

Divesting

The Other Side of the Coin

“Let there be no doubt about the fact that *public pension fund trustees and staff members do not support genocide or terrorism*”.

By Will Keating
January 2008

Foreword

My objective in assembling this information is to provide policy makers and representatives of the news media with facts and informed opinions about the downside of the divesting initiatives that seem to be picking up steam around the country. I will give the proponents the benefit of the doubt and suggest that they are well intended in their actions. However, the potential negative ramifications of these activities extend far beyond their impact on institutional investors. It does not take a quantum leap in logic to conclude that divesting will threaten our future role in the global economy, alienate our allies, and undermine the form of government that has served us well for over 200 years. Before you take a firm position on one side or the other of this issue, I strongly encourage you to give thoughtful consideration to the information contained herein.

About Will Keating

Will Keating retired from his position as executive director of the Public Employee Retirement System of Nevada after 21 years of service to that organization. Following his retirement from PERS of Nevada, he served an additional eight years as administrative officer of the National Association of State Retirement Administrators.

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Divesting - The Other Side of the Coin

By Will Keating

With a handful of notable exceptions, the press coverage of initiatives to encourage or force public retirement plans to divest of the securities of companies operating in certain countries has favored the position of the proponents of divesting. Based on this, one might conclude that the proponents are correct. On the other hand, one might conclude that emotion trumps reason and that sound bites trump thoughtful analysis in terms of what is generally considered to be newsworthy.

In your policy making or reporting capacity it is almost a certainty (i) that you have had some exposure to emotional sound bites from divesting proponents and (ii) that you will be solicited to get on the divesting bandwagon. Before jumping on that bandwagon, please review the four op-ed pieces that follow – they are representative of the handful of notable exceptions mentioned at the outset and will provide a degree of balance that you should at least consider in your decision making or reporting process.

A critical point can be seen through simple examples – consider the following two cases:

Case 1. A European pension fund sells the stock of a U.S. company to an Asian pension fund. From this would anyone conclude that the European fund is attempting to deprive the U.S. government of money or that the Asian pension fund is attempting to provide money to the U.S. government?

A thoughtful response to that question would be, “Don’t be ridiculous!”

Case 2. A U.S. public pension fund sells the stock of a Canadian company to a U.S. mutual fund. (Other facts include that the Canadian company is involved in oil exploration with some portion of their operation being in Iran.) From this transaction, would anyone conclude that the pension fund is attempting to deprive the government of Iran of money or that the mutual fund is attempting to provide money to the government of Iran?

A thoughtful response to that question would also be, “Don’t be ridiculous!” However, there are some people who would have you believe that the answers to both questions are yes. The question that should then be asked is, “What’s motivating those people?” That’s simple – some of them are either uninformed or they are hungry for press coverage that will make them appear to be patriots – if they are service providers in this space, they are probably conflicted – divesting creates a demand for their services (regardless of whether or not their services have any real value).

Proponents of divesting are frequently heard to say that divesting does not interfere with the federal government’s role in the area of international relations, even though there is compelling evidence available to the contrary. Some of that evidence is included in the first op-ed piece that is part of this document. Additional information follows:

Wall Street Journal, published June 14, 2007

The Bush administration is strongly opposed to the legislation, arguing that it threatens to torpedo the larger diplomatic effort to isolate Tehran.

The Bush administration is taking aim at states' efforts. Deputy Treasury Secretary Robert Kimmitt blasted the legislation in a speech last month, saying, "Our economic sanctions against Iran are intended to engage, not confront, our allies."

Excerpt from October 26, 2007 letter to Vice-President Cheney from Brian A. Benczkowski, Principal Deputy Assistant Attorney General, U.S. Department of Justice, regarding the Sudan Accountability and Divestment Act

"State and local governments, like the interest groups supporting this legislation, have neither the obligation nor the ability to consider how the divestments authorized by the bill could affect United States foreign policy. Congress and the Executive branch have both. As a practical matter, only the Federal government has the ability (primarily through its access to intelligence and its knowledge of broