreted to suit a particular objective. Whether the South Africa free universe and, by implication, portfolio selections made from it, possess average risk or higher-than-average risk should not be taken out of context of the traditional relationship between risk and reward. This relationship, however, is not always stable or predictive.

As I have already alluded, during the 1970's the traditional relationship between risk and reward appeared to have broken down. According to figures produced by the Federal Reserve, the return on blue chip common stocks during this period fell below returns for lower-risk corporate bonds and Treasury bills. While stocks are currently outperforming corporate and government bonds, uncertainty in the economic climate continues. The performance of most long-term bonds is less than the rate of inflation and fluctuations in interest rates translates into increased market risk for long-term, fixed-income securities. In short, the conventional high-risk/high-reward relationship has yet to become reestablished. In an era of international commerce and with continued threats of international loan defaults and insurgency, the notion of country risk should be considered as well. These events affect, in some part, the volatility of certain industries and holdings.

Finally, discussions of risk and reward should acknowledge the retrospective character of any analysis. Past performance does not always forecast the future. The question of fund performance and the maximization of return — which is, after all, the primary goal — is more appropriately linked to the diversification of assets across investment categories, and that is the third issue to which I would like to address myself.

The notion of diversification has been long recognized by investment managers as a way of reducing risk within a portfolio. In general, though, diversification has been discussed primarily in terms of equity holdings. The previously-mentioned quantitative measure known as R-squared applies to the Standard and Poor's 500; so does the beta coefficient. Indeed, most money managers and investment analysts

devote their energies to the financial performance of certain industrial sectors and certain companies within those sectors, which further reinforces the view that risk can be reduced through a well-diversified selection of common stocks.

A major criticism of divestiture is that, since affected companies are concentrated within certain industries — the aforementioned industrial equipment, international oil, chemicals, drugs, motor vehicles, office equipment, and tires and rubber — severe constraints are created on investment strategy. Divestiture is viewed as leading to an incomplete exposure to opportunities, resulting in a diversification loss beyond the fund manager's control.

There are two counter arguments to this claim. One is that there are already likely to be restrictions on fund management which affect diversification, fund performance, and rate of return, with or without South Africa restrictions. There are two primary sources of such restrictions. One consists of legal limitations, which might, for example, limit the level or type of equity holdings or prohibit the use of alternative investments such as commercial real estate or so-called "development investments." The other type of restriction is managerial. In general, active portfolio managers concentrate within certain securities and sectors. These self-imposed managerial restrictions represent a rational way of coping with the vast amount of information available pertaining to domestic and international investment opportunities. In fact, only recently have money managers and investment advisers begun to recognize the superior return and investment characteristics available from a world portfolio. In short, a counter-argument to the claim that divestiture places undue restrictions on portfolio strategy is that a priori restrictions probably already exist which may circumscribe investment strategy more greatly.

A second response to the claim that adequate diversification is constrained is the point that asset allocation across investment categories, with attendant aggregate risk and return characteristics, is what affects plan participants and taxpayers. Diversification thus should be discussed in terms of the overall portfolio, not merely in

terms of that portion affected by divestiture. It is at this point that the proposed divestiture legislation and development investment legislation become linked.

As it now stands, the proposed divestiture legislation primarily affects roughly \$1.3 billion par value of New Jersey pension fund assets which are spread across four asset subcategories: commercial paper; corporate bonds; common stocks; and, certificates of deposit. The proportion/percentage of South Africa-related holdings within the equities category is about 35%, or roughly \$28.5 million from a total of \$86 million. Holdings affected by divestiture within the corporate bond category comprise roughly 47%, or \$635 million out of a total of \$1.4 billion. The divestiture effect is most pronounced in the commercial paper category, with about half of the \$732 million loaned to corporations doing business in or with South Africa. As you know, commercial paper is highly liquid and quite safe. It consists of short-term corporate IOU's which are issued in large blocks and usually designed to compensate for such things as seasonal earnings distortions or inventory irregularities. It is a very popular money market instrument used by money funds and large institutional investors.

Finally, roughly \$83 million is invested in certificates of deposit in banks which do business in or with South Africa. This represents about 20% of the certificate of deposit category.

In addition to divesting the relevant portfolio asset subcategories of South Africa-related securities and, presumably, identifying replacement equity investments with attractive financial characteristics, fund managers can shift assets to other portions of the portfolio. Should, for example, the South Africa free equity portfolio of the pension funds become comprised of stocks, let us say with small company high-growth stocks with higher levels of risk and return, averaging an overall beta of 1.2, the allocations to stocks might need to be proportionately reduced and shifted to a lower risk category, such as Treasury bills, if the overall portfolio risk level is to be maintained.

Legal restrictions governing the size and type of asset subcategories may need to be relaxed or revised to permit such transfers. Especially with the use of development investments, where greater systematic risk is likely to occur, the flexibility to shift to more conservative assets is necessary in order to maintain a fund's level of risk and expected return. Conversely, the proportion of allowable equity holdings may need to be expanded if a fund wanted to supplement more conventional stocks and bonds with higher-risk/higher-return equities. A key point here is that a pension fund's long-term return is a function of its systematic risk level, which is primarily achieved through diversification across asset categories.

I would like to make mention of transaction costs and liquidity for a moment, too. Another concern expressed about divestiture is the expense of carrying out the policy. Transaction, research, management, and monitoring costs are mentioned as being potentially excessive. Direct commissions to traders, market disruptions, any spread between dealer prices to buy and to sell, and the sale and purchase of additional holdings to optimize portfolio performance under the new restrictions -- all of these costs vary given the size of the trade. Trading in smaller companies is more expensive than trading in larger companies. Similarly, larger trade sizes lead to higher trading costs. Wilshire Associates' experts have pointed out that South Africa free replacements are significantly more expensive to trade than South Africa-related companies because of size. In the case of pension funds, commissions are usually brokered, with fees ranging from .25% to 2.5% of the market transaction.

A plain response to these concerns is the following: If a divestiture policy is carried out over an extended period of time -- and the proposed legislation provides an open-ended time frame for execution -- then the impact of transaction costs is reduced. Fund managers need this temporal form of discretionary authority so that portfolio turnover does not produce excessive administrative and trading costs.

As for research and monitoring costs, there is a growing body of knowledge and expertise concerning the management of a South Africa free portfolio. There are more financial advisers, utilizing modern portfolio techniques, who are capable of identifying appropriate substitutes for excluded securities and who have developed knowledge and expertise concerning investment alternatives. Much of this discussion of research and monitoring comes back to a financial adviser's screen and style. Especially in the current climate surrounding the financial services industry, client interest in applying a South Africa screen to its investments should yield a positive response from many reputable and well-established firms.

It should be pointed out, however, that not all financial management styles are equally affected by divestiture policies. Wilshire Associates notes that growth-oriented equity managers are less affected, but may have to contend with higher market risk and lessened diversification. "Core" managers who specialize in blue chip investments are affected more, and would need to identify replacement equities while maintaining target portfolio characteristics. With in-house management, the provision of additional resources may be necessary to effectively implement the divestiture policies.

On the other hand, given the tendency of most organizations — especially public sector ones, I might add — to underestimate the capabilities of employees, redeployment of current staff might yield the necessary expertise to implement divestiture. Similarly, staff capacity may already exist concerning the alternative investments contained in the development investment proposal. In addition, as this sort of investment approach is taking place in other states, there is an emerging pool of experience and expertise from which to draw.

The main point here is that whereas divestiture and development investment represent a departure from the routine of fund management, as policies they can be implemented providing the necessary resources are identified and mobilized.

To summarize, I have tried to indicate by my remarks here this morning the following points: A divestiture and development investment strategy, if cautiously carried out, can occur without

lowering fund performance and rate of return. When incorporating social policy goals within investment strategy, the overall investment structure and asset allocation may need to be restructured. I would like to make reference to the same report that was referred to earlier this morning, the draft article written by experts at Wilshire Associates, who conclude in their discussion of the effects of divestiture on large pension funds that-- They say in their final statements of the article that most large funds will find it necessary to alter their investment targets and restructure their investment process. Wilshire, and I quote, concludes by saying: "Funds which are contemplating divestiture need to weigh these considerations, and funds in the process of implementing restrictions need to move cautiously to avoid the risk, diversification, and trading pitfalls." In other words, the authors say that if carefully done, divestiture can occur.

Another point I would like to add is that fund managers, in terms of exclusionary policies, are probably already utilizing exclusionary criteria in their investment strategy to achieve the best possible rate of return. Another point is that there are probably internal and most certainly external resources which are available to help make the transition.

The final point I would like to make, and I think the most important point, is that the paramount responsibility is a fiduciary one.

This final point pertains, of course, to the question of accountability. Affected by these actions are not just plan participants, but taxpayers as well. The costs and benefits of portfolio performance are shared by taxpayers and retirement system members, and are affected by a number of characteristics of pension plan design and funding. Contributing, too, to performance are economic assumptions, legal factors, and certain policy decisions.

This morning, however, you are considering yet another set of factors which also pertains to the question of accountability. Recognition of the social and ethical consequences of investments, coupled with proscriptions on investments which represent a violation of simple justice and human rights requirements, adds a level of accountability which is long overdue.

We are entering a new era in our institutional life. Questions of ethics and social responsibility are discussed with greater frequency in board rooms and corner offices, at formal public meetings and informally, in day-to-day practice. More people in both the public and private sectors perceive the relationship between effective bottom-line performance and performance in the public interest. Contributing to this is the belief that our world is shrinking, and that our words and deeds have widespread, if not universal, implications. We must take a closer look at our parochial concerns.

The strategic inclusion of public interest criteria into fund management can produce multiple positive results. Through wise consideration of policy alternatives, you are fulfilling your responsibilities in a most conscientious manner.

Thank you for your consideration.

ASSEMBLYMAN CHARLES: Thank you, Dr. Murningham. At this time I would like Mr. Keleman to return to the desk. I am sure that there are some of us who have questions we would like to ask.

MR. KELEMAN: Would it be out of order for me to ask Roland Machold, Director of the State Investment Division, to join us?

ASSEMBLYMAN CHARLES: Not at all. He should come forward. We would be happy to have him accompany you.

MR. KELEMAN: I am a part time volunteer expert. He is the full time professional. I think he might be in a better position to answer some of the questions that you may have.

ASSEMBLYMAN CHARLES: Mr. Machold, welcome to the hearing.

ROLAND M. MACHOLD: I have been here.

ASSEMBLYMAN CHARLES: I know that. If you would like, you could make some statements, some independent testimony, for the record -- if you wish to -- as opposed to just listening or entertaining questions from those up here.

MR. MACHOLD: No, I'll join with Frank in this discussion.

ASSEMBLYMAN CHARLES: I think I would like to start off by just asking some very basic questions about the mechanics. What is the relationship between the Investment Council and the Division of

Investment? We have the Investment Council, which you are the Chair of. Then we have the State Division of Investment. What is the relationship between the Council and the Division of Investment? How do you get involved in effecting what the Division does?

MR. KELEMAN: I think a good analogy of that relationship would be the analogy that you could make with regard to the function of a Board of Directors in a company. The primary function of the Council is to establish broad policy; namely, it is the type of issue we are discussing today. We then have the responsibility of overseeing, maintaining surveillance of the operations of the Division to see to it that they are fulfilling the policies which have been laid down and, in a sense, measure performance in their effectiveness.

We also have the responsibility of seeing to it that there is an appropriate organization in place, including the Director, to function as an effective State Investment Division.

You might be interested in knowing the unique characteristic of the relationship between the Council and the Division which is quite different than any other body in the Government. The Director and the Deputy Director of the Division serve at the pleasure of the Council. They have no tenure of office and a vote of seven of the ten members of the Council can cause a dismissal of the Director and Deputy Director. In this respect, they have to satisfy the Council, as opposed to, for that matter, the Executive or the Legislature. This was a unique characteristic built into the law in 1950 when the relationship of the Council and the Division was established.

But in any case, getting back to the essential question that you asked, we have that responsibility of seeing to it that there is an executive and an organization in place to fulfill the requirements of the Division, establish its policy, and maintain surveillance that is being carried out.

ASSEMBLYMAN CHARLES: How often do you meet -- the Council I am speaking of now?

MR. KELEMAN: The Council meets six times a year, but we have an executive committee that meets in the intervening months so that there are 12 meetings a year of the Council and its committee.

ASSEMBLYMAN CHARLES: How many employees do you have in the State Division of Investment, and what generally are their titles?

MR. MACHOLD: Sixty-two.

ASSEMBLYMAN CHARLES: What are the titles of these 62 employees? What functions do they do? Is that secretaries and economists? Who are they?

MR. MACHOLD: They break down roughly into research analysts, traders, portfolio managers, cashier managers, bookkeeping, data processing, and pension fund accounting.

ASSEMBLYMAN CHARLES: Who manages the various funds? Is that somebody within the Division or do you hire some outside investment company?

MR. MACHOLD: All of the funds are managed internally. We manage the funds internally through the responsibilities of the portfolio managers under the direct oversight of equity and bond committees which are collegial organizations established internally for day-to-day decision-making.

ASSEMBLYMAN CHARLES: Who selects the managers of the different funds? Is that the decision of the Council?

MR. KELEMAN: It is done internally by--

MR. MACHOLD: (interrupting) Well, partly civil service. The portfolio managers are civil service appointees. All appointees of the Division, in fact, with the exception of the Director and Deputy Director are civil service appointees. We interview and screen people, of course, very carefully. We are fortunate in having some of the roles tightened more recently. On one occasion, about 10 years ago, a gentleman qualified for the job who had managed a petty fund account at Fort Dix and he was supposed to be our Common Stock Manager. The specifications, generally speaking, are certainly fair the way they are drawn now. They require actual hands-on experience of managing substantial amounts of money for fixed periods of years. So, our internal portfolio managers working in conjunction with the administration and the various departments are experienced people.

ASSEMBLYMAN CHARLES: How many portfolio managers do we now have?

MR. MACHOLD: Five.

ASSEMBLYMAN CHARLES: For the different pension funds?

MR. MACHOLD: No, they are not for the different pension funds. The focus of investment in the Division is through the common funds. Mr. Keleman remarked earlier on that the \$13 billion of investments that we have in the Division -- that includes, of course, not only the pension funds, but 84 other funds -- are divided roughly into three parts: Common Pension Fund A, which is the equity fund; Common Pension Fund B, the bond fund; and the Cash Management Fund. There are other individual funds which are invested according--

ASSEMBLYMAN CHARLES: (interrupting) So there would be a manager over the A Fund, the B Fund, and C Fund?

MR. MACHOLD: There would be managers of those funds. One of the funds right now is being managed by a committee, in the absence of a portfolio manager, who recently took a job at a higher salary.

ASSEMBLYMAN CHARLES: I have noticed that one of the concerns that the Council has is that this investment strategy, as proposed in A-1308 or the divestiture as proposed in A-1309, will, in your opinion, lead to a lesser rate of return on the funds, the portfolio. At present, what is the-- I know that the Council obviously is satisfied with the rate of return that the pension funds are now receiving under the management that is presently constituted. I assume it is. What is the percentage of return?

MR. KELEMAN: I would think--

MR. MACHOLD: (interrupting) The figures were quoted for 1983 at being 37% for the bond portfolio and 55% for the stock portfolio. This is extraordinary. This is way out of line with what traditional returns have been. And the percentile rank is like we discussed in Frank's memorandum. This year both markets are down. That is the reason why we were a little bit above break-even last year, and now we are about \$1 million-- \$1 billion below market, because the markets are down about 10%. The stock market is down; so is the bond market. The specific returns are calculated by independent organizations. The only figures we have so far to date relate to the stock fund. The Merrill Lynch figures should be coming in shortly. We will publish those with our annual report which is due in November.

MR. KELEMAN: May I-- I think the answer may be confusing to you, Mr. Charles, and I don't want to presume, but let me--

ASSEMBLYMAN CHARLES: (interrupting) Go ahead.

MR. KELEMAN: Roland Machold is speaking in terms of the return. In financial parlance, when they talk about return, they are talking about both market value and the actual yield -- dividends or interest which was paid. I think that your question was really what is our return on investment.

ASSEMBLYMAN CHARLES: That's it.

MR. KELEMAN: The return on investment last year was a little over 8% across the whole board--

MR. MACHOLD: (interrupting) This is the yield for the effective rate--

MR. KELEMAN: (continuing) -- I'm sorry, the yield. I'm confusing myself. The actual yield, this year-- We are in the process of auditing our books. It is about 8.4% or 8.5%?

MR. MACHOLD: About that.

ASSEMBLYMAN CHARLES: You gave some statistics in the course of your testimony where you cited what percentile each particular fund rated at. I think one seemed to be in the top 1%; one was in the--

MR. KELEMAN: (interrupting) In the case of the cash management.

ASSEMBLYMAN CHARLES: Yes. One was in the 55% or something like that. Is that correct?

MR. KELEMAN: Yes.

MR. MACHOLD: It was 49, I think.

MR. KELEMAN: The equity portfolio, one year, was in the 49, and the other year at 43th percentile.

ASSEMBLYMAN CHARLES: Is there any feeling among the Division or among the Council that there is a need for more staff or more other sorts of resources within the Division so as to give you greater research and other types of functions?

MR. KELEMAN: Mr. Charles, the Council has been deeply involved and concerned about this entire matter and has been involved in some fairly in-depth studies about the needs of the Division. We do

believe that we need beefing-up. The State of New Jersey's Investment Division operates in a cost-effective manner that is really unbelievable by people in the business. To be a little bit more specific, we have a line item in the budget of about \$1.8 million a year. I don't care what factor of overhead you wanted to put on it, and as a business, I look upon it. I would say that we are managing our funds. And, if I put 100% overhead on that figure, for \$3 million or \$4 million, and we are managing \$13 billion, producing \$900 plus million of income, I know of no organization in this country, private or public, that has that cost-effectiveness.

Now you made a comment a moment ago which I would like to address. Are we in the Council satisfied with our return? We will never be satisfied unless we get to the 100th percentile. We are constantly examining and reexamining performance, and we are exerting as much pressure as we possibly can, up to and including as to whether or not consideration should be given to the use of outside managers as opposed to the present exclusively internal management of the funds. We are not there yet to make recommendations. I might say that to do the latter requires a change in the law, which we are studying as part of our overall consideration.

ASSEMBLYMAN CHARLES: One of the things that occurs to me almost immediately, from what I gather, is that you see or you feel that to be compelled to subscribe to 1308 and 1309 would require a certain amount of research outside of the— You are excluding a lot of companies or whatever under the terms of 1308 and 1309. I am thinking that perhaps if you had increased staff or something like that, you may have a different view. It may be that your view would be that, with the additional people who could research the other resources that would be available to you, that you might be able to carry out your fiduciary responsibilities and still be able to comply with all the requirements of 1308 and 1309.

MR. KELEMAN: Mr. Charles, I think you are hitting it right on the head. We are giving consideration to that right now. There is an in-depth study internally which we hope to come forward with by the end of October. At that time we intend to go to the Treasurer and

review it with him to get an independent overview of what our studies are showing.

ASSEMBLYMAN CHARLES: So, it may be that—

MR. KELEMAN: (interrupting) This has nothing to do with 1308 and 1309.

ASSEMBLYMAN CHARLES: What I am trying to focus on or trying to clarify is whether or not the problem with 1308 or 1309 is not what is inherent in 1308 and 1309, but what might be limitations within your department by way of limited staff to implement the requirements of 1308 and 1309.

MR. MACHOLD: Well, the analytical work that was provided and discussed — Wilshire, Trinity, and Meidinger — in effect, talk to all outside managers, that is, address the universes that are served by all outside managers. I think it is true that if you were forced into a wider range of companies, particularly smaller companies, more research would have to be undertaken. But, I think that, in itself, isn't a determining factor. The conclusions of those reports go to the overall issues of money management and don't address whether or not additional people simply solves the inherent problems of the marketplace by creating different risk, diversification, and return levels. Nothing changes the returns that are inherent in those universes — the risks and the diversification inherent in those universes. We could have an army of a thousand people and those particular investment alternatives don't change their nature. So, when we talk about investment universes, it isn't more knowledge that solves the investment problem. The question of eliminating or adding specific types of companies remains the same because their characteristics remain the same.

ASSEMBLYMAN CHARLES: I have heard from the second speaker, the person who testified to Dr. Murningham that there are, I guess, models; there are people who have a different view about whether or not under the proposals of 1308 and 1309 you could achieve the same returns.

MR. MACHOLD: That is why we talked to Trinity. Trinity, in fact, does manage, in the case of 1309, a South Africa-free investment portfolio. We asked them whether their technology could be applied to

very large portfolios. They agreed exactly with the Wilshire Study and the recommendations of Meidinger. Meidinger interviewed over 140 managers because they have outside managers in the Washington system, and a very, very high percentage of them said that they felt the returns would be lower. And, they are not limited by staff limitations.

ASSEMBLYMAN CHARLES: I want to move to a different question at this point. It has to do with, Mr. Keleman, your testimony regarding what 1308 does to the prudent man rule. As I read it, it says, in Section 5, "It is the fiduciary responsibility of the State Investment Council to preserve the capital and realize the greatest possible return on investments commensurate with acceptable standards of risks and prudence for the pension funds under its jurisdiction. This responsibility shall be the primary and underlying criteria for its pension investment policies and practices." Then it goes on to identify some supplementary principles, ones which you commented on in particular. If that is indeed the language in this Section 5, is that really affecting in any kind of deleterious way the current standard under which you operate? Do you read that to mandate that you should do something other than be prudent in the way you invest public pension money?

MR. KELEMAN: I do. Roland, would you like to comment on how it would impact your decision-making?

MR. MACHOLD: Well, I can't— It would impact yours, before it would impact mine. The prudent man rule, as established first in common law and then established and codified in ERISA and in various state laws, is very specific. It has words of art and test of reasonableness, for example. These are not included in this language. The principle of loyalty is not included in this language, for example. It is unclear to me whether this language here replaces existing prudent man law. We are already under the prudent man law of the State.

ASSEMBLYMAN CHARLES: Let me interrupt you. Is that by specific statute or is that just common law?

MR. MACHOLD: No, this is by specific statute.

ASSEMBLYMAN CHARLES: What is the wording of that statute? It is similar to this, isn't it?

MR. MACHOLD: Frank referred to it in his testimony. No, it is not. It is just paraphrased here. I can read it from our annual report, Frank.

ASSEMBLYMAN CHARLES: Please do. I want to be able to compare the-- I have heard testimony at an earlier hearing that it is not intended at all to adversely affect or to diminish the obligations of the investors or the trustees under-- the managers, rather, under the prudent man rule. I want to find out where specifically it differs.

MR. MACHOLD: Let me read you that language. I don't have the legal reference at hand.

"All such investments conform to standards of prudence set by State law which mandate that the Division make investments in which fiduciaries of trust estates may legally invest. Such investments are further defined as investments in property of every nature provided the fiduciary shall exercise care and judgment, under the circumstances then prevailing, which persons of ordinary prudence and reasonable discretion exercise. The Council resolves, the Division is bound by law to make prudent investments for the sole and direct benefit of the beneficiaries of the various funds under the supervision of the Council, and that the Division may not make any concession as to rate, risk, or returns which would benefit any other party at the expense of the beneficiaries of such funds."

Now, going back over that language, the paraphrase that is in here does not mention the loyalty principle, the property of every nature, the exercise of care and judgment, under the circumstances then prevailing, and then the definition of ordinary prudence and reasonable discretion. Now, those words have meaning far more than they are simply in here. Every word in there has been litigated for, in some cases, centuries. So, a change from the very specific language in itself has very considerable meaning.

ASSEMBLYMAN CHARLES: Without getting into the particular language that is included in here and the language you have made

reference to, it seems to me that the single difference that I hear is the definition that you read that currently operative— It says "in every investment, in every type of investment." Just then would this here identify some types of investments which might be excluded in the current bill, right?

MR. MACHOLD: Well, it says "property of every nature." I'm not sure that that is exclusive.

ASSEMBLYMAN CHARLES: That is all inclusive; I mean the current definition. This definition, I think, tends to exclude certain types of investments or encourages certain other types of investment, but I think the critical part of all these investment statutes -- and you can correct me if I'm wrong -- is the obligation to protect the pensioners and to protect taxpayers. Is that correct?

MR. MACHOLD: That is correct.

ASSEMBLYMAN CHARLES: The particular investment that you involve yourself in is, to some extent, immaterial so long as you are protecting--

MR. MACHOLD: (interrupting) Most of it.

ASSEMBLYMAN CHARLES: (continuing) -- the pensioners and the taxpayers; is that not correct?

MR. MACHOLD: Yes. In other words, if we just had a little pocket that didn't count.

ASSEMBLYMAN CHARLES: Yes. If there were some investment opportunities out there that you could just put aside without at all affecting the rates of return, without at all affecting the pensioners' interest, without at all impacting on the taxpayers' obligations, then you would have no problem with--

MR. MACHOLD: (interrupting) No, we would have a problem.

ASSEMBLYMAN CHARLES: Excuse me, you would?

MR. MACHOLD: Yes.

ASSEMBLYMAN CHARLES: Why is that?

MR. MACHOLD: Dr. Murningham was discussing the whole plan theory of investing, and that is accurate in an overall description, but that does not excuse the individual in making investments, no matter what the potential return or risk is, that they should be

balanced. That is to say, for high risk investments, you should have a clear prospect of high returns; for low risk investments, perhaps lower. But, there is nothing in the law which says you can take a high risk or a speculative investment, without the prospect of that return. Now, this is a matter which I have addressed to Ian Lanoff who was first administrator of ERISA and he has provided to me a separate opinion on this -- he is now in private practice -- which he provided to the State of New York. This confirms the statement I just made, that all investments are subject to prudence, that the entire portfolio is also subject to prudence. In other words, even though we had \$10 billion, and I decided to take \$10 and go down to Atlantic City knowing that there would be no effect on the pension funds, it would be obviously imprudent for me to place that \$10 on red.

ASSEMBLYMAN CHARLES: Yes, I think everybody agrees with that. That kind of example obviously doesn't help in our discussion because we all understand that. It is my feeling, it is my impression that the supplementary principles are featured and are proposed as guides with the proviso that they should not create the kind of gambling risks that you just described in your example. You don't agree then that there are investments that could be made pursuant to the supplementary principles that might be considered reasonable and prudent investments?

MR. MACHOLD: I'm sure there are, but the question is whether or not they address the capital gap or not. Whether they would be incremental is something which Mr. Keleman addressed in his testimony. We very much would like to make any of those investments because they obviously benefit the State. But, what we actually see in practice is that the specific investment of the type identified there, which fills a capital gap, has not come forth. We don't exclude the possibility that it exists and we would certainly anticipate it and react favorably to it.

ASSEMBLYMAN CHARLES: I understand what you are saying. Perhaps the sponsor of the bill would have a further comment on it, but I think what you are saying-- It seems to me that you aren't saying anything different than what is proposed in the bill. It seems that

what the bill proposes is that you do invest, if you find a capital gap, if you find an investment opportunity that doesn't violate the prudent man rule, then you do it. If you don't find a capital market gap or if you find a gap which has a gambling or unreasonable risk associated with it, then you don't. It seems to me that the bill doesn't go any further than that.

MR. MACHOLD: Well, it does, because in effect it requires that all investments meet one of those standards. To that extent, we would have to divest ourselves of a very large amount of money and reinvest it elsewhere. Each investment has to meet one of those standards. I would guess that if it construed the words under the first or the second of the provisos, that they shall be "private entities located within the State of New Jersey,"-- You can construe that very narrowly as just to companies which are headquartered here in the State; then basically almost 95% of our portfolio would have to be liquidated, including all of the Government bonds. I don't think that is intended, perhaps, but certainly the reading of the law would take you to that conclusion.

ASSEMBLYMAN CHARLES: So what you see is that if the bill were amended to make it clear that you were not mandated to invest all of the portfolio in these types of investments, but rather to do that as supplements to just an overall investment program, then you would not oppose on the grounds we are just talking about.

MR. MACHOLD: Frank, maybe you can answer that.

MR. KELEMAN: Let me just read this sentence: "Each pension investment decision shall be made in conformity with at least one supplementary principle in each case where the relating resulting investment or divestment offers a risk rate of return opportunity or other condition of investment which is equivalent to or more favorable than." Now we have to find one of these that we conform with. I'm not so sure it is possible to do that in each and every investment opportunity without falling back on a sacrifice that may not be obvious or very objective.

ASSEMBLYMAN CHARLES: On 1309, I believe you stated in your testimony, Mr. Keleman, that you discussed at the Council the South

African question and the question of investing public pension moneys in South Africa. You specified too that you sent your proxy in support of resolutions opposing the continuation, I guess. What types of resolutions had they been, for example? Resolutions in different corporations -- what types of resolutions have you voted on?

MR. KELEMAN: We had that infant formula situation about six or seven years ago, which involved--

MR. MACHOLD: (interrupting) Three years ago.

MR. KELEMAN: Was it? I'm sorry. It involved most--

MR. MACHOLD: (interrupting) I am just going to make a prelude for Frank. Most resolutions deal with much more routine corporate matters when we are voting proxies.

ASSEMBLYMAN CHARLES: Yes, I know that, but I am just talking now about the South African situation.

MR. MACHOLD: Oh, just on the South African issue. They vary from company to company.

ASSEMBLYMAN CHARLES: Can you give me an example?

MR. MACHOLD: Well, I will give you one example, the one that we cited in here -- sales to the South African government and police. These obviously have a very high profile, and even though they are likely to be very small in financial terms, certainly characterize the company as a poor corporate citizen, not just in South Africa, but I think in the eyes of many people around the world. The same thing applied with the infant formula thing, which also dealt with Third World Nations, where if they had marketed or mismarketed their different formulas in such a way as to cause the death of children in those countries, it would have had an effect far greater than simply sales in a small West African country. It would have been a fact which would have been worldwide. The same as the thalidomide problem that came up years ago or the sales of a few boxes of Tylenol a little while ago. So, we regard those kind of issues which have substantial financial effect on corporations.

In South Africa alone, there are a great many resolutions. Some we have supported on the other side. I will give you an example of one that we have supported, so far as the management of it. That

would be Morgan Guaranty Bank. They have had a resolution for the last two years to the effect that they should not make any loans to South Africa. We wrote to them and asked them what the significance was because of the financial nature of it, obviously. Their significance was less than one tenth of one percent, in fact, less than one hundredths of one percent. But, more importantly, to us, the loans were made to support -- at least by their statement -- housing in black Africa. Now, we don't take for granted exactly what corporations tell us because there are people who are publicists on every side of every issue. In that particular case we checked it out with the recommendations of the IRRRC, which report to have an independent and objective stance on these matters, and it was confirmed with their recommendation. Each situation is quite different.

ASSEMBLYMAN CHARLES: In those situations where you sent your vote in support of resolutions that would limit investment by the corporations in South African companies, in situations where those resolutions have been voted down at shareholders' meetings, what has been the response of the Investment Council with regard to continuing its investments in those corporations?

MR. KELEMAN: Let me just put this into prospective. The Council does not--

ASSEMBLYMAN CHARLES: (interrupting) Does that question have an answer to it or can't it be answered?

MR. KELEMAN: Well, it can be answered, in the sense, that on our annual review of our so-called approved list of investments, it could and possibly would affect our continuation of them being on our so-called approved list. Now, I think it is important that you understand the role of the Council in this matter. Since we are, in a sense, a volunteer group that meets relatively infrequently, once a month, we have to rely upon the Division setting up a mechanism to handle this matter. In the case of proxy statements, we developed a policy going back seven, eight, or even ten years ago, that we would respond to all proxy statements. A great many investors just say, "If we we don't like it, we will get out of it," or "We will stay in it and do not vote proxies." By deliberate policy decision, we have directed

the Division to actually vote proxies. The Division's oversight of that consists of an annual written report which the Division makes to the Council about the way they voted on all proxy statements. Where they deviate from management's recommendations or where there is significant social issues which come up, we ask them to give us a written explanation of how they voted their proxy statement. So in a sense, we are reactive after they acted.

ASSEMBLYMAN CHARLES: My question is a simple one. Let me tell you what I am getting at. Maybe I am not making it clear. So that it is clear, let me see if I can do it. I just want to know what you do in situations where you take the position, by the Council or Division or whatever, that you should vote your proxies in favor of a resolution at a stockholders' meeting that you should not invest ,or do whatever, in South Africa. That resolution fails. What do you do with your investments there? Do you continue to invest, when on one hand you said you shouldn't be investing, or do you discontinue your investment in that corporation?

MR. MACHOLD: I will give you a specific example. General Motors.

ASSEMBLYMAN CHARLES: Do you continue investing?

MR. MACHOLD: Yes, we continue investing. In effect, we have to weigh the situation. We supported Reverend Sullivan, who is a director of that company, in his proposition that they should not sell to the South African police and military. The decision was defeated. Our votes counted very slightly in the overall tally. It's an enormous company. And, we maintained our holding of the company. That depended upon financial factors. In fact, the automobile industry has been a great industry and also a very heavy employer in New Jersey.

ASSEMBLYMAN CHARLES: Does anybody have any questions? Bob?

ASSEMBLYMAN FRANKS: Yes, I think I have a couple in light of some of the comments that we have just heard, Mr. Chairman.

Mr. Keleman, what characteristics do you look for in adding a company to the approved list? How does a new company or a firm that you may not have been aware of, for whatever reason, find its way onto the approved list with the Division?

MR. KELEMAN: Actually, it emanates from the Division who maintains an oversight of all companies that have investment opportunities, but we do have a committee that establishes guidelines and, as a matter of fact, on an annual basis, who reviews those guidelines, as we did Thursday. On Thursday we reviewed the guidelines. There are about seven criteria that we have regarding the qualifications of a company that would be put on our approved list.

MR. MACHOLD: They are established growth, for example. They are the fact that the companies have preeminent positions in some of the industries that they serve, that they provide diversification for the pension funds, that they are not unduly leveraged, that they are a good corporate citizens--

ASSEMBLYMAN FRANKS: (interrupting) Mr. Machold, this isn't answering my question. You have seven guidelines that you look at in terms of measuring a company against these criteria which you would evaluate before moving them to an approved list. One of those points does cover the social responsibility of the particular entity involved.

MR. MACHOLD: Yes, that is the kind of criterion by which we eliminated J.P. Stevens, a company which was clearly a renegade in the--

ASSEMBLYMAN FRANKS: (interrupting) I was trying to follow the Chairman's question, and I was getting confused in the midst of the figure that we were looking for. I guess we ended it as defining it as return on investment, being cited at 8.4% or 8.5%. It struck--

MR. MACHOLD: (interrupting) That is not market return. That is just the yield of the investment portfolio.

ASSEMBLYMAN FRANKS: The yield. I think we are talking large dollar volumes here. The difference between 8.4% and 8.5% would translate into what, in terms of dollars, for example? What would a tenth of a point on the yield equate to in the fund discussed?

MR. MACHOLD: One percent, I think, is \$100 million, so a tenth of a percent would be \$10 million.

MR. KELEMAN: It should be kept in mind that when we are speaking of this yield, we are speaking of the yield of the entire

portfolio investments. It should be recognized that any investment we are making today— In the case of the purchase of a bond, we would probably be working with 13% to 13.5%; in the case of cash management, C.D.'s, and that type of thing, we are looking at the 12% level. However, in the case of stock and equities, if you take a look at the S&P of 500, the yields there are probably about 5%. Our problem is the balance of our total portfolio, so that we achieve the actuary assumption that I spoke of, 6.5%. The importance of equity is that, in theory at least -- and, in fact it is so -- through time there is market appreciation in the values of those, so, in a sense it rides with inflation. And, the total return, as opposed to the yield, becomes significantly higher than that 5% yield. In the sense, it is an inflation hedge when we put moneys into the equity side. At this particular point in time, over the last few years and into the immediate future, on an appropriately timed basis, we are seeking to increase our equity holdings.

ASSEMBLYMAN FRANKS: Frank, you touched for a moment on the issue of unfunded liabilities within the system; could you give us a brief explanation of that, the concept of unfunded liabilities.

MR. KELEMAN: Why don't you do it? I mean, here is the expert.

MR. MACHOLD: For awhile I used to write the State's official statement. We have a whole section on this, and we always had to ask that question ourselves, and Bill Joseph, so I am going to try to repeat his terminology. If you ever dealt with him, you know it is not a simple terminology.

In effect, the actuaries will determine two things: the assets of the portfolios and the projective accrued liabilities. To get on a little thinner ice, I would like to tell you exactly what that is. It basically takes the universe of employees who exist within the State and extrapolates what their times of service, actuarial lives, etc. will be over time, and comes up with what a projected total liability would be. In doing the assets, they do the same thing; they project what the value of those assets— They take the current assets and then they will project what those assets will be.

In both cases they are using rates of return which are linked together. One is the rate of inflation, which is assumed, and their salary increases over time, and the other is the actuarial assumed interest rate over the pension fund portfolio. So they, in effect, come up with two figures which I would characterize as somewhat artificial, but still accurate within the context of actuarial expertise, such as it is.

Now, the difference between the assets and the liabilities is the unfunded liability. The assets are based in State pension funds on the valuation of book values. When you measure the book values against this projected liability, you come out with generally some shortfall. That shortfall, whatever it may be, has to be amortized over what will be the funding period for the pension funds. In most of our pension funds, though, I think that there is one small exception. It is a 40-year funding period altogether. The result of realizing-- Let us suppose we have \$100 million of bonds that are worth only fifty cents on the dollar; in private industry they would look at that and say, "That is worth fifty cents on the dollar," and you would have to go ahead with your funding on the basis of the fifty cent bonds. But, not in the parlance of-- Yet, I will say, because this is subject to some consideration and possible change of State pension funds, they are based on book value. So, if we were to realize the fifty cent loss, that in effect immediately flows through to the unfunded liability that in turn is funded over time.

Now, I will add as a proviso, that both private-- Both the National Government accounting group as well as the FASP, which is the general accounting central principles organization, are seriously considering moving states to the market pension fund appraisal method. If we do that then we will have a major issue because if we get into a market environment, there will be a great premium to reduce volatility in the pension funds, both in the bond portfolio, by shortening the maturity of the bonds, and in the stock portfolio, by taking less risk. The reason for that is corporations may be used to very uncertain funding patterns, but I think it would be very difficult for the State to get used to very volatile funding patterns. I can't speak

for you fellows, but there is something about having a fixed payment of maybe \$400 million or \$500 million a year, and it would be wonderful to have no payment the next year with remarkable returns in the market. But, then it would be ghastly to have to come up with \$1 billion the next year if, in fact, the market had turned off from that. And, that is the kind of environment you get into in the the private sector, though there are ways of changing or ameliorating those terms. I think I gave you a longer answer than you wanted.

MR. KELEMAN: Bob, I will add that you and the Legislature over the years, I think have really bitten the bullet by providing, I think, probably the highest funded position of our pension funds of any state in the country. The opposite end of that spectrum would be the State of Massachusetts which is grossly underfunded and has been historically for many years. They are seeking to rectify that position, but nevertheless, as I made reference to, we are just about virtually 100% funded, which essentially says that we are not expecting our children to have to pay for the services we got today and in the past. And, that is the bottom line of the significance of our 100% funded.

MR. MACHOLD: Well, there is another significance to that which is very important. Our pension funds do not include the annual pension adjustment, which is the inflationary adjustment. If you were to include that -- and I am just guessing -- the funding of our pension plans might very well be 50% or 60%.

ASSEMBLYMAN BROWN: May I ask a question on that note? What is the book value of the pension funds as of, let's say, June 30, 1984?

MR. MACHOLD: \$10.2 billion.

MR. KELEMAN: Of the pension funds.

ASSEMBLYMAN BROWN: Of the pension funds. \$10.2 billion. That is as of June--

MR. MACHOLD: (interrupting) June 30, 1984. And, the market value is about is about \$1.1 million less.

ASSEMBLYMAN CHARLES: You have been on the Council for 14 years, you said? Has anybody been on there longer than you?

MR. KELEMAN: Yes, Len Johnson was on there probably two or three years longer than I have been. I might add Mary Roebling who just recently retired had been on it since its founding.

ASSEMBLYMAN CHARLES: In 1950?

MR. KELEMAN: Right.

ASSEMBLYMAN CHARLES: All right. 1308 proposes some changes in the structure, the setup. You don't like the changes that are proposed. You have been serving for 14 years, at least; do you have any thoughts or suggestions you would like to make to the committee as to how it might be changed — things that are not necessarily included in 1308, but things that you have been thinking about that might be helpful to the overall operations of the Council, to the Division of Investment, and to the taxpayers in the pensions of the State of New Jersey?

MR. KELEMAN: Mr. Charles, I really think that this State put together a program in the system which has worked extremely well, and I think that everything which is cited in this new law, 1308, is being handled and handled appropriately by the Council and the Division in the way it operates.

ASSEMBLYMAN CHARLES: I am talking about things that are not necessarily what is embraced by 1308. I am not asking you to limit your suggestions to what 1308 does, but just your view of the operation as it now exists. Do you have any changes or recommendations outside of 1308?

MR. KELEMAN: I have some deep concerns about our ability to hold professional staff in light of civil service restrictions on salary ranges. We are dealing with a class of individuals, and I know we have this in other areas, like judges and so on, where the salaries that we provide to financial professionals are grossly under what banks, insurance companies, and investment bankers pay. For example, we just received a report that this last year we lost eight of our professionals, and I would say, roughly speaking, that about half of our 62 people you might consider to be professionals, and in each and every instance, at significantly higher wages. They go to work for some trust company. We are "training ground," if you will, for competent people, and we lose them.

ASSEMBLYMAN BROWN: On that note, you pointed out, though, that new people come on board without having the expertise that you all possess. Those individuals that are replaced-- You just indicated that you are a training ground. How do you justify your statement and your presentation that if other people are appointed, they would be somewhat of a liability to the operation by the mere fact that they don't have the experience and expertise. Where do these people come from who replace those people who you lose?

MR. KELEMAN: Fortunately we have a very loyal group of senior people, who-- Maybe they like Trenton. They do stay and are, in fact, excellent teachers and are providing us with an ability to train these younger people who join us.

ASSEMBLYMAN BROWN: So if people are appointed, they really wouldn't be a liability.

MR. MACHOLD: The people we lose are generally in the data processing area and the trading desk. Those are the two principal areas.

ASSEMBLYMAN BROWN: What is the make-up of the Council? How are the members appointed?

MR. KELEMAN: Five of the individuals come from the pension funds themselves. There is one from Public Employees, one from Teachers, and one from the Police and Firemen. We have one from the State Police and one from Consolidated Police, which is an old static pensions fund. These individuals are generally of the rank and file of our public employees system. The other five individuals are appointed for five-year terms -- staggered so that the term expires each year, one each year -- by the Governor, and the law requires that the Governor, in making such appointments, appoint at least three of the five who have some expertise and knowledge in the area of finance.

ASSEMBLYMAN BROWN: What about the other two?

MR. KELEMAN: Well, it is silent on it. As a practical matter, the Governor has always appointed people who have some association with financial institutions, such as teachers associated with a trust company, investment bankers, or what have you.

ASSEMBLYMAN BROWN: The old members from those unions-- Don't you have a case where leadership changes in those unions, and different people are appointed?

MR. KELEMAN: They are not the unions. They are the pension funds, obviously with a lot of union membership in each of them. I am sorry; what was your question?

ASSEMBLYMAN BROWN: Are they all the same people who are there for the time of appointment?

MR. KELEMAN: This year four of the five were renewed, and one was changed, and frankly-- As a matter of fact, the individual who has just joined us has rejoined us. He had been a member of the Council three years or so ago for some period of time. He ceased being a member and now is again a member, just having joined us on Thursday.

ASSEMBLYMAN BROWN: So, there is no transition, you are saying, basically of any significance?

MR. KELEMAN: There is. There is a slow evolution, but--

ASSEMBLYMAN BROWN: That is somewhat contradictory to your point that the Legislature would change, therefore members would change, and I was just wondering how the comparison was made. If you have people changing now, how would the fact that legislators would be changing be so unique?

MR. KELEMAN: As far as the Council is concerned, obviously two individuals would change in keeping with the Legislature decision. But, more important and a greater concern that we have, as far as the operation of the Council is concerned, is that we are having a new -- and I forget the term which is used -- six-person advisory group, which is completely subject to political appointments, whether it is the Speaker of the House, the President of the Senate, or the Governor. I suppose they would change with administration changes.

ASSEMBLYMAN BROWN: Similar kinds of things already exist to some degree. That was my whole point. The Governor now appoints certain people, although they have a certain period of time, but another Governor can appoint someone else, so it is not a lifetime position for anyone; is that correct?

MR. KELEMAN: That is correct.

ASSEMBLYMAN BROWN: That is something I wanted to establish.

ASSEMBLYMAN CHARLES: Just to follow up on that, what is-- Each term is five years for the public fund, the members selected by the Governor. What is the typically average term that someone serves on this Investment Council? You have 10 people. Is it 14 years, like yourself? Are you unusual in that you have been there 14 years?

MR. KELEMAN: I think I am a little bit. I would offhand say probably about 10 years.

ASSEMBLYMAN CHARLES: Ten years is the average of the gubernatorial appointments. And the others, do you have any idea how long they sit?

MR. KELEMAN: Five or six years.

ASSEMBLYMAN CHARLES: Okay. It is sometimes good to have changes in memberships of things at some period, not short intervals, but at least at some definite intervals, so that you might have an infusion of different kinds of ideas and different kinds of enthusiasms for the position. I am just wondering whether or not the Council, as it presently is constituted -- whether by law, in practice, or the way you appoint people -- whether you don't get stale and aren't examining different notions of investment, and different things that are going on in the investment world. I know as professional managers you must be, if you are employed somewhere in the professional area of investments. I am just wondering whether or not as an institutional matter, we shouldn't think about limiting the life span of the people on the Council so maybe it would promote the infusion of thoughts and different ideas to the investment policies of the State.

MR. KELEMAN: If I may, may I make two observations? First, I do believe that if we examine -- and I haven't done this in detail, but I would make an estimate -- that probably every year there are at least two and possibly three new faces. This year there will be two that I am certain of. I think another thing which ought to be considered-- I have been associated with many different organizations over the years. I have never been in an organization like this Council where there is a total absence of cliquishness. Whether this is by chance or whatever, I can't say, but we have no social relations with

each other because of the geographic diversity of us spread out all over the State. In this sense, I can say, without reservation, that we have never had any internal politics within the Council or to my knowledge in the Division itself. I have to say it is very unique because in most organizations -- I have been on boards of hospitals, research institutes, museums, and things of that nature -- invariably you find small cliques developing which really run the show. This has been totally absent in the case of the Council, whether by chance or whether because of the wide distribution that has historically existed of its membership; I can't comment on that. But, the fact is that there is a total absence of that.

ASSEMBLYMAN CHARLES: You said something--

MR. MACHOLD: I was just going to speak to your point about the infusion of new ideas. In the sense, this is part of my responsibility. It is something we look at all the time. We have added conventional mortgage pools and options. We are looking at futures now. We are starting a loan program, which has been held up because none of our banks are members of DTC. We are actively looking at these new horizons. This isn't altogether on my initiative; it is simply because the Council members, members of the systems, or others have a continuing interest in the management of the funds. So, I think a lot of things are being done. We also have outside consultants who, I would say, on an average of every couple of years, will look at us and say, "Well, maybe you ought to look at something like this or do something like that." I think that we are getting a very sustained flow of what you might call new ideas.

ASSEMBLYMAN CHARLES: I have one more question at this point, and then I would like to ask Dr. Murningham some questions. I believe I heard you say during the course of your testimony that -- and I may have written it down wrong -- it was your conclusion or somebody's conclusion, who did some study, that over the long-term these riskier companies-- The riskier type of investments that might be the result of 1308 and 1309 would render the same type of return as the current -- what we might call, using your term -- less riskier investment. Is that what you said? You are comparing -- and I don't know where

exactly in your testimony it occurred -- but I thought I heard you say that if you look at the experience over the long-term, you might get the same kind of return with the types of investments that are proposed under 1308 and 1309 that you currently get.

MR. KELEMAN: Yes, except it would be a lot more cyclical. Dr. Murningham made reference to the beta coefficient. This means that these smaller companies-- As an example, companies in a general sort of way--

ASSEMBLYMAN CHARLES: (interrupting) All right, I understand. So, you said yes. You did say that?

MR. MACHOLD: Only the equities.

ASSEMBLYMAN CHARLES: Only the equities.

MR. MACHOLD: That is one quarter.

ASSEMBLYMAN CHARLES: That is one quarter, okay. So at least as to equities then-- You are talking about what? You aren't talking about the debt securities? You are just talking about equities?

MR. MACHOLD: Stocks.

ASSEMBLYMAN CHARLES: What percentage of the funds are involved in these equity securities?

MR. KELEMAN: About 27%, I think it is.

ASSEMBLYMAN CHARLES: So, at least as to equity securities then you could over the long-term get involved in a 1308 and 1309 type of a program without detriment to the investment portfolio?

MR. KELEMAN: Excuse me. There is a detriment possible because if we have to sell some of those holdings at the wrong time, we may find ourselves in a cycle where we are in a down position. I made reference to the fact that in this last year, the smaller companies declined about 15% in values as opposed to the larger companies which declined, I think, 6%. So, if at this point we have to sell stocks in order to satisfy some requirements of paying beneficiaries, we would be at a gross disadvantage.

ASSEMBLYMAN CHARLES: If you were given a period of time over which to sell them, you wouldn't be at that gross disadvantage?

MR. KELEMAN: This is when you start talking to ten people of the behavior of the stock market, and you will get ten answers.

ASSEMBLYMAN CHARLES: Dr. Murningham, I think that is a good lead into you, because you say it can be done. From what I hear from others, it can't be done; that is, you can't -- 1308 and 1309 -- have such laws and still have a public pension portfolio that maximizes its return, reserves the capital, and satisfies the taxpayers in the State of New Jersey.

DR. MURNINGHAN: I think the point on that is that even with the difference in size -- and many of the groups that were cited make reference to the size differences and how critical they are -- that the process of transistion from one situation to another has to be very, very carefully structured. I think nobody is suggesting that a divestiture policy or reinvestment policy can be implemented overnight. Paying attention to the management structure and paying attention to the way assets are allocated across the different categories, paying attention to whether the statutory language allows for the professional judgment that is necessary-- Some reference has been made to the proposals and maybe there needs to be some attention paid to that. Given proper resources and given an attention-- Even the Wilshire people don't conclude that it is impossible to implement such a policy. What they stress over and over again is the need for looking at the overall structure of investments and the overall investment strategy. That is often difficult to do especially if there is not an adequate provision of resources to a group.

MR. MACHOLD: May I? I just want to address the question and bring to your attention that the companies that are identified in 1308 are not the same companies that are looked at in the Wilshire Study. Wilshire talks about small companies. They are not looking at the types of companies that have a specific supplemental objective to them. They are not looking at companies, which in the case of the Urban Loan Authority, had an 81% default rate, or in the case of the Economic Development Authority, which had a 17% default rate. There would be a different universe then you are contemplating by the supplemental principles.

ASSEMBLYMAN CHARLES: Speaker Karcher.

SPEAKER KARCHER: If I understand you, Dr. Murningham, you said that it can be done, but a great unknown there is how much cooperation and how much commitment there is by the people who are to administer that policy, and with what dedication and diligence they carry it out. Is that correct?

DR. MURNINGHAN: Well, I think that when you talk about any policy you are talking about the policy itself in terms of the extent to which it is adequate — it is feasible as well as being desirable. You are also talking about the implementation of that policy, the management implications that go along with it. Certainly, looking at investments, there are many factors that enter into a discussion of that, that pertain not only to investment policy, but to some of the other forces I described earlier in terms of legal environment, a lot of macroeconomic forces at work as well as just day-to-day returns. On the management side, I think it is also a question of the extent to which people are able to specialize in certain areas and are able to, using a lot of different quantitative techniques, apply those techniques in the best way possible to make the best kind of decisions. And sometimes that may mean that existing levels of resources may need to be supplemented by resources from elsewhere or from outside on that. But, the policy has to be examined both in terms of how carefully it is drawn as well as the implementation implications and the extent to which there are sufficient resources to carry it out over a period of time.

MR. KELEMAN: I would just like to comment with regards to the nature of the problem. If I had a \$25 million investment of stock in a company that has a total of \$500 million of stock in the marketplace and I make the decision to sell it, it is not long before the world knows that there is a \$25 million block of stock overhanging the market. On the other hand, if I have that \$25 million in a company that has \$5 billion worth of stock outstanding, that overhang is not a problem. The point that I am trying to make is that when we seek to place our moneys in relatively large blocks -- because we have large amounts of money to place -- in small companies -- this is in reference to the transaction cost -- we run the risk of taking a significant

loss. The study, which we referred to, indicates that that loss could be of the magnitude of between 2-1/2% and 3%, as I recall it. This means that if the stock is selling for \$50 that we may not realize \$50; we may only reach \$49 or \$48.50 in the sale of that \$25 million of stock. And, that is the transaction cost. Similarly, the reverse, when you buy.

SPEAKER KARCHER: Transaction costs-- Not to digress from the present conversation. Transaction costs have a broader implication or a broader meaning than just the brokerage commission.

MR. KELEMAN: Oh indeed. We are talking about the execution cost. The commissions are, in a sense, trivial. You made reference to two-tenths of a percent or thereabouts. It is quite low.

SPEAKER KARCHER: It is a very small number compared to the substantial difference between the terms.

MR. KELEMAN: Exactly.

SPEAKER KARCHER: To go back to the discussion we were having, Mr. Chairman, you have no question that the Investment Council is a creature of statute; it is created by statute and you function within that statute. Is that correct?

MR. KELEMAN: Indeed.

SPEAKER KARCHER: And, if that statute were to change, you would have no question that you were still creatures of that new statute, and we could rely upon you to do your very best to implement that?

MR. KELEMAN: No question about it.

SPEAKER KARCHER: By the way, the Investment Council, as presently constituted, is not bound by-- Are they bound by the Executive Ethics? Do you have disclosure?

MR. MACHOLD: Indeed we do.

MR. KELEMAN: Yes. We are bound in a different fashion than other government employees.

SPEAKER KARCHER: For instance, everybody up here who are members, we disclose what-- We have to disclose everything that generates income for us, including our stockholdings. Does the Investment Council do that?

MR. KELEMAN: We have a disclosure statement which is just internal, which we did for our own edification. This indicates that if we have a 1% position in any business, we would so disclose. Furthermore, if we are involved— For example, if an individual is an officer of a bank, we disclose that information to each other for the purposes of avoiding conflict.

SPEAKER KARCHER: I understand that. But the statement, Mr. Chairman, is this on behalf of yourself individually or on behalf of the entire Council?

MR. KELEMAN: The entire Council. We actually have a written form which says we are not a member of a political-- we are not involved with a political party; we don't hold elective positions, and so on.

MR. MACHOLD: In conformance of the law. The officers of the Division do file the same form that you are talking about. We disclose our stockholdings and every member--

SPEAKER KARCHER: You, as an employee? But the members of the Council don't?

MR. MACHOLD: Yes, they do too if they own more than 1%. They are not bound by law.

SPEAKER KARCHER: If they own more than 1% of the corporation?

MR. MACHOLD: Of any company.

SPEAKER KARCHER: Of any company. So it is not similar to the Legislature. The Legislature has to reveal--

MR. MACHOLD: (interrupting) I am not sure what the Legislature's is.

SPEAKER KARCHER: If we have an aggregate stock dividend of \$1 thousand, we have to reveal every single stock we own.

MR. MACHOLD: I have to do it myself as well.

SPEAKER KARCHER: Well, I understand you would have to.

You're retired; is that correct? You used to be in something called K.S.M. Is that right? Which is a welding company?

MR. KELEMAN: Yes.

SPEAKER KARCHER: Did you divorce yourself from the company when you became— Or did you retire?

MR. KELEMAN: Oh no, I am still on the Board of-- K.S.M. sold out to a larger corporation, which is an Oregon-based corporation. I have been a member of the Board of Directors of that company to this day.

SPEAKER KARCHER: And a stockholder?

MR. KELEMAN: And a stockholder.

SPEAKER KARCHER: K.S.M. does business in South Africa, doesn't it?

MR. KELEMAN: Yes, we do, indirectly.

ASSEMBLYMAN CHARLES: I have just a few more questions. Maybe only one to clear up something in my mind. There has been a lot of talk about diversification, and I guess you experts, you professionals in the field, understand that a lot better than legislators. We talked about the Class A, Class B, and the Class C, and you mentioned different portfolios--

MR. KELEMAN: (interrupting) Fund A, B, and C.

ASSEMBLYMAN CHARLES: (continuing) Is there any kind of set formula that prescribes what percentage of the portfolio goes into the particular type of class fund? Or is that a management decision?

MR. KELEMAN: We actually make a decision on the basis of each of the funds, as to what they should be in because-- keep in mind, I am not going outside of the pension funds. We do have \$3 billion in non-pension funds under our oversight. In the case of all of these funds which we are, in a sense, managing, we make specific decisions as to how they shall be invested. For example, some which require a great deal of liquidity, we will only put in the cash management fund. On the other hand, the pension funds which have a long-term horizon are primarily placed in stocks and bonds. With regard to those pension funds, we recently, going back seven or eight months or a year ago, decided to increase our ratio of equity to fixed income from what, up to that point, had been a 25% goal. We have now increased it to 35%. As a matter of fact, we have directed the Division to seek to achieve this over a two-year period. I hasten to say that going from 25% to 35%, and in consideration of the growth of the total fund, we are speaking of going from a present level of about

\$3 billion up to about \$5 billion or \$6 billion, which is a lot of new acquisition requirements.

ASSEMBLYMAN CHARLES: That is something then that there are no rules or regulations that are statutory or--

MR. KELEMAN: (interrupting) That is the policy made by the Council.

ASSEMBLYMAN CHARLES: That is the policy made. So, that these different funds we are talking, the A Fund— Is that the correct nomenclature?

MR. KELEMAN: The A Fund is the equity fund. We are saying that in the total aggregate of investments, we want the A Fund to increase to a point where it will be 35% of the total.

ASSEMBLYMAN CHARLES: All right. And, that is just something that the Council sits down on and deliberates on and establishes a policy?

MR. KELEMAN: We bring in consultants. We discuss this with experts outside of the Council and the Division and so on.

ASSEMBLYMAN CHARLES: I have one final question. You said you administer \$3 billion of other funds aside from pension funds; what funds are they?

MR. MACHOLD: The State General Investment Fund, for one; that happens to be the largest right now.

MR. KELEMAN: The sinking funds of all the hospitals. I know Mr. Karcher has had an interest in the hospitals, but typically they are in the health care facility financing authority. The sinking funds of those hospitals are put into our hands.

MR. MACHOLD: That actually is in a separate-- That is entirely different. All the bond funds-- Every time there is a transportation bond issue or something, money is to be raised and be placed into a fund for distribution as the expenditures are made.

ASSEMBLYMAN BROWN: Mr. Chairman, while you are looking, has the Investment Council recommended to their investment managers a preference to the New Jersey banks -- stocks of New Jersey's banks?

MR. KELEMAN: Are you saying stocks or C.D.'s?

ASSEMBLYMAN BROWN: Have they suggested to their managers any preference to New Jersey banks and New Jersey companies?

MR. KELEMAN: On a competitive bid, for example the C.D.'s, if there is a tie, the New Jersey corporation-- The best bid of the New Jersey corporation gets it. That is the only concession we have made with regard to New Jersey banks.

ASSEMBLYMAN BROWN: And New Jersey companies also?

MR. KELEMAN: In the case of New Jersey companies, we buy bonds or--

ASSEMBLYMAN BROWN: (interrupting) Do you still do the same as the banks?

MR. KELEMAN: We are dealing now with a decision that we buy. We are not buying from companies.

ASSEMBLYMAN BROWN: No, I'm not suggesting that you buy from companies.

MR. KELEMAN: But let me say this. We are 10 New Jersey citizens.

ASSEMBLYMAN BROWN: (interrupting) The stock of the companies, I'm saying--

MR. KELEMAN: (interrupting) Roland is bringing to my attention that 67% of the approved list are companies who have employees in the State, and I can assure you that our bias is to New Jersey because we are all New Jersey taxpayers and New Jersey citizens.

ASSEMBLYMAN CHARLES: Does anybody have any additional questions?

ASSEMBLYMAN FRANKS: Mr. Chairman. Dr. Murningham, I think it is becoming clear that the bone of contention here is to whether or not a South African-free portfolio would stand the test of time that bars the earnings we could expect from such a portfolio. It is apparently the position of the Division of Investment that would be very difficult, and not at all likely -- at least to chance it -- that a South African-free portfolio would net the pensioners and taxpayers the types of results that historically the New Jersey Fund has been able to yield. I'm curious; do you have any firsthand experience in managing South African-free portfolios?

DR. MURNINGHAN: No, I have no firsthand experience. I am only relying on the expertise of others who do, as well as those who have been cited today as having done computer projections of what a portfolio would look like. I want to stress again the point that a South Africa-free portfolio really means that sub-categories of that portfolio are South Africa-free. I think again it is attention to the entire portfolio and not just that portion that is immediately affected by divestiture. What the analysts say about that, who do have experience with this or have done computer calculations of what the net effect might be, in that adjustments would have to be made in some of those other subcategories to accommodate for the changes taking place within that section that is affected by divestiture, especially in the larger funds.

MR. KELEMAN: Bob, may I comment on that question? I think there is an important thing that hasn't been addressed. We have heard the report dealing with the improved return as a result of this divestiture. According to the statistics that I saw from your last report, \$78 million of bonds were swapped, in the sense, for \$64 million worth of bonds, and the so-called \$14 million loss was more than offset by improved earnings through time on that portfolio. The question which hasn't been addressed is suppose that other portfolio had not been South Africa-free and had been the best of all-worlds? We here in New Jersey constantly are involved with bond-exchange programs, bond swaps. And, for example, last year -- and this is a report that we put out quarterly and is available to anyone who wants to see it -- we, in fact, swapped \$528 million of bonds for not a lesser lot, but the same face value of another \$528 million, and realized out of it, not just the exchange of bonds on a face-to-face equal basis, we also realized \$3 million in cash, cash that came in hand at that time and improved our annual income by \$1.6 million a year.

What I am trying to say is that we have heard that there has been an improvement by making this exchange from a bond portfolio of \$78 million that included South African investments to a South African-free investment with certain numbers associated with it. I would love to see the specifics of that exchange to see how it would

compare had the South African-free restriction not been imposed. Because, as I said, without that restriction, we are doing this on an ongoing basis, and you might like to have a copy of this report, which gives every transaction and shows exactly what has happened. And Bob, what I really am trying to bring to your attention is that this improvement in result may not be the potential improvement that would have been realized had there been less concern about the South African-free investment concept.

ASSEMBLYMAN CHARLES: Did you make any swaps which ended up in less than the face amount? Have you ever done that?

MR. MACHOLD: No, we have not. No the swap that she is talking about— A professional bond trader would look at that and say, "You took a \$14 million loss." And, you wouldn't look at the coupon pickup which is only part of it; you would look at what the yield was and that involves the maturity in the sinking fund and the call features of the bond. To look at it any other way would justify any kind of exchange out of the stocks of the bond and simply say that you got a better yield, and it wouldn't take into account the relevant values of those two securities.

ASSEMBLYMAN CHARLES: I have no other questions. Do you have any? (negative response)

I would like to thank you all for appearing and offering the testimony that you have. If there are no more questions, this public hearing now stands adjourned.

(HEARING CONCLUDED)

APPENDIX

September 24, 1984

Summary of Testimony
Frank K. Kelemen
Chairman
State Investment Council

The State Investment Council, acting as fiduciary for their policemen, firemen, teachers, public employees and judges of New Jersey, opposes Bills A1308 and 1309

A1308

A1308 would introduce non-financial political issues into the investment process, materially reduce the fiduciary protection investment returns and/or increase investment risks for pension fund portfolio.

A1308 provides for the appointment of two legislators to the State Investment Council. The Council was created in 1950 as the result of previous political scandals and was designed to be separate from political influences. The Council consists of five non political gubernatorial appointees and five representatives of the pension fund boards. The appointment of two legislators to the Council would bring political issues of the moment to Council deliberations and would dilute the representation of pension fund beneficiaries on the Council.

A1308 mandates that each investment decision confirm to at least one "supplementary" principle designed to direct investment to economic development in New Jersey ,and that the State Investment Council must adopt regulations to implement the "supplementary" principles. After a review of the principles, and after a comparison of investment results of other State agencies using such principles (EDA and ULA), the Council believes that concessions in risk and return are inherent in the "supplementary" principles.

A1308 would create a Citizens' Advisory Board, consisting of two appointees each by the Speaker of the Assembly, the President of the Senate and the Governor. This Board's responsibilities would supercede the existing responsibilities of the Council and exclude the representation of the public employees, teachers, policemen, firemen and judges who are the beneficiaries of the pension funds.

The underlying premise of A1308 is that there is a "capital gap" in New Jersey, consisting of good investments which can't find a market. Independent commissions under both Governors Byrne and Kean found no evidence of such a gap, and none came forward at public hearings.

The same commissions also reviewed the structure of the Council

and the record of its activities, and concluded that

"The balance which exists between the accountability of the pension investment fiduciaries to the beneficiaries of the funds with the insulation from political influence is of decisive importance. It is crucial that the pillars of fiduciary responsibility - namely, prudence and loyalty - be maintained. The current structure allows for and facilitates that to a better extent than any other we have seen or considered."

The Council is delighted to invest in New Jersey, so long as the terms are fair to the pension funds. Furthermore, the Council is sensitive to social issues and this sensitivity is reflected in votes on corporate proxies. The Council believes that a good corporate citizen is usually a good financial investment.

On balance, the net effect of the enactment of A1303 would be to increase the risk and lower the returns and diversification of the pension fund portfolios; to mandate substantial losses which would have to be borne by the taxpayers (which could approach \$1 billion) and to shift the authority for policy making and or

oversight from a non political Council, which equally represents pension fund beneficiaries and the public, to two legislators, the Speaker of the Assembly and the President of the Senate.

A1309

A1309 would require the divestiture by State pension funds of investments in companies engaged in business in South Africa.

All members of the State Investment Council believe that apartheid is a ghastly political system which is doomed to failure. Nevertheless, it is the Council's fiduciary mandate to evaluate the financial effects of all pension fund investment proposals. On the basis of this evaluation the Council concludes that the enactment of Assembly Bill 1309 could have serious adverse financial effects on investment risks and returns, retirement security of pensioners and the taxpayers of the State.

First, the State pension funds hold investment in 69 corporations identified with South Africa aggregating \$2 billion, or 20% of the book value of the pension fund portfolios. Every one of these companies is identified as a New Jersey employer.

These companies include Johnson & Johnson, American Cyanamid, CPC International (formerly Corn Products), Ingersoll Rand, Merck & Co. Schering Plough, Corning Glass, DuPont, Exxon, FMC,

General Electric, General Motors, Heublein, IT&T, Marriott, IBM, McGraw Hill, Minnesota Mining & Manufacturing, Mobil, New York Times, Owens Illinois, Pennwalt, Perkin Elmer, Philips Petroleum, Raytheon, R.J. Reynolds, Squibb, Texaco, Union Carbide, United Technologies, Westinghouse and Xerox. All of these companies employ at least 1,000 people in New Jersey or are headquartered in the State.

Second, a forced divestiture of pension fund holdings would incur losses of \$65 million at current market rates. Any such losses would be added to the unfunded liability of the pension funds and funded by the taxpayer over time.

Third, the elimination of companies which do business with South Africa would sharply limit investment alternatives for the pension funds. Such companies represent over 50% of the total market value of the S&P's 500, a proxy for the stock market. A diversion of State pension funds to smaller domestic companies might be able to provide high returns at times, but only with the assumption of increased risks, reduced diversification and increased transaction costs.

The elimination of such companies would exclude 52% of the top rated AAA and AA industrial debt obligations and 75% of the top rated commercial paper. Diversion of these investments to government securities would produce lower returns.

The Council's evaluation was confirmed by the analyses of independent consultants, specifically, Wilshire Associates, Trinity Investment and Meidinger Asset Planning.

Trinity had an interesting statistical analysis which concluded that the effect of divestiture would be like trying to compete in a poker game without half of the Aces, Kings, Queens and Jacks.

The Council is sensitive to South African issues. It has supported shareholder resolutions banning a company from selling to the South African military and government and it regards signatories of the Sullivan principles as better corporate citizens and better investment prospects.

The Council believes that the costs of divestiture would be at least \$50 million annually.

The conclusions of the Council are based on a financial evaluation and the Council does not in any way condone the political system or the Government of South Africa.

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LIST OF APPENDICES
to testimony of
Frank K. Kelemen

September 24, 1984

- Appendix 1 Letter from the Boards of Trustees of the following pension funds, all opposing Bills A1308 and 1309;
- The Consolidated Police and Firemen's Pension Fund
 - The Police and Firemen's Retirement System
 - The State Police Retirement System
 - The Public Employees' Retirement System
 - The Teachers' Pension and Annuity Fund
- Appendix 2 Report to Governor Byrne of the Task Force on the use of State Pension Fund to Further Economic Growth in New Jersey, dated January 15, 1982
- Appendix 3 Investment Report - New Jersey State Pension Study Commission, dated March 15, 1984
- Appendix 4 Testimony of Richard R. Spies on Assembly Bills 1308 and 1309
- Appendix 5 Corporate Data Exchange, Inc.: Pension Investments, a social audit; a table showing the standing of State Pension Funds on social investing
- Appendix 6 Letters from Trinity Investment Management Corporation, dated September 4, 1984

- Appendix 7 South African Divestment, the Investment
Issues, by Wilshire Associates
- Appendix 8 U.S. Corporations in South Africa eligible
for investment by the Division of
Investment, as of June 30, 1984
- Appendix 9 Meidinger Asset Planning Services, Inc. -
Selection from "District of Columbia,
Special Investment study, South Africa
Proposal, dated March 31, 1983
- Appendix 10 Letter from Sidney Krasner, Executive Vice
President of of Shearson Lehman/American
Express, dated July 9, 1984
- Appendix 11 State actions on Legislation Concerning
Divestment of State Funds in the Republic
of South Africa, as of June 14, 1984

State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF PENSIONSWILLIAM J. JOSEPH
DIRECTOR20 WEST FRONT STREET
CN 295
TRENTON, NEW JERSEY 08625

March 26, 1984

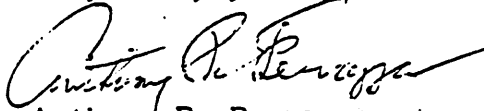
Mr. Frank K. Kelemen
Chairman
State Investment Council
Division of Investment
CN 290
Trenton, NJ 08625

Dear Mr. Kelemen:

The Consolidated Police and Firemen's Pension Fund Commission at their meeting held on February 22, 1984 expressed their deep concern and dismay in reading two articles that were recently published in Barron's and Asbury Park press.

Likewise, the Commission also were made known of two legislative bills A-1308 and A-1309 affecting the investment process in the Division of Investments. The Commission considered that such action will have an adverse effect on the safety and purpose of the pension fund which is to have the fund administered solely in the best interest of the beneficiaries and free of the possibility of any political influence or interference regarding investments. The Board, therefore encourages the Investment Council to inform all appropriate groups and individuals of the concerns of this Commission as expressed herein.

Very truly yours,


Anthony P. Ferrazza
Chief

APF:sc

cc: Board Commissioners



State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF PENSIONSWILLIAM J. JOSEPH
DIRECTOR

February 29, 1984

20 WEST FRONT STREET
CN 293
TRENTON, NEW JERSEY 08625

Mr. Frank K. Kelemen
Chairman
State Investment Council
Division of Investment
CN 290
Trenton, NJ 08625

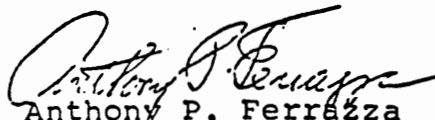
Dear Mr. Kelemen:

The Board of Trustees Police and Firemen's Retirement System at their meeting held on February 27, 1984 unanimously passed a motion to express their deep concern and objection to two bills introduced in the New Jersey State Legislative: A-1308 and A-1309.

These bills, in the Board's opinion endanger the pension funds management process and would have an adverse effect on the safety of the pension funds investments. The objective goal of the investments is to safeguard the financial interest for the sole purpose of the respective funds beneficiaries and to be prudently administered by financial experts with freedom from political influence or interference.

The Board, therefore, encourages the Investment Council to inform all appropriate groups and individuals of the concerns that this Board has expressed herein.

Very truly yours,


 Anthony P. Ferrazza
 Secretary
 Board of Trustees

APF:law
cc: PFRS Board Members



State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF PENSIONSWILLIAM J. JOSEPH
DIRECTOR20 WEST FRONT STREET
CN 205
TRENTON, NEW JERSEY 08625

February 28, 1984

Mr. Frank K. Kelemen
Chairman
State Investment Council
Division of Investment
CN 290
Trenton, NJ 08625

Dear Mr. Kelemen:

The Board of Trustees of the State Police Retirement System at a regular meeting on February 22, 1984, unanimously passed a motion to express their deep concern and objection to two bills introduced in the New Jersey State Legislature: A-1308 and A-1309. These bills, in the Board's opinion, weaken the investment process; therefore, will have an adverse effect on the safety and purpose of the pension fund, which is to have the fund administered solely in the best interest of the beneficiaries and free of the possibility of any political influence or interference. The Board encourages the Investment Council to take whatever actions it deems necessary to inform all appropriate groups and individuals of the concerns the Board has expressed herein.

Very truly yours,

Anthony P. Ferrazza
Secretary
Board of Trustees

APF:law
cc: SPRS Board Members

May 22, 1984

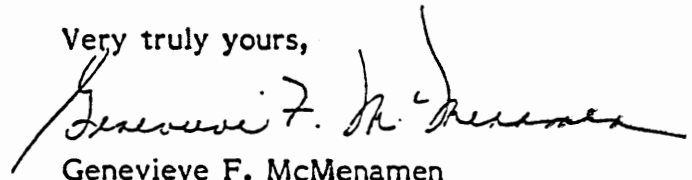
Mr. Frank K. Kelemen
Chairman
State Investment Council
Trenton, NJ

Dear Mr. Kelemen:

While we, the Board of Trustees, Public Employees' Retirement System, find apartheid in South Africa morally reprehensible, we are very concerned that Assembly Bill No. 1308 and 1309 may impair the fiscal integrity of the public pension funds of the State of New Jersey.

In our capacity as fiduciaries, we do not support either Bill as currently proposed and recommend that the Assembly further study this issue which not only could impact the State's pension funds but also employment in the State of New Jersey.

Very truly yours,



Genevieve F. McMenamen
Chairperson
Public Employees' Retirement System

GFM:bjm

c: Mr. Roland M. Machold
Director
Division of Investment



State of New Jersey

DEPARTMENT OF THE TREASURY
DIVISION OF PENSIONSWILLIAM J. JOSEPH
DIRECTOR

March 7, 1984

20 WEST FRONT STREET
CN 295
TRENTON, NEW JERSEY 08646

Mr. Frank K. Kelemen
Chairman
State Investment Council
Division of Investments
CN 290
Trenton, NJ 08625

Dear Mr. Kelemen:

The Board of Trustees of the Teachers' Pension and Annuity Fund, at their meeting on March 1, 1984, discussed the impact of two bills recently introduced in the New Jersey State Legislature: A-1308 and A-1309.

The Board, while recognizing the social merits of the proposals, unanimously and emphatically expressed their opposition to these bills and reaffirmed their support of the State Investment Council policies and regulations. The Board recognizes its fiduciary responsibilities regarding investment of pension monies and strongly feels that the Council structure, philosophy and performance has served them well in this regard.

We are very appreciative of the fine performance of the Council and the Division and encourage you in every way to continue your firm commitment to the beneficiaries of the Fund.

Please feel free to inform any and all appropriate groups or individuals of our position on these matters.

Very truly yours,

A handwritten signature in cursive script that reads "Mary C. Conrey".

Mary C. Conrey, Secretary
Teachers' Pension and Annuity Fund

MCC:daf

Report of Task Force on
The Use of State Pension Funds
to Further Economic Growth in New Jersey

January 15, 1982

New Jersey State Library

Introduction and Acknowledgements

Our Committee was appointed on November 20, 1981, and our charge was to "investigate whether there are new ways in which the State [of New Jersey] could invest public employee pension funds in a matter contributing to the economic growth of the State as a whole." In the letter of appointment, Governor Byrne asked us to submit a report on our findings before the completion of his term in office and this report is intended to fulfill that charge.

Since our appointment, we have met a total of four times -- December 4, December 18, and December 31, 1981 and January 13, 1982. We have also attempted to review as much of the available literature on this subject as time has permitted, including importantly the reports of similar groups in other states and the writings of several articulate critics and advocates of broader investment policies for state pension funds. In this latter category, we benefited especially from the work of Lawrence Litvak, the author of Pension Funds and Economic Renewal^{1/}, who elaborated on his written views in a personal presentation to the committee.

With the exception of Litvak, our committee elected not to invite presentations by individuals or organizations outside our immediate membership.^{2/} The primary reason for this decision was the lack of time available for such

^{1/} Lawrence Litvak, Pension Funds and Economic Renewal, Council of State Planning Agencies, Washington, D. C., 1981.

^{2/} The only other exceptions were the representatives of the Governor's Office, particularly Mr. John J. Huston, the Deputy Director of the Office of Policy and Planning; and Mr. Roland Machold, the Director of the Division of Investment. We benefited enormously from the participation of these individuals in our discussions, and their special perspectives were invaluable throughout our deliberations. All opinions expressed in this report are, of course, solely the responsibility of the Committee members, but we hope Mr. Huston and Mr. Machold have helped us avoid obvious errors of fact or logic.

meetings^{3/}, and our subsequent conclusion that the most we could accomplish in the time we did have was to recommend appropriate directions for further discussions by some successor group and to define some general principles that such a group might follow in those discussions. As a result, we felt that more specific discussions with a variety of expert witnesses and advocates of different views on this subject would not be appropriate at this time. On the other hand, our meeting with Mr. Litvak was an important part of our own research effort.

The members of our Committee have come to these discussions with a variety of different perspectives and experiences. Each of us has had some experience (either theoretical or practical) in the general area of investment policy, but none of us claims to be an expert in the field of investing for social objectives. We have all come to these discussions convinced that any steps that might be taken to enhance economic development in the State or improve the welfare of its citizens should be considered very carefully by the Governor's Office and the Investment Council. At the same time, we are completely persuaded that no such actions should be permitted if they involve any compromise in the pension funds' primary objectives: achieving the maximum return possible, at an appropriate level of risk, for the intended beneficiaries of these investments, the past and present members of the various public employee organizations; and minimizing the cost to the State's taxpayers of providing those pension benefits. As a Committee we approached our task with enthusiasm, but also with a considerable degree of skepticism about the possibility of actually achieving such secondary goals without compromising that primary objective -- in terms of either the return earned by the investments of the pension funds or their risk level.

Finally, we should note that our Committee was not asked to review the current structure of the Investment Council and the Division of Investment,

^{3/} Our Committee had less than two months to conduct its investigation and prepare this report. In other states such studies have taken a year or more: California, for example, first appointed such a task force on June 30, 1980 and that group's final report was completed only last fall.

and we have not attempted to do so. Similarly, we have not tried to form any view of the appropriateness of the Council's current investment policies unrelated to the basic question of increased investment in New Jersey. We did not, for example, consider the appropriateness of the mix of different investment instruments within the pension funds' overall portfolio. Nor did we consider the issue of proxy votes for the common stocks held by the pension funds; clearly, many proxy resolutions raise issues of "social responsibility" for public investors, but those issues do not normally extend to the question of economic development in a single state. In general, however, we have the impression that the current structure and policies have served the State and the pension fund beneficiaries very well over the years, and we would be reluctant to see any major changes in that structure without very careful consideration.

General Principles

In the course of our discussions, several general principles have emerged as sensible guidelines for the pursuit of broader social objectives through pension fund investments. While these principles seem self-evident to many of us, we have been surprised to learn that they have been ignored in much of the literature on this subject. As a result, we believe it would be useful to articulate these general guidelines explicitly before moving on to a discussion of specific investment alternatives. In our view, those guiding principles include:

(1) Investments which involve rates of return that must be subsidized by the pension funds are not appropriate at any time. Such investments necessarily result in reduced pension benefits for State employees or the need to increase State contributions to the pension funds to maintain those benefits even in the face of these lower returns. In our view, subsidized investments are never appropriate for public employees pension funds, no matter how worthy the social objectives those investments are meant to accomplish. If those social objectives are so worthy that such subsidies are in order, then a direct State (or Federal or municipal) appropriation should be considered. The appropriation process is

designed precisely for the purpose of deciding where public funds can achieve the greatest good for the citizens of the State, including (but not exclusively) those who are employees of State or municipal agencies; the pension funds have other objectives and are not the appropriate vehicles for such subsidies. Other, more indirect forms of subsidy are also inappropriate, we believe, whether those subsidies involve assuming an increased level of risk without adequate compensation or investing in instruments which result in excessive administrative or selection costs for the pension funds.

(2) Investing in instruments for which an established market already exists is normally of only marginal usefulness to the broader social objectives which those instruments are meant to serve. If the pension funds purchase government-guaranteed mortgages, for example, the net effect of that action may well be to displace other, presumably private funds that would have found those securities attractive on their own investment merits. Under these circumstances, investment in these securities by the pension funds would achieve little or nothing in terms of the desired social objectives; in our view, such purchases are, as social investments, purely symbolic.

(3) Legislative actions or regulations requiring pension funds to invest specified percentages of their assets in particular "socially responsible" forms are almost always counter-productive. For example, a formal requirement that x% of New Jersey pension funds be invested in New Jersey entities would (depending on how the term "New Jersey firms" was defined) almost certainly lead to a symbolic substitution of one group of investments for another in the pension funds' portfolio, without any effect at all on the amount of capital actually invested in New Jersey. To the extent that such legislation or regulations could be written specifically enough to require that capital would end up being invested in firms that would not otherwise be able to sell their securities, then those investments would almost certainly involve some degree of explicit or implicit subsidy by the pension funds. Moreover, even if those particular investments were appropriate at the time the requirements were imposed, it is not at all clear that the same requirements would be appropriate under differ-

ent economic and social conditions: the capital needs of different segments of the State economy have a way of changing rapidly over time, while legislative requirements and administrative regulations are normally adjusted much less frequently. In general, we believe it is much more sensible to rely on the judgment of the people on the Investment Council and within the Division of Investment to take account of the broader needs of the State whenever it is possible to do so without compromising the basic investment objectives, rather than mandating specific "socially responsible" policies ahead of time.

Specific Investment Possibilities

The analysis of specific investment opportunities is -- or should be -- basically an empirical question: are there investment opportunities in the State of New Jersey which simultaneously offer competitive risk and return characteristics and achieve broader public objectives, but are not able to attract the funds they require without special efforts by the State pension funds? If capital markets in the State are working efficiently, such opportunities should not exist and anyone looking for them is in a kind of "Catch 22" situation: any investment offering a competitive return at an appropriate level of risk should be able to attract the necessary funds without any special consideration from the State pension funds; if, on the other hand, the investment cannot attract such funds, then, almost by definition, it must be offering a return that is not competitive and any pension funds committed would involve the kind of implicit subsidy we said earlier was inappropriate.

It is possible, however, that certain inefficiencies do exist in capital markets at any given moment which might be exploited by the pension funds. In particular, it is difficult to know with certainty whether other funds are truly available for all investments that really do offer a competitive return. In cases where such funds are not available, a portfolio the size of the State pension fund may well be able to play an important leadership role in helping to develop the market for these instruments and in setting an appropriate price. Such efforts are unlikely to be dramatic in nature or in scale, but

they may be able to make an important difference on the margin. Again, though, the existence of such opportunities is an empirical question, and a complete answer requires a more thorough analysis of the State's financial markets than we have been able to conduct in the amount of time available to us. Nonetheless, we do have some observations, based on our own experiences and impressions, about several of the investment vehicles which have been suggested under the general rubric of socially responsible investing:

1) Tax-exempt issues of State and municipal agencies. Even though such issues are clearly designed to serve useful social purposes, these investments are not at all appropriate for State pension funds. The fact that the interest received on such bonds is exempt from Federal (and some state) income taxes means that they can offer a lower return and still be attractive to investors in high tax brackets. Pension funds do not pay income taxes on their investment earnings, however, and so there is no offsetting compensation for these lower returns.

2) Government-guaranteed securities. In general, the existence of a government guarantee is likely to assure adequate capital funding even without special consideration from the State pension fund. Further research is necessary to determine whether market inefficiencies really do exist here, but our impression is they do not. If that is the case -- and we believe it is -- special efforts by the pension funds to invest in such instruments will, in terms of achieving those social objectives, be largely symbolic and superfluous.

3) Housing instruments. Several forms of residential mortgage instruments have been suggested, all the way from issuing individual home mortgages to buying packages of GNMA securities. In general, we are skeptical about most of these suggestions, feeling that the high cost of mortgage money (and of housing itself) is much more a problem in current markets than the availability of such money; without explicit subsidies, there is very little the pension funds can do to lower those costs. Looking at some of the specific instruments that have been suggested, we would make the following comments:

First, the investment of pension funds in mortgages for individual State employees or retirees does not seem to us to be appropriate. The Division of Investment does not have the necessary staff, the administrative structure, or the localized expertise to make such mortgage loans.

Second, purchases of government-guaranteed mortgage loans may be useful in some cases, but by and large their value in helping to achieve social objectives is only symbolic. Again, though, such investments are already being made by the pension funds.

Third, any purchases of private, non-guaranteed mortgages should be reviewed carefully to insure that no implicit or explicit subsidies are involved, to the detriment of the pension funds' primary beneficiaries. It is important that the pension funds not be put in the position of the "lender of last resort," picking up mortgage packages no other investor would consider purchasing.^{4/} At the same time, we feel there is a leadership role the pension funds can play in this area, paying particular attention to New Jersey issues. The Investment Council's current policy of limiting the proportion of any such issue it will purchase to 20% probably represents a reasonable balance between these two concerns, in that it prevents the pension funds from being the lender of last resort -- indeed 80% of the issue has to be marketed to other investors -- while at the same time allowing the pension funds to play a significant leadership role in the placement of New Jersey mortgages.

Fourth, the existence of State-wide or regional mortgage pools might make the purchase of private mortgages less difficult for the State pension funds, and possibly other investors as well. Such intermediaries would allow investors to pool the risk associated with these investments and share the administrative costs of selecting specific mortgage packages. There has been some discussion about the possible formation of intermediaries of this kind, but they have not met with much success to date. Still we believe it is an idea worth pursuing.

^{4/} One of our members compared this position to that of the insurance company forced to provide automobile insurance for all of the "assigned risk" pool, without being given any opportunity to sell to the more profitable segments of the market.

It is not the role of the Investment Council and the Division of Investment to create such organizations -- although they have tried to encourage them in the past and the Council's current regulations do permit investment in pools of conventional mortgages. It is possible, however, that the Governor's Office and the Legislature can work together with the New Jersey financial community to help encourage the development of such pools and to provide the support necessary to make them attractive and competitive investments.

Finally, we believe that the time is not right for pension funds to take the lead in developing shared appreciation mortgages or other forms of investment in which the lender holds an equity interest in the property. In addition to all the personal and legal problems of determining how that equity is shared between the individual resident and the lender/investor, the pension funds would almost certainly face substantial administrative costs trying to oversee such a program. Moreover, as a non-taxable organization, the pension funds would lose out on the tax deductions and deferrals available to other, taxable investors such as banks and insurance companies.

4) Direct loans to New Jersey businesses. These loans face many of the same objections as direct purchases of private mortgage packages, and again the pension fund should not be forced to be the lender of last resort for debt that could not be sold elsewhere. Moreover, well-established markets exist for most corporate debt, and Federal and State programs already reach some of the firms which are too new or too small to raise money in those markets. Again, more research would need to be conducted before anyone could reach a definitive conclusion, but it is certainly our impression that the market is generally efficient in this area and there is no special contribution the pension funds can make at this time.

5) Venture capital and other equity investments. New issues of the common stock of very small companies have been suggested by many people as an area where the efficiency achieved by more traditional markets is lacking. As a result, extraordinary returns are said to be available for investors willing to take some risk and invest in what has become known as "venture capital."

It is the nature of financial markets, however, that investment vehicles which consistently offer above-average returns invariably get discovered and quickly become very popular. As a result of that popularity, the extraordinary returns those investments had been offering dwindle to a more reasonable level (where "reasonable" takes into account the level of risk being assumed relative to other investments available in the market). Again, more research would be useful, but it is our general impression that there are sufficient venture capital funds available in New Jersey at the present time to meet the needs of promising new ventures. In general, we believe that other government actions -- tax policies, regulatory policies, community infrastructure, educational and training programs, etc. -- along with general economic and business conditions, play a much larger role in the encouragement of new business in the State than anything in the capital markets themselves (other than the basic cost of capital). As a result, we do not expect that there is a major role for the pension funds to play in this area.

Next Steps

It is clear from the preceeding discussion that we are generally impressed by the steps that have already been taken by the Investment Council and the Division of Investment to do what they can to encourage economic development and other broader social objectives in the State. It is also clear that we are generally skeptical about whether significant new investment opportunities really do exist to encourage further development, without compromising the primary objectives of the pension funds. As a general rule, we believe that the normal capital markets are usually the best vehicle for meeting the various capital needs in the State, without any special underwriting from State pension funds.

Throughout our discussion, however, we have been frustrated by the apparent lack of useful data and thoughtful analysis in this entire area. As was indicated at several points in this report, the question of whether or not there are specific investment opportunities unmet by existing capital markets which

offer competitive returns to potential investors and achieve broader social objectives is basically an empirical one. Yet, as far as we can tell, very little rigorous analytical work has been done to determine whether those opportunities really do exist. In the time we had available, then, we were forced to rely on more anecdotal evidence and our own impressions of the capital markets in the State.

In view of this lack of hard evidence, our conclusions should be regarded as tentative. We believe that efforts should be made to solicit the views of people within the State who are closer to the various capital markets than most of us, to see whether there is any evidence at all of such market failures. In addition, a careful and systematic examination of the experiences and findings of other states should be undertaken. If the results of those studies seem to indicate the real possibility that "gaps" in capital funding do exist, appropriate data should be collected and analytical studies undertaken, along with a review of the possible institutional changes which might be required in order to pursue the kinds of approaches described here and elsewhere. Until these steps have been completed and until consistently persuasive evidence has been gathered to show that pension funds can be invested to achieve these secondary objectives without compromising the primary goal of maximizing the investment return for the beneficiaries, we believe that no formal change in investment policy should be made. The primary obligation of the pension funds to provide for the financial security of 360,000 beneficiaries requires that we do nothing less.

Martin A. Bierbaum	Professor of Urban Planning, Rutgers University
James J. Hughes	Executive Director, New Jersey Economic Development Authority
Leonard C. Johnson	Former President, New Jersey Business and Industry Association
Frank K. Kelemen	Chairman, Cooper Medical Center, and Chairman, State Investment Council
Walter O'Brien	Director of Government Relations, New Jersey Education Association
Peter Shapiro	Essex County Executive
Richard R. Spies (Chairman)	Associate Provost, Princeton University

INVESTMENT REPORT

NEW JERSEY STATE
PENSIONS STUDY COMMISSION

March 15, 1984

6. Current use of non-economic criteria.

The socially sensitive investment scheme is more difficult to address because of its apparently innocuous impact on the rate of return and the quality of investments. The "all other things being equal" base and the double duty advantage seem to suggest a relatively painless way of pursuing socially and ethically redeeming goals. If non-economic considerations do not compromise the economic ones, why not include them in the decision-making process? This proposition is hard to argue against.

The State Investment Council policies already allow parochial interests (in the form of "New Jersey first" decisions) to guide investments in those cases where all other things are truly equal, e.g., in the competitive bidding of certificates of deposit of equal quality and maturity. Moreover, there are a number of cases in which non-economic criteria bear upon the economic criteria used in making investment decisions. On a number of occasions, the Division has voted a proxy against management in situations where it believed that management's recommendations would have an adverse economic impact on the company. These proxy votes have been made in a number of areas which are often identified as "socially sensitive" areas. Non-economic criteria do play an important part in the Council's decision-making process but only insofar as they bear upon valid economic factors which have to do with prudent decision-making. These non-economic factors may involve company policies relative to the treatment of ethnic or racial groups, which allows New Jersey investments to take into account generally accepted principles of corporate behavior such as those addressed in the Sullivan principles.

The Commission endorses the current decision-making process of the Council in this regard because it allows for relevant considerations of a non-economic character to be taken into account without compromising the fiduciary integrity of the Council. It also allows for the flexibility in investment criteria of a non-economic nature by not tying the Council to

investment standards established by outside agencies whose policies may be modified or altogether abrogated. Again, the Commission's affirmation of the current structure is predicated on the conviction that both employer and employee interests are well represented on the Council and that the charge to the Council of protecting the interests of the beneficiaries by investing solely for their benefit (as stipulated by law) is appropriate.

7. Lack of quantitative support for socially sensitive investments.

Another reason why the Commission believes that the current structure facilitates the most appropriate consideration of non-economic factors is because the list of situations in which "all other things are equal" for potential investments is terribly limited. The Commission has not found good, hard, quantitative data that there are so-called capital gaps in New Jersey which preclude worthwhile investment proposals from being funded. Even during the economic difficulties of 1981, James Hughes of the New Jersey Economic Development Authority observed that, in his opinion, there was no shortage of attractive investment opportunities.¹⁰ The lack of such supporting material makes it difficult to argue persuasively that it is possible to use pension money to bolster new businesses in New Jersey without sacrificing return or the quality of investment. Undoubtedly, if pension money were made available for venture capital purposes to a large extent, plenty of opportunities for investment would arise. However, the point of socially sensitive investment is to invest without sacrifice. Insufficient information exists to endorse socially sensitive investment on this point.

The lengthy lists, which some have proposed be included in investment decision-making to allow for non-economic considerations to have their full impact, suggest an optimism about social investing (without sacrifice) which has not been borne out by experience. The Commission held a public hearing in December of 1982 regarding the wisdom of social investments. Two organizations testified, taking opposite positions. The representatives which supported the merits of social investing did not produce quantitative information which demonstrated that social investing can be accomplished without investment sacrifices. Moreover, it appears from recent literature on the subject that investment schemes which were advanced as social investing without financial compromise have not succeeded in avoiding the sacrifices of return and quality which socially sensitive investing is, by definition, supposed to avoid. A recent study by the Federal Reserve Bank of Boston is worth quoting at length because New Jersey is specifically mentioned.

¹⁰ Memorandum from Roland Macold to State Investment Council, 12/28/81, p. 3.

For those who support the proposition that it is undesirable to trade lower returns for social considerations, the experience of public pensions with privately insured mortgage-backed securities is somewhat alarming. Most of the states involved believed that they were not sacrificing returns to accomplish social goals, but rather were following the prescription that, where all other financial considerations were equal, social goals could enter the investment decision. If such a prescription were workable, it ought to be successful in the area of housing, since clearly defined benchmarks exist against which to measure alternative investments. Two states, New Jersey and South Dakota, took advantage of the benchmarks and compared the risk and return on the privately insured mortgage-backed certificates with those of other mortgage instruments. Once they determined the yield was below market, they rejected the proposed packages. At least 10 other states, however, failed to make this comparison and invested in securities that were significantly riskier and less liquid than GNMA's at yields that were generally below the GNMA rate. As a result, the pension funds inadvertently sacrificed returns and the returns sacrificed were not negligible -- often more than 200 basic points.¹¹

The Commission believes that there are some things which stand out in this summary of the Federal Reserve study. First, New Jersey was able to avoid the surprise of other states regarding these socially sensitive investment proposals because it investigated the issue beforehand and realized the consequences; the Council should be congratulated on this. Secondly, the summary points out that one should find that the "all other things being equal" argument would apply in the area of housing if anywhere, because there are some benchmarks to measure the benefits of the investment. On the contrary, the argument was not supported by these experiences. It was demonstrated to be fallacious, in the hard light of market experience, even though theoretically it looked good. Thirdly, it is worthwhile to note that the sacrifice made by these other states was not negligible, but very significant.

The lack of quantitative data supporting the idea of socially sensitive investments (made without sacrifice) and the availability of important data arguing forcefully to the contrary leads the Commission to the conclusion that, although socially sensitive investing has the appearance of merit, practically speaking it lacks the substance which is required for sound investing. The "all other things being equal" argument sounds tantalizing and simple, but at this point it appears to lack real possibilities (other than

¹¹ "The Pitfalls of Social Investing: The Case of Public Pensions and Housing," New England Economic Review (Boston: Federal Reserve Bank of Boston, September/October, 1983), p. 36.

those currently employed by the Council) and in some cases serves as a Trojan horse for investment schemes (benefitting powerful special interests) which are counterproductive to stated investment goals. Certainly, socially dictated investments violate the loyalty principle of fiduciary responsibility. Even if only the beneficiaries are considered, the near impossibility of making judgments about the interests of the beneficiaries in non-economic terms would mean that sacrifices in investments would be disloyalty to some. Although socially sensitive investment, in theory, does not abrogate the loyalty provisions of the fiduciary's responsibility, the Commission believes that it does in practice. If non-economic criteria are included in financial decisions when they do not directly bear upon economic considerations, it is implicit that the interests of others are being included in an inappropriate manner. Double-mindedness about the purpose of investments fosters confusion and ambiguity in the decision-making process which is inconsistent with the exclusive purpose and sole interest provisions of pension law. Moreover, the lack of success in avoiding financial sacrifices has left certain fiduciaries open to the charge that their socially sensitive investments violated not only standards of prudence but loyalty as well.

8. Summary

In summary, on the issue of social investment, the Commission believes that only economic considerations should be taken into account in the investment process except in those cases where non-economic criteria have a bearing upon economic considerations and in those few, simple cases where it is clear from the outset that "all other things are equal." Socially dictated investment is a violation of fiduciary trust, which the Commission believes is a foundational element of public policy. Socially sensitive investment is generally inappropriate because there are so few cases in which investments taking non-economic criteria into account can be made without sacrifice. Other concerns, noted above, make the prospects of social investment even less attractive to the Commission.

Testimony of Richard R. Spies on Assembly Bills 1308 and 1309.

My name is Richard Spies. I am the Vice Provost of Princeton University and a member of the Economics Department there. The reason for my testifying before you this afternoon is that I have participated in two separate studies -- under two different administrations of the New Jersey State Government -- of the issues which are under consideration in your Committee, particularly the question of investing State pension funds to further economic development in New Jersey. As a result of these studies, I have both personal views and some degree of official status in the general area of social investing in New Jersey.

More specifically, in 1981 I was asked by Governor Brendan Byrne to chair a non-partisan task force charged with studying the possible use of State pension funds to further economic growth in New Jersey. The final report of that task force, which was intended to address the question of social investing in a general way rather than specific investment proposals, was submitted to Governor Byrne in January 1982.

Having clearly demonstrated my political naiveté and being hard-headed enough to come back for more, later in 1982 I was asked by Governor Thomas Kean to join the newly created Pension Study Commission, and I subsequently chaired the Investment Subcommittee of that group. The Investment Subcommittee dealt with many of the same issues as the earlier Byrne task force, and our report was included in the final Commission report which was issued last March.

I am sure you will be relieved to hear that I do not intend to review those reports in detail here, but I do commend them to you for your careful consideration. Both reports addressed very explicitly the

two critical issues which I believe are at the heart of proposed Bills 1308 and 1309:

first, the implications of introducing various social investing considerations into the criteria for the investment of public employee pension funds, both positive considerations such as economic development in the State and negative considerations such as those raised by business activities in South Africa;

and, second, the whole question of oversight and accountability, and the role and structure of the State Investment Council.

I hope you will review those reports carefully before reaching any conclusions about the legislation which is before you now.

Others, particularly Frank Keleman who is chairman of the State Investment Council, will speak directly to the details of the proposed legislation and its likely impact on the investment performance of the roughly \$10 billion in State-managed pension funds. Rather than trying to replicate that testimony, let me instead describe very briefly two general conclusions which I have reached as a result of the discussions I have participated in on this subject.

First, I believe that investment decisions which are based in part on secondary objectives such as in-state economic development or South African divestment always -- and I emphasize the word always -- result in some compromise in the primary objective of achieving the best overall economic return consistent with appropriate levels of risk. The language in these bills and in similar proposals in this and other states refers to investments which, in the words of Bill 1308, "offer a

risk, rate of return, opportunity or other condition of investment which is equivalent to, or more favorable than, an alternative investment decision that is not in accordance with the supplementary principle." Economists have talked about this notion for years: we even give it a fancy name -- *ceteris paribus*, which is just Latin for "all other things being equal" -- just to make it sound esoteric and unassailable. The only problem is that, in the real world of investment, things are never truly equal in this sense. The report of the Byrne task force describes what it calls a Catch-22 situation:

"any investment offering a competitive return at an appropriate level of risk should be able to attract the necessary funds without any special consideration from the State pension funds; if, on the other hand, the investment cannot attract such funds, then, almost by definition, it must be offering a return that is not competitive and any pension funds committed would involve the kind of implicit subsidy we said earlier was inappropriate."

In short, at the risk of oversimplifying -- but only slightly -- I would argue that the very notion of secondary objectives inevitably means some subsidy of these causes by both the employer (i.e. the State and municipal governments participating in the plan) and the employees served by these funds. I should add that the Byrne task force which produced this report included people such as the Director of the Economic Development Authority, Jim Hughes, and Peter Shapiro, the County Executive from Essex County, both of whom have a strong interest in seeing economic development in the State encouraged and supported.

The second point I would like to make is to urge you to consider carefully the very real costs -- in terms of the time and expense of fund administration and in terms of lower long-term investment returns -- of introducing short run political considerations into the investment process. In my judgment, the current structure of the State Investment

Council represents an excellent balance between the need, on the one hand, to permit public accountability and encourage socially responsible behavior, and, on the other hand, the advantages of an investment process which is independent of local political and business pressures. The record of other states with more political processes -- and the record of New Jersey prior to 1950 -- indicates pretty clearly the problems which can arise when political pressures are brought to bear on the investment process.

Thank you. I would be happy to try to answer any questions you may have.

CDE

HANDBOOK

CORPORATE DATA EXCHANGE, INC.

PENSION INVESTMENTS

A SOCIAL AUDIT

Plan	Investments in PNU Companies	Investments in OSHA Violators	Investments in EEO Violators	Investments in SA Investors/ Lenders	Total Plan Investments in Target Cos*	% of Plan Com Stock Invested in Target Cos
<i>(Collectively Bargained-Joint Control — cont'd)</i>						
Laborers Pension Tr Fd for Southern Calif	\$ 5.7	\$ 1.4	\$ 0.3	\$ 4.2	\$ 8.6	55%
Motion Picture Industry Pension Plan	7.2	3.2	7.9	8.8	16.3	61
NMU Pension & Welfare Plan	9.6	0.5	3.6	9.6	17.4	40
Northern Calif Retail Clerks & Food Emp Pen Plan	14.0	4.6	4.6	12.9	27.3	40
Operating Engineers Pension Tr (Los Angeles)	1.9	—	7.7	1.4	9.6	37
Operating Engineers-Employers Central Pen Fund	27.7	4.8	5.1	20.1	40.9	35
Operating Engineers Loc 312 & 612-Emp Retir Fund	20.1	3.1	5.1	17.8	31.5	42
Plumbers (Steamfitters) Industry Pension Fd (NY)	4.1	0.9	1.4	3.8	7.2	43
Printing & Graphic Comm Union-Emp Retir	5.3	0.3	3.0	4.4	9.9	44
Retail Clerks Union & Employers Pension Fund	3.8	1.6	2.9	2.8	7.5	28
Retail Store & Food Emp Pension Fund (Detroit)	5.0	0.9	1.4	6.6	8.4	34
Seafarers Pension Plan (Brooklyn, NY)	6.2	1.9	2.2	5.7	12.7	40
Sheet Metal Workers National Pension Plan	2.4	1.4	2.0	1.9	4.9	26
Southern Calif Retail Clerks & Food Emp Pen Plan	12.2	1.1	4.2	6.5	17.9	27
Teamsters Affiliates Pension Plan (Union Fund)	8.1	1.8	2.9	7.2	14.3	29
Teamsters Central Penn Pension Plan	8.6	1.7	1.1	9.0	12.6	19
Teamsters Central States, SE & SW Pension Fund	23.7	6.7	9.8	17.8	41.2	45
Teamsters Local 641 Trucking Emp N NJ Pension	0.8	0.4	1.1	1.3	2.5	19
Teamsters Local 705 Pension Trust (Chicago)	4.7	1.2	1.9	3.7	8.3	36
Teamsters Local 807 Labor-Mngt Pension (NY)	2.1	1.0	0.9	4.3	5.3	41
Teamsters Pension Plan of Phila & Vicinity	3.8	2.5	3.4	5.4	11.2	48
TIAA-CREF	1,044.7	188.7	400.4	829.4	1,762.5	42
Timber Operators Council-IWA Pension Plan	5.1	2.0	3.0	4.9	9.8	46
Typographical Union Negotiated Pension Plan	6.2	0.8	3.2	5.9	11.7	48
UMW 1974 Pension Plan	12.2	2.8	3.8	11.6	21.7	47
Upholsterers Union National Pension Program	14.8	2.8	4.6	9.1	23.5	45
Subtotal	\$ 1,444.4	\$ 277.0	\$ 554.2	\$ 1,174.8	\$ 2,472.3	40%
PUBLIC (20)						
Calif Public Emps & Teachers Retir System	\$ 629.1	\$ 152.3	\$ 211.2	\$ 392.1	\$ 984.3	47%
Connecticut State Trust Fund	51.2	12.5	21.3	34.5	84.5	36
Florida State Board of Administration	41.9	11.9	15.6	30.6	79.9	61
Los Angeles County Emp Retir Assn	89.6	41.9	40.7	70.2	166.2	34
Maryland State Retir Systems	144.8	34.6	31.4	128.4	242.1	39
Minnesota State Board of Investment	252.1	55.4	89.0	232.2	439.9	40
New Jersey State Common Pension Funds	132.3	9.6	26.7	116.2	212.4	32
New York City Employees Retir System	255.9	70.7	100.7	202.7	439.2	44
New York City Teachers Retir System	269.9	56.6	103.3	216.8	454.6	41
New York State Common Retir Fund	432.3	101.3	111.8	302.4	694.9	39
New York State Teachers Retir System	520.5	192.5	117.2	431.4	982.4	54
Ohio Public Emps Retir System	239.5	39.8	64.5	155.5	366.7	38
Ohio State Teachers Retir System	296.3	65.2	73.6	203.9	455.6	42
Oregon Public Emp Retir System	76.1	18.9	36.2	78.8	142.0	49
Pennsylvania Public School Emp Retir System	99.8	36.8	36.5	99.5	203.4	51
Tennessee Valley Authority Retir System	77.1	15.0	4.5	58.1	120.4	54
Texas Teachers Retir System	254.7	60.4	83.9	203.4	420.4	58
Virginia Supplemental Retir System	97.1	12.4	32.2	73.6	169.6	40
Washington Dept of Retir Systems	110.1	25.9	21.1	68.1	161.1	44
Wisconsin State Board of Investment	223.2	81.5	132.3	212.1	435.8	42
Subtotal	\$ 4,293.6	\$1,095.4	\$1,353.6	\$ 3,310.5	\$ 7,255.3	44%
Grand Total	\$17,569.7	\$3,161.7	\$5,445.9	\$11,960.2	\$27,872.2	

NOTE: All dollar figures in millions. Totals may not add due to rounding.
 * Target companies appearing in more than one social performance category have only been counted once in the totals.

PNU Predominantly Non-unionized.
 OSHA Occupational Safety and Health Administration.
 EEO Equal Employment Opportunity. SA South Africa.

TRINITY INVESTMENT MANAGEMENT CORPORATION

TEN TREMONT STREET, BOSTON, MASSACHUSETTS 02108-2008 • (617) 742-9525

September 4, 1984

Mr. Roland M. Machold
Director
Division of Investment
Department of the Treasury
State of New Jersey
Trenton, New Jersey 08625

Dear Mr. Machold:

Thank you for your request that we share with you some of Trinity's experiences in managing a portfolio for Michigan State University, whose policy prohibits us from using common stocks of companies doing business in South Africa. You seem to have information that we have had good performance, and that our example might be an endorsement--in investment terms--for the policy proposed for the State of New Jersey.

Yes, we won't deny it, we have been very successful with the MSU portfolio using the investment community's traditional benchmark--the S&P 500. Because our record is in the public domain, we see no point in not telling you what it has been:

	Total Return Since Inception <u>7/30/82 to 8/31/84</u>
S&P 500	+ 71.9%
South Africa Free Universe*	+ 68.7%
INDATA Median Equity Manager	+ 57.5%
Trinity's MSU Portfolio	+105.0%

*A capitalization-weighted universe of 470 stocks of USA companies not doing business in South Africa.

Unfortunately, a Misleading Example

We are both proud and pleased that we have been able to serve MSU so well.

But, we would be professionally negligent, if not downright misleading, if we were to tell you--or let you infer--that we would have done as well with New Jersey's \$3.5 billion in equities as we have managed to do with MSU's mere \$9.6 million.

Quite the contrary--in our judgment based on our day-to-day experience of identifying undervalued stocks within the limited South Africa Free Universe and then going into the market to buy them--we are convinced that what we have been able to do with Michigan State University's portfolio could not be translated into much larger portfolios, such as the New Jersey portfolio.

The Critical Difference

Market liquidity is the critical difference.

For MSU, we run a portfolio of about 60 issues. That many issues, by the way, is more than most managers would use for a portfolio with total assets of only \$9.6 million.

With rare exceptions, when we identify an undervalued issue within the SAF Universe that we want to use in the MSU portfolio, we can buy that position within a single day, and without disturbing the market price because we are taking, on balance, less than 20% of a single day's volume. On rare occasions we may be in the market for two days.

But if we had your problem of investing \$3.5 billion in equities--that's over 360 times the size of the MSU portfolio--we honestly wouldn't know how to do it and still preserve any selectivity capability.

Remember, Trinity's record with MSU was built on being able to select what we felt were the 60 most undervalued stocks out of a Universe of 470 stocks. We used virtually every stock we felt confident was in fact undervalued--and the 20% of the SAF Universe we ranked as solid BUYs is a much higher percentage than most investment processes are willing to rank as solid BUYs.

A Vivid Example

Let's assume we know for sure that the 60 stocks now held in MSU's portfolio will be as successful over the next year as were the stocks we held one year ago.

Furthermore, assume that the only New Jersey dollars that you want to invest in those stocks are dollars that would have to be raised by selling off stocks now held in the New Jersey equity fund that includes companies doing business in South Africa.

That would mean you are faced with finding a new home for the proceeds from 43 stocks that you would be forced to sell off by the adoption of such a policy. Those 43 now prohibited stocks are equal to 36.8% of your portfolio or \$1.4 billion.

Now, we wave the magic wand, and tell you to BUY what Trinity is owning in MSU. After all, look at the record on the previous page. After all, those guys at Trinity know what they are doing. They have a record to prove it.

It wouldn't be easy:

- o You have some advantage. You only have to sell off 43 stocks and you have 59 stocks into which to invest the money.
- o But, because the South Africa Free stocks are smaller, and because they have much lower average daily trading, it would be an impractical transition.
- o We begin by using two common sense rules:

--trading in any stock will be limited to 20% of that day's volume

--no new position in the New Jersey portfolio will be less than 0.5% of the total portfolio, nor more than 5.0% and/or 5.0% of a company's capitalization. (This latter rule is, in fact, New Jersey's own operating guideline.)

Under those perfectly proper realities, here's what any manager would face in making the transition:

- a. The minimum number of days it would require to establish a full position in some stocks would be 20 days.

The median days required to trade all the stocks would be 71 days.

For some of the stocks it would require more than 100 days, and for one stock an impossible 1,429 days.

- b. It would take 27 trading days (more than a calendar month) to complete only 50% of the program.

You know by experience that how you would rank a stock on Day One may be a whole lot different than on Day 27. Many stocks you start out to buy might well give you second thoughts as they run up in price and/or have other problems.

An Unfair Example?

Perhaps so. After all, the SAF Universe was designed for MSU's very small portfolio. To put part of New Jersey's money into those 59 stocks might be rigging the answer.

Let's loosen the noose. Let's assume:

- o You can use every stock on the current New Jersey Approved List except the 67 that would have to be eliminated by an SAF policy.

This means that there will be absolutely no selectivity whatsoever involved. You simply are going to take the money you must raise because of the proposed SAF policy, and invest it in the stocks that have been carefully identified as a suitable universe from which you are now identifying undervalued stocks for the portfolio.

- o You use only the existing New Jersey guidelines; i.e., at least 0.5% positions, and no position more than 5.0% and/or 5% of a company's capitalization.

Here's what you would be faced with:

- a. The minimum number of days it would require to establish a position in some stocks would be 9. That's less than the 27 to get into the MSU portfolio, but still a great many days at the minimum.

The median days required would be 29--nearly 1.5 calendar months.

The maximum required would be 607--better than 1,429 for the MSU list, but still a silly number.

b. It would take 12 trading days to reach 50% of the transfer.

In both cases--using the highly successful MSU list or in using New Jersey's entire approved list less the restricted stocks--the time at the trading desk would be very costly in terms of performance.

There is no way of telling how much damage would be done while you were in there day after day after day taking 20% of the volume of a stock. But we would be suspicious of any so-called "expert" who said there wouldn't be a market impact.

You may decide--as an investment decision--to buy a \$50 stock. But after you have been in there steadily for a month buying 20% of the volume, that stock is likely to move up, and may no longer be undervalued in your investment judgment.

And this problem is a two way street. Getting into any stock that is thinly traded in the context of a portfolio's needs can be costly. Generally, it is more costly to get out. When you don't want it any longer, much of the rest of the world feels the same way and will extract a penalty as you try to unload.

One Final Scenario

Let's assume that you do want to exercise some selectivity, not simply buy everything on your approved list.

Thus, instead of using your 177 issue approved list, we use the much larger universe of SAF stocks, and then through a selectivity process agree to buy only issues of above-average quality that are also ranked in the top 3 deciles by Trinity's Multiplex model. (This is a looser constraint than we use for MSU, where we limit BUYs to the top 2 deciles.)

Let's compare all three possible portfolios:

	<u>MSU's Current Portfolio</u>	<u>New Jersey's Current Approved List</u>	<u>Selected BUYs From 674 Stock Universe</u>
# of Issues Available	59	177	136
Average Market Cap. (Billions)\$	1.9	\$ 2.0	\$ 1.5
Days needed to get 50% Done	27	12	18
Median Days to Trade	71	29	54
Minimum Days to Trade	20	9	21
Maximum days to trade	1,429	607	1,231

What drives the trading days--and thus the price pressure up--in all of these cases is the reality that a SAF policy eliminates from consideration stocks with more than \$300 billion in market capitalization that are the backbone of any large portfolio such as New Jersey's.

In the current New Jersey portfolio, the average market capitalization is \$4.5 billion. But the average market capitalization of the stocks that would have to go out of the current portfolio is \$7.0 billion.

Finding a new place to invest money that comes out of stocks with an average \$7.0 billion in market capitalization when you are forced to use stocks whose average

market capitalization is only \$2.0 billion, or roughly 72% smaller, is at the heart of these difficult trading scenarios.

Focus Only on Trading

In this letter we have focused only on the trading problems. We have not discussed the distorted characteristics of a SAF Universe in other terms. Virtually entire Industry Groups are eliminated by a SAF policy, and this means opportunity cost. Being sealed off from the complete market will create diversification problems and thus non-market risk problems that other managers don't face.

And so on. The list is a long, long one and we assume you already know those hazards.

Yes, Trinity's MSU Experience is Meaningless in New Jersey's Terms

Let me conclude by coming back to your basic request. You said in your call that other "professional investors" had cited our MSU experience as an example that a SAF policy is manageable without inhibiting investment results.

Trinity does not see it that way. What we did for MSU worked for their \$9.6 million dollars--and we hope it continues to work.

But, by first-hand experience, we would be the first to tell you that we haven't the foggiest idea how to translate our investment process--working in such an inhibited and limited universe--into New Jersey's needs for its \$3.5 billion.

To cite Trinity as an example is ridiculous. It's like some promoter watching his neighbor's kid make a very successful sled run down a gentle slope and deciding that kid is just right for the Olympic bobsledding team. Hungry for business, the promoter has nothing to lose.

But the kid on the sled--who knows his capabilities--has much to lose (and in our analogy that kid would be Trinity). More importantly, the parent of the kid, holding the ultimate responsibility, should know the risks involved and listen to both his kid on the sled and his own common sense, before he signs up. That parent is perhaps your legislature.

Data Available

You can meet with our Paul Reeder who crunched the summary numbers cited in this letter. He has pages and pages of computer printout that explore many other aspects of the challenge you face with a SAF policy. From that work you will find a great many other cautions over and above the liquidity ones cited in this letter.

Please keep in mind that our comments in this letter are limited to the investment aspects of the SAF policy. We are personally very sympathetic with the aims of such a policy, but as professionals in response to your question, we are willing to point out the risks being taken in investment terms.

If you have more specific aspects you would like explored, please give me a call.

Sincerely,


Stanford Calderwood

SC:wp

TRINITY INVESTMENT MANAGEMENT CORPORATION

TEN TREMONT STREET, BOSTON, MASSACHUSETTS 02108-2008 • (617) 742-9525

September 4, 1984

Mr. Roland M. Machold
Director
Division of Investment
Department of the Treasury
State of New Jersey
Trenton, New Jersey 08625

Dear Mr. Machold:

This is my second letter of this date. In our telephone conversation, I mentioned tongue-in-cheek that the challenge you face with a possible SAF policy is very akin to a man going into a poker game with a deck stacked against him. You asked if I could be specific.

This letter tries.

Methodology

We first had to relate an individual stock to a particular card.

I don't have to tell you that when you manage billions of dollars in an equity portfolio it is much more complicated than simply finding undervalued stocks that are going to outperform the S&P 500.

Under New Jersey's rules you have to buy at least 0.5% positions, but no more than 5% of a company. At the same time, you cannot have more than 5% of your dollars in any one company. These are common sense rules, widely used. Clearly, even if both stocks had equal chance of outperforming the S&P 500, there is considerable difference between the index's largest and smallest stock:

	<u>Largest IBM</u>	<u>Smallest Eagle-Picher Ind.</u>
Market Capitalization	\$ 67,635 mm	\$ 217 mm
Average Daily Trading	\$ 154.9 mm	\$ 0.1 mm

Thus, to relate stocks from top to bottom, from Aces to Twos, we multiplied the market capitalization times the daily trading (and then took the square-root for an easily read figure).

Under such a scheme, IBM would be an Ace. The smallest company, Eagle-Picher, would be a Two.

Next, we ranked stocks in your total universe and broke the list into 13 equal levels to represent each card in the deck--Two to Ace.

Thus, there were 21 stocks ranked as Aces, 21 ranked as Kings, and so on down to 21 ranked as Twos.

As you might expect, in your actual portfolio, you had many more Aces (19 stocks) than you did Twos (4 stocks). This simply validated the underlying assumption that stock size and trading were important considerations beyond simple selectivity.

Impact of SAF Policy

We next looked at the cards (stocks) that would be eliminated by an SAF Policy from your total Universe.

Here's what we found:

<u>Card Category</u>	<u>Stocks Lost</u>	<u>% of Cards Lost</u>
Ace	10	47.6%
King	12	60.0%
Queen	9	42.9
Jack	9	42.9
Tens	3	14.3
Nines	8	38.1
Eights	4	33.3
Sevens	11	52.4
Sixes	4	33.3
Fives	3	14.3
Fours	7	33.3
Threes	7	33.3
Twos	3	14.3
Total	90	32.7%

So there you sit at the table.

- o The other players around the table are getting cards from a 52-card deck. They have available to them all the Aces, all the Kings, all the Queens, and so on.
- o But you are getting cards from a deck that has been reduced by 17 cards to a total of only 35.
- o And among the 17 missing cards are ones you need desperately in your \$3.5 billion fund:

2 Aces
2 Kings
2 Queens
2 Jacks

But, take heart, you at least have 3.4 Tens and about as many Eights.

What is The Opportunity Cost?

The casual investment "expert" who is testifying that the SAF policy won't inhibit performance tends to answer the opportunity question with "...nobody knows for sure." The implication is that because stocks that are SAF do have, on balance, performance that about equals the normal institutional stocks, there isn't any real problem. The question of size and liquidity, the basis for classifying our cards, is generally ignored and passed over lightly.

But the money at stake is not that of the experts who say there are no investment implications of working from a list that denies about \$400 billion in market capitalization to the portfolio manager.

If it were your money, would you want to sit at the table and be denied 17 critical cards the other players could use if they wished?

Missing the Point

It does not boil down to a comparison of the performance of stocks in an SAF Universe and those in a non-SAF Universe.

The dimensions of size and trading liquidity are critical to large funds such as New Jersey's.

What good is it if there are stocks in a SAF Universe that perform as well as the prohibited stocks, if the portfolio involved is so large it can't practically buy enough of those better performing stocks.

It is economically costly in terms of research to identify an undervalued stock. And that cost is not related to size or trading liquidity. If anything, it costs more to identify the smaller stocks that are thinly traded because so few Street Analysts are watching such stocks.

So, you wind up paying more to identify a stock you can use under an SAF policy and then find out you can't buy as much as you would like. You look around the table, discover that the other players have identified an Ace at much less cost, and can buy all they want and need easily. You could have identified that Ace, but you can't buy it.

Valid Analogy?

We can't say for sure, but we suspect it can be tested easily.

The next time an "expert" testifies that dropping \$400-plus billion in market capitalization isn't going to be costly, invite him to the back room to play a little poker.

My guess is he wouldn't want to expose say \$50,000 of his own capital in a game where he was being dealt from a deck of only 35 cards and you were being dealt from a full deck. If he doesn't want to play that game in the real world with his own real money, why is he so generous about going into a much more serious game with such obvious inhibitions and with billions at stake?

He may be looking for business. He may be using his role as an "expert" to push a perfectly good social cause he feels strongly about.

In any event, we urge strongly that the situation be explored in real terms, not in

global terms that can hide the realities of the trading desk where big stocks with big daily trading are mandatory for multi-billion dollar funds.

Again, let me stress that these views are based purely on investment considerations, and are not an expression of any opinion about the social issue involved.

Sincerely,

A handwritten signature in black ink, appearing to read "Stanford Calderwood", written in a cursive style.

Stanford Calderwood

SC:wp

W

August 28, 1984

Mr. Roland M. Machold, Director
New Jersey Division of Investments
349 West State Street
Trenton, New Jersey 08625

Dear Mr. Machold:

Attached, for your review, is a draft copy of an article that has been accepted for publication by the Financial Analyst Journal regarding South African divestiture. Our intent in writing the paper was to address the implications of divestiture upon large institutional portfolios. Obviously, divestiture affects public plans much more than their private counterparts. Legislative bodies, citizen groups, and in some jurisdictions employee associations are actively involved in political issues surrounding South Africa's racial policies.

Wilshire has prepared analysis on this issue for the State of Oregon which they used as part of their oral presentation to their State legislature. Unfortunately, their presentation was not reduced to writing. In short, Wilshire removed all stocks and bonds from the Oregon portfolio that would be divested and restructured the portfolio on a pro rata basis. The impact of this restructuring was an incremental increase in the portfolio's risk characteristics.

In addition to our work with Oregon we have also studied this problem for other states and localities, including California. As you may be aware, we have the privilege of working with both California Public Employees and California State Teachers two of the largest public funds in the country. We are working with both of these funds on a number of investment issues including divestiture.

If, after you have reviewed the article, you have any questions, please contact me at your convenience. Wilshire has a number of large public plan clients and I am responsible for most of those relationships, therefore, I have had to address many of the concerns and issues that you are facing. If you have any other areas you would like to explore please do not hesitate to contact me. I have clients in both

W

Mr. Roland M. Machold, Director
New Jersey Division of Investments
August 28, 1984
Page Two

New York and Pennsylvania and I'm in your part of the country quite frequently. Possibly during one of my future trips we can get together to discuss these issues on a more personal basis.

Respectfully,



Allan Emkin
Senior Associate

AE/ba
Enclosure

cc: Bill Berkmeirer

Submitted for Publication
Not For Quotation
Comments Welcome

SOUTH AFRICAN DIVESTITURE: THE INVESTMENT ISSUES

Wayne H. Wagner
Chief Investment Officer
Wilshire Associates
Asset Management Division

Allen Emkin
Senior Associate
Wilshire Associates
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Analyst
Wilshire Associates
Asset Management Division

June, 1984

An increasing number of public pension funds are or will be considering some form of restrictions on investments in companies doing business in South Africa. The states of Massachusetts, Connecticut, and Nebraska, along with the cities of New York, Philadelphia and Washington D.C., have already imposed various investment restrictions on their pension fund portfolios. Other legislative bodies are being presented with similar legislation by a coalition of religious, political, and labor groups opposed to South Africa's race policies.

This paper does not attempt to address the moral, political or ethical issues involved in such a policy. The purpose of this paper is to address the practical implications of managing large institutional portfolios under divestiture restrictions. Clearly, this question has important ramifications. If growth in retirement benefits is compromised, or new taxes required to compensate for potentially diminished investment returns, these are important issues that must be addressed when a divestiture policy is under consideration.

IS THE PROBLEM MANAGEABLE?

Previous analyses of the implementability of the restrictive policies have brought forth a wide degree of divergence and a great deal of controversy.

In the opinion of professional investment managers as gathered for the Washington D.C. Retirement Board, the anticipated effects of prohibitions on South Africa related businesses were substantial:

- the vast majority of managers felt that performance would be reduced;
- nine out of ten thought diversification would be hampered;
- three out of four thought that quality would be impaired; and
- half said they would refuse to accept fiduciary responsibility under such conditions.

In contrast to the opinions expressed above, several studies have come to quite the opposite conclusion:

- "the effect on portfolio risk of excluding the companies operating in South Africa...is, contrary to intuition, not particularly important." <1>
- "...such a restrictive policy really is not all that inhibiting." <2>
- An investment advisor specializing in the management of restricted portfolios testified that "A skilled investment manager should be confident that exemplary returns can be achieved within the guidelines of the proposed legislation." <3>

Numerous questions must be answered concerning potential conflicts between well established fiduciary responsibilities and impending divestment decisions<4>. The National Association of State Investment Officers adopted a resolution opposing laws that force managers to make investments based on "anything but the best interests of pension fund members." In addition to concerns about compromising fiduciary responsibilities, State Retirement Officers worry whether it is possible to implement restrictions, particularly on large portfolios, without reducing investment opportunities, and ultimately, investment results.

Investment Officers, divestiture advocates, and previous authors all agree that divestiture restrictions have minimal practical effects on smaller portfolios, say \$50 million or lower. We concur. But what about larger funds that have billions of dollars to invest? Would they be able to continue their current risk/reward strategies to fund future benefits, or would radical restructuring be required?

In this paper we address how these critical questions affect large pension funds:

- If these restrictions were imposed, could current investment policy be continued?
- If not, what would be the likely implications on investment structure and ultimate investment results?

THE SCOPE OF THE CHALLENGE

The securities eliminated as a result of South African divestiture represent a large portion of available investments. Most multi-national companies do business in numerous foreign countries, and these companies form a large percentage of the high quality, "blue chip" investments favored by institutional investors such as pension funds.

Identification of the companies to be eliminated for South Africa connections is not the purpose of this paper. We will rely on a commonly used list that includes all companies with employees in South Africa or business relationships with the government of South Africa. This list of prohibited companies includes 229 firms whose common stocks were valued on December 31, 1983 at over \$600 billion in market capitalization.

Six hundred billion dollars is over half the capitalization of the Standard & Poor's 500, often considered to be the "opportunity set" for institutional investors. Almost 35% of the weight of all common stocks, as represented by the Wilshire 5000 index, is eliminated with the 229 stocks.

Of the largest fifty companies in the U.S., 31 are on the prohibited list, including such institutional favorites as IBM, Exxon, Merck and 3M. Of the largest 100 companies, 49 are eliminated.

The companies on the list tend to be concentrated in industries whose products or production processes are readily transportable, and where maturity, size, and/or world-wide product acceptance have led toward international markets. Some of the capitalization weight of the S&P 500 industry groups are virtually totally excluded:

INDUSTRY	% OF S&P 500 CAP WT ELIMINATED	LARGEST COMPANY ELIMINATED	REPLACEMENT COMPANY
Industrial Equipment	99%	General Elec	Dover
Banks	97	Citicorp	Texas Comm
Photographic	93	Eastman Kodak	Xidex
Chemicals	87	Dupont	Diamond Shamrock
Drugs	87	Am. Home Prod.	Syntex
Conglomerates	86	MMM	Greyhound
Tire & Rubber	85	Goodyear	Gencorp
Office Equipment	84	IBM	Commodore
Motor Vehicles	81	General Motors	Mack Trucks
International Oils	76	Exxon	Murphy Oil (domestic oil)

Other industries such as utilities, trucking, real estate and energy extraction are hardly affected, since most of their

business is conducted without international implications.

Clearly, the size of a company and its industry affect the probability of being on the divestiture list. Conversely, companies that are too small or too localized to have developed international markets are unlikely to be affected by these restrictions.

From an investment viewpoint, large international companies reduce investment risk through size, financial strength, diversification of product line and dispersion of markets served. Companies that do not possess these strengths are more likely to suffer during difficult economic times. The challenge to the portfolio manager, then, is to construct portfolios of similar investment opportunity without substantially altering portfolio risk characteristics.

A UNIVERSE OF ALTERNATIVES

If substantial parts of the "opportunity set" represented by the S&P 500 are eliminated from investment consideration, portfolio managers would need to identify new companies that best represent, within the confines of the policy, the sources of investment returns in the U.S. economy. Analysis of this Alternate universe provides insights into the portfolio effects of divestiture.

We have constructed a South Africa-free universe by replacing each prohibited company in the S&P 500 by another company in the same industry. In all cases, the replacement companies were the largest available American companies without South African connections. In total, 152 companies in the S&P 500 universe were replaced. This Alternate universe can be used to analyze both the effects of eliminating the South Africa related companies and the practical problems that derive from the nature of the companies necessarily used to replace prohibited stocks.

INVESTMENT OPPORTUNITIES WITHOUT SOUTH AFRICAN STOCKS

Size of the Universe

The most obvious effect of substituting small companies for large is on the total capitalization value of the universe. The stocks that comprise the S&P 500 were worth over \$1.175 trillion at first quarter end 1984. The capitalization value of the South African related stocks was \$554 billion, while the value of the stocks added to the alternate universe was \$107 billion. As a result, the Alternate universe was worth \$728 billion, less than 62% of the value of the S&P.

Rates of Return

Other researchers have noted that the average investment return on companies affected by divestiture is significantly lower than the returns of companies free of South African connections. Indeed, it has been suggested that investment results could actually be improved under a divestiture policy. For example, our computations show that a dollar invested in the South African related companies would have grown to \$1.94 over the recent five years, including dividends. A dollar invested in the alternate companies would have grown to \$2.60, a difference in annual rate of return of over seven percent. But what is the source of this substantial difference?

Numerous studies^{<5>} have indicated that smaller stocks have outperformed larger stocks by substantial amounts for many years. Studies at Wilshire Associates^{<6>}, for example, show that the largest 500 companies returned 9.7% per year for the last ten years, while the second largest 500 returned 17.9% per year.

Thus the apparent higher return of South Africa-free companies is a restatement of the truism that smaller, riskier companies promise -- and usually deliver -- higher returns. In fact, any criteria that eliminates blue chip stocks in favor of smaller, riskier stocks will improve expected returns. During recent longer periods small stocks have indeed outperformed large stocks, but conclusions based on this evidence must consider that this extra return does not accrue without incurring greater investment risk.

For example, in the down market from July of 1983 through June of 1984 the largest 500 stocks decreased in value 6.6%, while the second largest 500 declined 15.0%.

"The greater the investment risk, the greater the rate of return" is not a maxim that allows retirement plans to take unlimited risks. The appropriate level of risk depends on the actuarial requirements of the plan, the funding status, the legal restrictions, and the retirement board's interpretation of fiduciary responsibility. All these factors affect a fund's ability to bear added risks in the hopes of higher, but uncertain returns. Relative rates of return can be judged only in the context of risk assumed.

Investment Risk

Beta and R-squared (also called the coefficient of determination) are two commonly used measures of portfolio risk. The sensitivity of a portfolio to changes taking place in the market is measured by the former, while the latter indicates the degree of diversification in comparison to the market benchmark. The market, as represented by the S&P 500, has a beta of 1.0 and an R-squared of 1.0. A portfolio's risk tolerance is appropriately

measured by beta: a portfolio whose beta is greater than one is more volatile than the market while one with a beta of less than one is conversely less subject to market movement.

Active portfolio management implies concentrating in favored securities and sectors, thus reducing diversification below the 1.0 that would indicate perfect diversification. Most actively managed equity portfolios have an R-squared between .80 and .92, while the R-squared of index funds approach 1.0.

The Alternate universe is very well diversified, having a R-squared of .968, due in large part to the high percentage of common holdings with the S&P 500. Although well diversified, it is more risky than the market, with a beta of 1.08. This implies that the Alternate universe will rise or fall, on average, eight percent faster than the S&P 500.

Large funds that employ a multiple manager structure often specify a target beta as a means of controlling total portfolio risk. To meet a specified target with securities selected from the riskier Alternate universe, managers would have to select from among the least risky Alternate stocks, or else hold larger cash positions to reduce the portfolio beta to the target.

These quantitative measures of risk show the Alternative universe with 3% more diversification risk and 8% more market risk. However, divestiture also involves strategic risks that are more difficult to quantify. For example, during late 1983 and early 1984, the only sector to show positive price appreciation was Energy.<7> Energy stocks, however, are heavily affected by divestiture restrictions. Divestiture thus leads to an incomplete exposure to opportunities. The result is a diversification loss beyond the manager's control and a risk that must be borne by the fund.

Industry Weighting

To construct the Alternate universe, large companies in the S&P 500 were replaced by other, smaller companies in the same industry. As a result, the industry weights of the Alternate portfolio differ from the weights of the S&P 500:

LARGE INDUSTRY WEIGHT REDUCTIONS

INDUSTRY	% of S&P 500	% of ALTERNATE	DIFFERENCE
Business Mach	8.7%	3.1%	-5.6%
Internat. Oil	8.0	4.5	-3.5
Drugs	6.2	3.1	-3.1
Motor Vehicles	4.0	1.8	-2.2
Prod. Equip.	4.1	2.0	-2.1

The complement of the loss of importance of these industries is the gain in weight of industries not similarly affected:

LARGE INDUSTRY WEIGHT INCREASES

INDUSTRY	% of S&P 500	% of ALTERNATE	DIFFERENCE
Telephone	5.8%	9.2%	3.4%
Utilities	5.6	8.8	3.2
Domestic Oil	6.6	8.9	2.3
Energy Explor.	3.5	5.4	1.9
Paper	2.0	3.1	1.1
Railroads	1.9	3.0	1.1
Insurance	2.2	3.3	1.1

Note that the industries with greater emphasis are those whose business is done primarily in the United States. These industries are thus more suspect to country risk within the U.S. economy that is not offset by sales and earnings from foreign countries.

Investment Desirability and Quality

The investment desirability of the Alternate universe and the S&P 500 can be compared using the Value Line <8> Timeliness and Safety rankings. The Timeliness Rank is a measure of the stock's anticipated twelve month price performance, while the Safety Rank is a measure of the companies relative financial strength. The table below compares the distribution of timeliness ranks for the S&P 500 and the Alternate universe:

PROPORTIONS OF S&P 500 IN TOP TWO CATEGORIES OF VALUE LINE TIMELINESS RATING

UNIVERSE	NUMBER OF STOCKS	CAPITAL- IZATION (\$BIL)	% OF TOTAL CAP	INSTITUTIONAL HOLDINGS (\$BIL)	% OF INST HOLD
S&P 500	137	\$440	37%	\$203	41%
ALTERNATE	133	216	30	93	34
DIFFERENCE (TIMELINESS)	4	\$224	7%	\$110	7%

Almost as many Alternate universe companies as S&P 500 companies are rated in the highest two categories of Timeliness. However, there are substantially fewer dollars of available companies in which to invest. While 37% of the capitalization weight of the S&P 500 is in the top rated categories, only 30% of the smaller Alternate universe is top rated. Current institutional holdings of the top rated stocks is \$203 billion, or 41% of the total institutional holdings in S&P 500 stocks. Divestiture would

reduce the holdings of top rated stocks by \$110 billion, and only 34% of institutional holdings would be top rated.

Investment managers subject to divestiture restrictions would have fewer shares of highly rated stocks to chose from. They would be forced to search for alternatives or to compete for larger proportions of the top rated non-South African companies.

The effects of divestiture restrictions from a "Safety Rating" view are shown below:

PROPORTIONS OF S&P 500
IN TOP TWO CATEGORIES
OF VALUE LINE SAFETY RATING

UNIVERSE	NUMBER OF STOCKS	CAPITAL- IZATION (\$BIL)	% OF TOTAL CAP	INSTITUTIONAL HOLDINGS (\$BIL)	% OF INST HOLD
S&P 500	179	\$688	59%	\$285	58%
ALTERNATE	137	316	43	116	42
DIFFERENCE (SAFETY)	42	\$372	16%	\$169	16%

There are 42 fewer companies with top Safety Ratings, with a difference in capitalization weight of \$372 billion. Top Safety companies represent 59% of the market capitalization of the S&P 500 but only 43% of the Alternate universe. Note that institutional managers have placed 58% of their S&P 500 holdings in the top Safety Ratings, while 42% of institutional holdings in the Alternate universe are top rated in Safety.

A restricted institutional manager attempting to maintain the same standards of portfolio safety would be forced to increase concentration in top Safety rated South African companies. If all institutional managers were subject to the same constraints, \$285 billion of current institutional high safety investments could be forced into the \$316 billion high safety companies in the Alternate universe.

It seems clear that only smaller funds could easily make the transition to South Africa-free portfolios without compromising security attractiveness or, particularly, investment safety.

Liquidity and Trading Costs

Liquidity is one of the key areas in which large funds may experience difficulties not encountered by smaller funds. Thomas F. Loeb <9> constructed a table of actual dealer quotes to show how company size and trade size affect transaction costs. Loeb's cost of trading includes direct commission costs, market maker spreads and trading impact.

According to Loeb's study, larger trade sizes lead to higher trading costs. For example, the cost of acquiring a \$250,000 dollar position in a billion dollar company are estimated at 3.1%. A trade of \$2.5 million, ten times the size, would cost 7.7%, more than double. Similarly, trading in smaller companies is significantly more expensive than trading in larger companies. A trade of \$500,000 dollars in a \$100 million dollar company is over twice as expensive as the same size trade in a billion dollar company (8.1% vs. 4.0%).

Loeb's figures were used to estimate the transaction costs of acquiring (or selling) a twenty five thousand, a two hundred fifty thousand, and a two and a half million dollar position in each of the 152 South African related stocks. These three position sizes imply equally weighted portfolios of \$38 million, \$380 million, and \$3.8 billion. The same transaction costs were estimated for equally weighted positions in the 152 South Africa-free companies.

TRANSACTION COSTS VS TRADE SIZE

Company		# Companies		-----Transaction Cost-----		
Size	(Mil)	SoAfr	Alt	\$25,000	\$250,000	\$2,500,000
UNDER	\$100	1	1	3.9%	5.9%	15.7%
	\$100 - 500	19	57	2.1	3.2	7.9
	500 - 1000	21	67	2.0	3.1	7.7
	1000 - 1500	20	17	1.9	2.7	6.2
OVER	1500	91	10	1.2	1.3	2.8
South African Related				1.5%	2.0%	4.6%
South Africa-free				2.0%	3.0%	7.3%

The South Africa-free replacements are significantly more expensive to trade than the South Africa related companies because of company size. The increase in cost of trading is more significant for larger funds.

The problem may be more severe than indicated here: large proportions of many of the smaller Alternate companies are held by company officers and employees. The amount of stock available on the open market is in many cases substantially less than the apparent available supply.

Higher transaction costs will be incurred during initial transition and for all subsequent portfolio activity. If there were a rush among large funds to replace South Africa related stocks, execution costs could be significantly higher.

Security Research and Administrative Costs

The larger the company and the greater the institutional holdings, the easier it is to obtain reliable information from

multiple security analytic sources. The Alternate companies are less well known and are covered by fewer analysts, and would require additional manpower to follow. To illustrate the effects, we counted the number of earnings estimates submitted to the I/B/E/S service<10> on the 152 South African related stocks and on their replacements. Brokerage house analysts submitted an average of 19.9 estimates to I/B/E/S on each of the South African related stocks and 10.9 estimates on the alternatives.

To the extent that South Africa free stocks are subject to more frequent changes in fortune, higher turnover -- executed at higher transaction rates -- would be expected. More transactions lead to higher custodial activity and, therefore, higher administrative costs. In summary, operating a South Africa-free portfolio is likely to be more manpower intensive, a cost that would likely be passed on to the fund.

MANAGEMENT STYLE AND SOUTH AFRICAN RESTRICTIONS

In the investment environment of the 1980's, managers are often retained as specialists, utilizing specific investment skills to attain particular investment objectives. Plan sponsors often hire a complementary set of managers, hoping to employ different expert manager skills within the context of an overall objective and structure.

Not all management styles are equally affected by the South African restrictions. For example, an "aggressive growth" manager is likely to be less affected than a "core" manager. In this section, selected equity managed portfolios of varying styles are analyzed to determine the effects of divestiture.

The table below displays the effects on the portfolio of eliminating divestiture stocks from the actual holdings. The Combined portfolio is created by combining equal weights of the eight management styles.

MANAGER STYLE AND DIVESTITURE EFFECTS

MANAGEMENT STYLE	%	R-SQUARED		BETA		STD ERROR	
		ORIG	SA FREE	ORIG	SA FREE	ORIG	SA FREE
Passive Core	47%	.99	.96	1.00	1.08	0.2%	0.4%
Active Core	40	.97	.91	1.01	1.07	3.0	5.7
Yield/defensive	46	.90	.88	1.02	1.04	5.9	6.6
Rotator	46	.93	.89	1.02	0.95	4.8	5.9
Contrarian	26	.94	.93	1.09	1.10	4.6	5.1
Small Cap	26	.79	.79	1.36	1.39	12.0	12.4
Growth	8	.86	.83	1.21	1.27	8.4	10.0
Aggressive Grow	22	.68	.65	1.48	1.46	17.6	18.3
Combined	31%	.94	.92	1.17	1.22	5.2	6.3

Core oriented managers are affected the most because of their tendency to hold the blue chip investments that are most affected by divestiture. Growth oriented managers are affected less, but need to contend with higher market risk (beta) and lessened diversification.

In most multi-manager plans, the growth and higher risk oriented managers usually represent smaller proportions of multi-manager funds, while the most affected "core" managers manage the bulk of the assets. These "core" managers would be forced to hold larger amounts of their selected securities that were not eliminated as a result of divestiture, or to select new companies from the Alternate universe while maintaining the target portfolio characteristics.

If the core managers were unable to hold to their target investment characteristics, the plan administrator may compensate by requiring growth stock managers to lower their risk-taking, implying a complete restructuring of the plan investments.

How any particular manager would adjust is beyond our speculation, but the evidence cited above indicates that the restructuring would not be simple nor inexpensive. It is possible that the plan would have to reconsider its basic investment structure to present managers with attainable targets.

One other factor needs to be considered with respect to investment managers. Many investment management organizations and brokerage firms are on or are affiliated with companies on the prohibited list. Presumably the use of the services of these organizations would be prohibited, thus limiting the choice of management organizations. The problem appears to be particularly severe in the area of brokerage and investment banking where most of the largest, best capitalized, and most frequently used firms are connected to South African businesses.

FIXED INCOME MANAGEMENT

The implications of divestiture for fixed income portfolios are similar those for equity portfolios: a smaller universe of corporate issues with lower average quality.

The amount of corporate debt outstanding rated Baa or higher by Moody's was approximately \$300 billion at the end of 1983. Of this \$300 billion, the 152 South African restricted companies in the S&P 500 had \$133 billion outstanding, or 44% of the total. The Alternate companies had only \$28 billion in outstanding debt at the end of 1983. The total amount of corporate debt available from the Alternate universe was \$195 billion -- a 35% reduction in the amount of available corporate debt securities.

Divestiture results in a corporate debt universe of lower average quality. The eliminated companies are larger, financially stronger, and more diversified than the smaller replacement

companies. The table below compares the distribution of corporate debt for the eliminated and replacement companies by Moody's ratings.

CORPORATE DEBT OUTSTANDING

MOODY'S RATING	ELIMINATED COMPANIES		REPLACEMENT COMPANIES	
	DEBT (\$BIL)	% OF TOTAL	DEBT (\$BIL)	% OF TOTAL
Aaa	\$10.40	8%	\$0.00	0%
Aa	60.60	46	0.65	2
A	36.60	28	9.50	35
Baa	15.00	10	4.60	16
Ba	1.40	1	4.70	16
B	2.20	2	0.85	3
Caa	1.30	1	0.00	0
NR	5.50	4	7.90	28

While 92% of the debt securities eliminated by divestiture are rated Baa or better, only 72% of the replacement companies are rated Baa or better. Fixed income managers subject to divestiture will have substantially less corporate debt of investment grade available. They would need to accept lower quality bonds or to compete for the remaining higher quality issues in much the same way equity managers would have fewer desirable companies from which to choose.

Divestiture is simplified for fixed income managers by the large supply of government issues available. At the end of 1983, approximately \$954 billion in government and corporate bonds were outstanding, 12% of which was South African related. When government debt is included, 85% of the South Africa free debt securities are rated Baa or better by Moody's. The limits implied by South African divestiture will be felt most by managers who take advantage of higher yields from corporate issues and by managers who actively move from industry to industry to take advantage of yield spreads.

CASH MANAGEMENT

Cash management will be affected if managers are not permitted to purchase commercial paper from South Africa related companies or Certificates of Deposit from banks lending money to South African business or governmental agencies.

Typically, prime commercial paper is issued on an unsecured basis only by large, financially very secure, diversified corporations -- characteristics typical of the companies on the divestiture list. Most other companies are unable to issue commercial paper unless it is insured or guaranteed. Thus, the universe of companies issuing commercial paper would be reduced by divestiture, with lower average quality. The following table shows the distribution of Moody's commercial paper ratings of

eliminated companies and their replacements:

EFFECTS ON QUALITY OF COMMERCIAL PAPER

MOODY'S RATING	# OF ELIMINATED COMPANIES	# OF REPLACEMENT COMPANIES
P1	91	29
P2	20	14
P3	3	0
NR	2	0
	116	43

Of the 116 eliminated companies with Moody's commercial paper ratings, 78% were rated Prime-1; only 67% of the replacement companies were rated Prime-1. Most importantly, of the 152 eliminated companies, 75% were rated. Of the 152 replacement companies, only 28% were rated. Divestiture would reduce the amount of available commercial paper for use by cash-equivalent managers.

Divestiture would prohibit the purchase of certificates of deposit from 13 of the 15 largest banks that make loans to South African companies or government agencies. Certificates of deposit from an additional 64 smaller banks are also prohibited. By eliminating the largest banks, divestiture would reduce the universe of bank CDs to include only CDs from smaller, less diversified banks. This remaining universe would carry more default risk. In the same way equity managers would be forced to compete for remaining quality issues or accept lower quality and less diversification, managers of cash-equivalent securities making use of commercial paper and bank certificates of deposit would be forced to make substitutions.

SUMMARY

Divestiture restrictions on companies that do business in South Africa can have substantial impact on investment management activities of large portfolios. In general, the effect will be to increase investment risk, reduce investment and diversification opportunities, and to increase the costs of research, trading, and administration. The larger the fund, the greater the impact to be expected. Most large funds will find it necessary to alter their investment targets and restructure their investment process.

Funds that are contemplating divestiture need to weigh these considerations, and funds in the process of implementing restrictions need to move cautiously to avoid the risk, diversification and trading pitfalls.

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U. S. CORPORATIONS IN SOUTH AFRICA
(As of June 30, 1984)

	<u>Sullivan Signatory</u>	<u>Approved List</u>	<u>Holdings</u>		<u>CD or Commercial Paper List</u>	<u>N.J. Employment</u>
			<u>Equity</u>	<u>Bond</u>		
Abbott Laboratories	Yes	x	x	x		*
Air Products & Chemicals Corp.	No	x				*
American Broadcasting Co.	Yes	x	x			*
American Cyanamid Co. (NJHQ)	Yes	x	x	x		HQ
American Express Co.	Yes	x	x		x	*
American Home Products Corp.	No	x	x			*
American Hospital Supply Corp.	Yes					*
American International Group	Yes	x	x			*
Armco Inc.	Yes	x		x	x	*
Baker International Corp.	No	x	x			*
Baxter Travenol Labs Inc.	No	x				*
Black & Decker Manufacturing Co.	Yes	x				*
Boeing Co.	No	x	x			*
Borden Inc.	Yes	x		x		*
Borg-Warner Corp.	Yes	x			x	*
Bristol-Myers Co.	Yes	x	x			**
Burroughs Corp.	Yes	x				**
CBI Industries Inc.	No	x				*
CBS Inc.	Yes	x	x	x		**
JPC International Inc. (NJHQ)	Yes	x	x			HQ
Carnation Co.	Yes			x		*
Caterpillar Tractor Co.	Yes	x		x		*
Chase Manhattan Corp.	Yes				x	-
Chesebrough-Pond's Inc.	No	x	x			*
Citicorp	Yes	x	x		x	*
Coca-Cola Co.	Yes	x	x		x	*
Cooper Industries Inc.	Yes	x	x			*
Corning Glass Works	No	x	x			**
Crown Cork & Seal Co.	Yes	x				*
Cummins Engine Co.	Yes	x	x	x		*
Dana Corporation	No			x		*
Dart & Kraft Inc.	Yes			x		*
Deere & Co.	Yes	x	x	x	x	*
Dow Chemical Co.	Yes	x	x	x	x	**
Dresser Industries Inc.	Yes	x				-
Dun & Bradstreet Corp.	No	x	x			*
DuPont de Nemours & Co.	Yes	x	x		x	**
Eastman Kodak Co.	Yes	x	x			*
Eaton Corp.	Yes	x	x	x		*
Echlin Inc.	No	x				-
Exxon Corp.	Yes	x	x	x		**
FMC Corp.	Yes	x		x		**
Firestone Tire & Rubber Co.	Yes			x		*
Ford Motor Co.	Yes	x				**

U. S. Corporations in South Africa (continued)

	Sullivan Signatory	Approved List	Holdings		CD or Commercial Paper List	N.J. Employment
			Equity	Bond		
General Electric Co.	Yes	x	x	x	x	**
General Motors Corp.	Yes	x	x		x	**
Gillette Co.	Yes	x	x			*
Goodyear Tire & Rubber Co.	Yes			x		*
Hewlett-Packard Co.	Yes	x	x			**
Honeywell Inc.	Yes			x		*
Ingersoll-Rand Co. (NJHQ)	No	x	x	x		HQ
Int'l. Business Machines Corp.	Yes	x	x		x	**
Int'l. Flavors & Fragrances Inc.	No	x				*
Int'l. Minerals & Chemical Corp.	Yes	x	x	x		*
Int'l. Telephone & Telegraph Co.	Yes				x	**
Johnson Controls Inc.	Yes	x				*
Johnson & Johnson (NJHQ)	Yes	x	x			HQ
Joy Manufacturing Co.	Yes	x				*
Kimberly-Clark Corp.	No	x				*
Lilly (Eli) & Co.	Yes	x	x			*
Lubrizol Corp.	No	x				*
Marriott Corp.	Yes	x				**
Marsh & McLennan Cos.	No	x				*
Martin Marietta Corp.	No	x				*
McGraw-Hill Inc.	Yes	x				**
Merck & Co., Inc. (NJHQ)	Yes	x	x			HQ
Minnesota Mining & Manufacturing Co.	Yes	x	x			**
Mobil Corp.	Yes	x	x	x	x	**
Monsanto Co.	Yes	x		x		*
Motorola Inc.	Yes	x	x			*
NCR Corp.	Yes	x		x		*
Nalco Chemical Co.	Yes	x				-
New York Times Co.	Yes	x				**
Newmont Mining Corp.	No	x	x			*
Owens-Illinois Inc.	No			x		**
Pennwalt Corp.	Yes			x		**
PepsiCo, Inc.	No	x	x			*
Perkin-Elmer Corp.	Yes	x				**
Pfizer Inc.	Yes	x	x			*
Phillips Petroleum Co.	Yes	x	x	x	x	*
Raytheon Co.	Yes	x	x			**
Revlon Inc.	Yes	x				**
R. J. Reynolds Industries Inc.	Yes	x		x	x	**
Rohm and Haas Co.	Yes	x	x			*
Schering-Plough Corp. (NJHQ)	Yes	x			x	HQ
SmithKline Beckman Corp.	Yes	x	x			*
Sperry Corp.	Yes	x				*
Squibb Corp.	Yes	x	x			**
Std. Oil California (Chevron)	Yes	x	x	x		*

	Sullivan Signatory	Approved List	Holdings		CD or Commercial Paper List	N.J. Employment
			Equity	Bond		
Standard Oil Co. (Ohio)	No	x	x	x	x	*
Stanley Works	Yes	x	x			*
Stauffer Chemical Co.	No	x		x		*
Tenneco Inc.	Yes			x		*
Texaco Inc.	Yes			x	x	**
Time Inc.	Yes	x				*
Union Carbide Corp.	Yes			x	x	**
United States Gypsum Co.	No	x				*
United Technologies Corp.	Yes	x			x	**
Upjohn Co.	Yes	x				*
VF Corp.	No	x				-
Warner-Lambert Co. (NJHQ)	Yes	x	x	x		HQ
Westinghouse Electric Corp.	Yes	x			x	**
Xerox Corp.	Yes			x		**

New Jersey Employment Key:

- .Q - Companies with headquarters located in New Jersey and employ 1,000 or more employees.
- ** - Companies with 1,000 or more employees in New Jersey in calendar year 1983.
- * - Companies with less than 1,000 employees in New Jersey in calendar year 1983.

DISTRICT OF COLUMBIA
SPECIAL INVESTMENT STUDY
SOUTH AFRICA PROPOSAL

March 31, 1983

DISTRICT OF COLUMBIA
SPECIAL INVESTMENT STUDY
SOUTH AFRICA PROPOSAL

March 31, 1983

David Eager
Caroline Cummings
Cathy Keil
MEIDINGER ASSET PLANNING SERVICES, INC.
2600 Meidinger Tower
Louisville Galleria
Louisville, Kentucky 40202

SUMMARY

Meidinger Asset Planning Services, Inc. conducted an indepth study that addressed the investment implications of a total divestiture of the District of Columbia's Pension Funds of investments in companies or financial institutions doing business with South Africa. Our analysis of the list of restricted stocks, as identified by the U.S. Consulate General in Johannesburg, will be referred to as the "Consulate General's List" throughout this report.

This report contains:

- . . . a definition of the proposed law;
 - a listing of companies affected
- . . . the scope of the Meidinger assignments;
- . . . the findings;
 - surveys
 - interviews
 - other studies
 - portfolio analysis
- . . . Meidinger's conclusions and recommendations.

In summary, our conclusions are as follows:

1. Few Pension Plans in the country follow these type restrictions; those that have adopted such have only implemented these restrictions recently. Therefore, we have no historical factual evidence by which to analyze the effects of such a program.
2. Many City and State "Operating" Funds restrict investment in South Africa, as opposed to Pension Funds.
3. Relatively few investment managers in the country are "geared" toward this type investing. Many managers, in fact, stated that they would refuse to accept fiduciary responsibility to manage an account with such restrictions and having the investment objectives of the District of Columbia Plans.

4. The Consulate General's List contains 201 public companies doing business in South Africa and represents nearly \$500 billion in market capitalization of equity securities.
5. Of those 201 companies, 139 are "S & P 500" companies. Those 139 companies, however, represent 96% of the total market value of the Consulate General's 201-Company List.
6. Of the 139 companies, 29 are found in the top 50 of the S & P 500 Index.
7. We found three other prohibited stock lists used for purposes of avoiding investments in companies doing business in South Africa. The names on the other lists vary considerably from the U.S. Consulate-General's list and contain other major corporations such as Standard Oil of California, Texaco, Phillip Morris and Royal Dutch.
8. The U.S. Consulate-General's List's stocks that are S & P 500 stocks represent almost entire major industry groups (chemicals, autos, machinery, beverages and hospital supplies, for example). Alliance Capital Management, whose role is that of an industry/sector rotator, will be limited by the elimination of the entire industry groups.
9. The District's Equity Investment Managers currently hold approximately \$145 million invested in equity securities. Of that amount, about 26% of their portfolios would be forced to be divested, should the law pass. That represents over \$38 million.
10. The list of prohibited banks provided to us would require the investment managers and the trustee to avoid Certificates of Deposits in most of the major banks. Therefore, competitive rates may not always be available.
11. Based upon the Fund's February 28, 1983 assets, approximately \$34 million of Certificates of Deposits or 36% of the total would have to be liquidated.
12. The impact upon the bond management would be the least of all categories, since most of the D.C. Fixed Income managers tend to hold U.S. Government and Agency Bonds. First and Merchants, which may invest heavily in corporate issues would be more affected than T. Rowe Price or Riggs National Bank.

13. Based upon the February 28, 1983 assets, \$8 million in bonds would have to be liquidated. These bonds represent approximately 8% of the total bond portfolio.
14. The District of Columbia Investment Manager's ability to properly diversify will be severely impacted should the restrictions be imposed.
15. The financial characteristics of the equity securities on the Consulate General's List are generally higher quality, less volatile, higher yielding and larger companies.
16. The elimination of these companies from a portfolio would increase overall portfolio risk.
17. The S & P 500 Index outperformed the Restricted Stock Universe over the last ten-year period, commensurate with a higher risk level. This performance is expected and explainable due to the faster growth levels of smaller companies during that time period.

CONCLUSIONS

The Consulate General's List of 201 companies represented nearly \$500 billion in total market capitalization and between 30%-40% of the total equity market. If other companies noted such as Texaco, Digital Equipment, Royal Dutch and Standard Oil of California were included the figures would rise to 40%-50% of the market.

The companies on the Consulate General's List that are S & P 500 companies represent 96% of the total market value of the "restricted" companies.

Twenty-nine of the top 50 S & P 500 stocks would be prohibited investments, should the law pass. If names from the IRRC list of companies doing business in South Africa were included, this figure would rise to 32. Those 32 companies alone represent over \$300 billion in total market capitalization of the equity market.

The quality of the Consulate General's List of companies was higher than the S & P 500. Nearly 60% of the South African holdings are rated A+ while just under 50% are rated A+ in the S & P 500. Further, those companies on the Consulate General's List that are in the S & P 500 were of even higher quality.

The Consulate General's List of companies are:

- . . . slightly less leveraged (indebted), and
- . . . have slightly higher profitability, but
- . . . have had slower growth rates.

In the market those stocks are 12% less volatile than the S & P 500 and outperformed the S & P 500 in 1982 by 29.1% versus 21.6%. However, over the past ten years those stocks have earned 5.4% versus 6.6% for the S & P 500. The performance comparison points out the strong performance of smaller companies in the earlier years of the ten-year period. Further, it illustrates the ability of the Consulate General's List of stocks to substantially outperform the market during certain periods.

RECOMMENDATIONS

We believe that imposing the restrictions of the proposed South African law would be detrimental to the investment managers' ability to meet their objectives, would cause the Fund to be more volatile and hold securities of lower overall quality, could reduce future Fund performance and, consequently, cause the District to have to increase contributions (taxes) and/or reduce its ability to improve benefits in the future.

From that standpoint, we recommend that the Board oppose the enactment of the law because of the implications for the Fund's investment program.

Our recommendation does not mean to incorporate any lack of support for the moral issues behind the law. Rather, it focuses only on the investment issues which we, as fiduciaries of the Fund assets, believe are significant and could potentially have severe implications on longer-term performance.

While performance of the smaller companies not on the list may be higher in the future than the restricted stocks, the fact is that the District of Columbia Portfolios could not invest heavily in those companies because of their inherent risk level, the large size of the Fund itself and the liquidity problems associated with owning meaningful sized positions in such companies.

Further, our recommendation is not meant to be imposed upon the issue of the investment of the District's own Operating Funds. That analysis must be made based upon the particular needs and requirements of those funds. Our general observations, however, would be that such restrictions can much more easily be imposed upon the short-term investments than on an investment portfolio of a pension fund.

Sidney D. Krasner
Executive Vice President

Appendix 10



July 9, 1984

Roland M. Machold
STATE OF NEW JERSEY
DEPARTMENT OF THE TREASURY
DIVISION OF INVESTMENT
Trenton, NJ

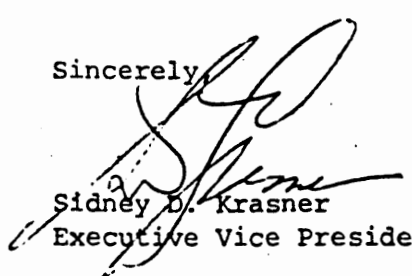
Dear Mr. Machold:

The Asset Management Group of Shearson Lehman/American Express has not used political affiliations of corporations as a determining factor in making investment decisions, nor have political affiliations of corporations been used by our Asset Management Group as a determining factor for portfolios managed by our organization.

We believe that a forced restriction of portfolio purchases and forced divestiture of restricted securities could seriously impair the ability of money managers to effectively manage, therefore placing them at a disadvantage in the market place. We estimate that one third of the universe of corporate bonds, and a high percentage of the universe of equities that we would potentially recommend to pension plans would be eliminated. The result is that our universe would be substantially reduced, curtailing opportunity, and probably causing liquidity problems at time of purchase or sale. Under these circumstances we anticipate that a deviation in performance from non restricted portfolios managers could result.

It is important that we act responsibly and we respectively suggest that restricting portfolio managers and money managers will probably yield poorer results for large portfolios compared to those who are unrestricted.

Sincerely,


Sidney D. Krasner
Executive Vice President

SDK:mm

State Actions on Legislation Concerning
Divestment of State Funds in
The Republic of South Africa

Appendix 11

The following list was compiled as of June 14, 1984. While not all of the necessary information was immediately available, the list is indicative of current trends regarding state legislation concerning investment in the Republic of South Africa.

Alabama -- H 290, introduced in 1983: Prohibits investment of state retirement funds in any company operating in or doing business with South Africa or Namibia. Died in 1983; reintroduced (HB 67) 2/7/84. Ways and Means Committee. DIED.

Arizona -- Floor amendment attached to a Prudent Man Bill (SB1154), introduced 4/11/83; Prohibits investment of state retirement funds in corporations headquartered in South Africa. The bill, with the amendment, was passed by the House, but the amendment was removed in conference committee. The bill was signed by the governor, 5/4/83, without the amendment. HB 2502, introduced 2/1/84, and SB 1266, introduced 2/6/84, prohibited investment of all public monies in all businesses based in, operated or owned by the South African government. Neither was assigned to a committee and both DIED.

California -- AB 808, introduced in 1983: Prohibits, after 1/1/85, the investment of state funds in any company doing business in or with South Africa. DIED, Finance and Insurance Committee, 1/30/84.

SB 1368, introduced 1/19/84: Prohibits, after 1/31/85, the investment of any new state or local retirement fund in any corporation which does business with South Africa, any communist nation or its instrumentalities. PENDING, as of 1/9/84, Public Employment and Retirement Committee, no further action.

Ballot Initiative: An initiative statute that forces all California state, county and municipal agencies to divest themselves of all investments in South Africa. Introduced August 1983: Did not receive sufficient qualified voter ballot signatures; FAILED 1/9/84.

Colorado -- HB 1360, introduced 2/22/83: prohibition on state investment in financial institutions or companies doing business with South Africa. DIED, Committee on State Affairs, 4/13/83.

Connecticut -- Public Act 82-324, Connecticut General Statute Section 3-13F, introduced in April 1982: Legislation was developed by gubernatorial task force. Limits investment of state pension funds to South African-related U.S. corporations meeting three standards: (1) Sullivan signatory, within the top two Sullivan ratings; (2) does not provide strategic services or

goods to the South African government, military or police; (3) recognizes the rights of all South African workers to strike for social and/or economic benefit without fear of dismissal or blacklisting. Legislation ENACTED, 6/9/82.

Delaware -- HB 26, introduced in 1/18/83: Prohibits, after 7/1/83, investment of any state assets in any company doing business in the Republic of South Africa. Reported favorably by House Committee; PENDING, Revenue and Finance Committee as of 6/14/84.

Florida -- SB 132, introduced in 4/3/84: Requires state treasurer to exercise voting rights with respect to divestiture of securities owned by state retirement funds which are invested in companies doing business in South Africa. DIED on the calendar.

HB 215, introduced 4/5/83: Prohibits, after 1/1/84, the investment of public trust funds in firms doing business in or with the Republic of South Africa. DIED, on the calendar, 6/3/83.

HB 17, introduced 4/3/84, as substituted for HB 215: Directs the State Board of Administration, as custodian of shareholder voting rights of securities owned by certain state retirement trust funds, to exercise those rights in support of policies which would influence South Africa to end apartheid. Specifically directs Board to support proposals requiring the divestment of corporate assets and termination of corporate operations in South Africa. DIED in Senate Finance and Tax Committee.

Illinois -- HB 569, introduced 3/8/83: Prohibits investment of any state pension funds in any company doing business with or in the Republic of South Africa. DEFEATED, third reading in House Executive Committee, 5/25/84.

Indiana -- HB 1249, introduced 1/5/84: Assigned to Unemployment Committee on Public Policy and Veteran Affairs. Concerned divestment of certain funds by state educational institutions in companies working with or in South Africa. DIED in committee.

Iowa -- H 130, introduced 2/1/83, as amended: Prohibits, after 7/1/84, the state treasurer from purchasing securities issued by, or depositing money in, a financial institution participating in loans to the government of South Africa. Senate Government Committee, 4/11/84. DIED.

S 165, introduced 2/1/83, as amended: Prohibits, after 7/1/85, investment of state pension funds in any company doing business in or with the Republic of South Africa. Senate Commerce Committee, 4/11/84. DIED.

S 378, introduced in 3/8/83: Prohibits investment of certain State Board of Regents funds in any company doing business in or with the Republic of South Africa. Provides that proceeds from sales of these investments should be invested as much as possible in companies doing business in Iowa. Applies to investments made after 7/1/84 and investments held after 7/1/86. Senate Education Committee, 4/11/83. DIED.

Kansas -- HR 6187, introduced 4/6/84: Requests certain state investment boards to disapprove all investments in corporations which invest in South Africa. ADOPTED, 4/26/84.

Louisiana -- SB 983, introduced 4/30/84: Prohibits investment of any state pension fund in any financial institution or company doing business in or with the Republic of South Africa. PENDING, Senate Retirement Committee, 4/30/84; no further action.

Maryland -- HR 49, introduced in 1983: Urged the state of Maryland not to invest in any business conducting business with or making loans to the Republic of South Africa. REPORTED UNFAVORABLY from the House Appropriations Committee, 3/16/83.

Massachusetts -- Chapter 669 of Act 1982, introduced 1/1/82: Pension funds for state employees and public school teachers are to divest themselves, within three years, of any interest in corporations that do business in South Africa or banks that make loans there. APPROVED, legislature overrode a gubernatorial veto, January 1983.

Michigan -- Public Act 512 of 1982, introduced 4/1/81: Prohibits the state's educational institutions from investing in any organization with operations in the Republic of South Africa. APPROVED, 12/31/82.

HB 4516, introduced 5/4/83. Amends existing law. Prohibits a public employee retirement system from investing in South Africa after 1/1/90. Requires divestiture after 1/1/85 at the rate of 1/5 of the total portfolio of South African-related investments per calendar year. PENDING, Senior Citizens and Retirement Committee; 5/4/83; no further action.

Minnesota -- HF 1811, introduced 2/18/82: Recommended by Governmental Operations Committee. Prohibits the State Board of Investment from investing state money in corporations and banks that have holdings in South Africa and Namibia, unless those businesses can prove they have fair employment practices regarding race and labor organization. Passed by the House and Senate; VETOED by the governor, 3/22/82. Reintroduced as HB 1220, 4/14/83, and HB 1281 5/5/83; both bills DIED in the Governmental Operations Committee.

Nebraska -- LB 553, introduced 1/19/83. Prohibits, after 7/1/85, the investment of any state funds in any financial institution which has outstanding loans to the South African government or its instrumentalities. Amended to incorporate the Sullivan Principles top category requirement. APPROVED, 4/19/84.

LR 43, introduced in 1979: Urged Investment Council to remove from list of approved trust fund investments all banks and corporations that do business in South Africa. PASSED, 1980.

Nevada -- SB 266, introduced 3/23/83: Affected State Industrial Insurance and State Public Employee Retirement Systems. Prohibited making or maintaining investments in any financial institution or company doing business in or with South Africa. DIED, Committee on Governmental Affairs.

New Jersey -- SR 3006, introduced 3/30/83, as amended: Urges state-regulated industries not to invest in any company which conducts business in the Republic of South Africa. Amended in Senate, 4/23/83; APPROVED 6/16/83.

SJR 16, introduced 1/10/84: Urges U.S. business firms with investments or operations in South Africa to consider divesting these holdings. Passed out of Senate. PENDING, Assembly State Government Committee, 5/17/84.

AB 1444, introduced 2/27/84: Permits various financial institutions to invest in the African Development Bank, but prohibits investment in the bank from being used in or going to South Africa. PENDING, State Government Committee, 2/27/84; no further action.

AR 11, introduced 1/10/84: Requests state-regulated industries and public educational institutions not to have interest in any firm conducting business in South Africa. PENDING, State Government Committee, 1/10/84; no further action.

New York -- AB 5034A, initially introduced 3/1/83, as amended: No monies or assets of the common retirement fund shall be or remain invested in the stocks, securities, and other obligations of any institution or company doing business in or with the Republic of South Africa. PENDING, Ways and Means Committee, 6/6/84.

SB 6757, introduced 6/9/83: Same as AB 5034A. PENDING, Civil Service and Pension Committee, 6/9/83; no further action.

SB 7835, introduced 2/21/84. Requires trustees of certain public pension funds to divest all funds that are currently invested in any corporation which: (a) does business in Namibia, or (b) is an affiliate or subsidiary of any corporation operating in South Africa, or (c) provides strategic materials or services, as defined, to South Africa. PENDING, Civil Service and Pension Committee, 2/21/84; no further action.

Ohio -- H 553, introduced 10/14/83: Prohibits the investment of certain state funds in corporations doing business in South Africa, unless such corporations have obtained performance rating in the top two categories of the Sullivan Principles rating system. PENDING, Economic Affairs and Federal Relations Committee, 11/16/83; no further action.

SB 53, introduced 2/14/84: Prohibits investment of state and certain pension funds in any company or corporation doing business in or with the Republic of South Africa. PENDING, Finance Committee; reported 2/16/84; no further action.

HB 283, introduced 4/5/83: Prohibits the investment of state funds in any company present, "as defined," in the Republic of South Africa. PENDING, Financial Institutions Committee, 4/8/83; no further action.

AB 234, introduced 11/9/83: Prohibited the State Investment Board from investing pension funds in South Africa. DIED 4/6/84; Joint Resolution to put the legislation in an inactive stage.

District of Columbia -- D.C. Law 5-50, introduced 1/5/83: Prohibits investment of public funds in any company doing business in or operating in the Republic of South Africa or Namibia. APPROVED, 3/8/84.

Oregon -- H 2772, introduced 2/21/83: Prohibits the investment of certain state pension funds in any firm which employs more than 50 persons; earns over \$500,000 a year; or has investments of more than \$2 million in the Republic of South Africa. DIED, Human Resources Committee, 4/26/83.

Pennsylvania -- House RL 67: Protesting sale of South African gold currency in the Commonwealth of Pennsylvania. PENDING, 4/18/83, House Rules Committee; no further action.

House RL 68: Protesting granting of credit to South Africa by the Export-Import Bank. PENDING, Federal-State Relations Committee, 4/18/83; no further action.

HB 802, introduced 4/18/83: Prohibits state depository banks from participating in financial transactions with the Republic of South Africa. PENDING, Finance Committee, April 1983; no further action.

HB 804, introduced 4/18/83: Requires cities to enact ordinances which require the withdrawal of city funds from banks and other businesses doing business with the Republic of South Africa. PENDING. House Finance Committee, 4/18/83; no further action.

HB 1400, introduced 7/21/83: Prohibits state universities from investing in South Africa. PENDING, Education Committee, 7/21/83; no further action.

SB 956, introduced 7/21/83: Provides for the divestiture of Commonwealth funds which have been invested in financial institutions or other entities which do business with the Republic of South Africa. PENDING. Banking and Insurance, 7/21/83; no further action.

Rhode Island -- SB 531, introduced 2/29/84: Requires State Investment Commission to liquidate investments that the state holds in any company doing business in South Africa. DIED, 5/3/84, Senate Finance Committee.

S 132, introduced 1/18/83: A measure prohibiting the investment of certain public pension funds in corporations doing business in South Africa. Amended 4/28/83 to create a joint committee to study the matter and also the Sullivan Principles. APPROVED, 5/23/83.

Texas -- S 1115, introduced 3/11/83: Prohibits assets of the public retirement system from being invested in a company doing business in or with the Republic of South Africa. DIED.

SCR 135: Establishes a special commission to investigate investments held by various state retirement funds to see if they have ties with South Africa. ADOPTED, 6/30/83.

Wisconsin -- In 1976, the attorney general ruled that an existing law which prohibited university investment in companies practicing or condoning racial discrimination could also apply to firms operating in South Africa. This ruling was implemented between 1976 and 1978.

MARCY M. MURNINGHAN, Ph.D. (Harvard)

Marcy M. Murningham is Coordinator of Research for Mitchell Investment Management Company. Her responsibilities in this capacity are to examine corporate practice in the area of social responsibility. She has been involved with public policy and institutional behavior as a practitioner and scholar for the past 10 years.

Her current work involves gathering and analyzing information about corporate behavior in certain non-financial areas to be used in investment decision making. In addition to developing social screening procedures, Dr. Murningham's work includes attention to how corporate structure, innovation and productivity are interrelated and serve as indicators of corporate success and socially-positive behavior.

Before joining Mitchell Investment Management Company, Dr. Murningham served as a research associate to a variety of national groups. She was the staff associate for the national task force on federal elementary and secondary educational policy for the Twentieth Century Fund whose report, "Making the Grade", was issued in 1983. She served as a research associate to John Millett and compiled case studies concerning the governance and management of public higher education in the northeastern states; Dr. Murningham's work appears in Dr. Millett's book Conflict in Higher Education, published by Jossey-Bass in 1984. In 1982, Dr. Murningham co-authored a report to the President of Dartmouth College concerning program options for the Nelson A. Rockefeller Center for Policy Studies; she also served as a staff associate to the National Committee on Urban Policy, sponsored by the National Academy of Science. In 1981 she co-authored an analysis of the Community Investment Fund for the Chairman of the Federal Home Loan Bank Board and served as a research associate to a special study on conditions of teaching for the Director of the National Institute of Education.

From 1978 to 1980, Dr. Murningham was a staff associate to Robert Wood, then Superintendent of the Boston Public Schools. She was responsible for the reorganization of the school system and served as senior officer for intergovernmental relations. Prior to joining Dr. Wood, Dr. Murningham collaborated with Rosabeth Kanter and Barry Stein in the design and implementation of a productivity improvement project for a major corporation and contributed to numerous studies of the problems men and women face in corporate management. In 1976, Dr. Murningham provided staff support for a seminar concerning the development of a national urban policy sponsored by the Institute of Politics at Harvard's Kennedy School of Government. She also contributed to a study concerning tax exemption policies affecting higher education institutions for the Lincoln Institute of Land Policy.

Marcy received a B.A. degree in religion from Albion College and an Ed.M. degree in administration from Antioch University. She holds a doctorate from Harvard University in Administration, Planning and Social Policy from the Graduate School of Education. Her doctoral work examined judicial decision making and its effects on institutional behavior, especially during the post-remedial phase of court intervention into the management of public affairs. She continues her teaching and publishing activities and is currently a Fellow at the John W. McCormack Institute of Public Affairs at the University of Massachusetts at Boston.

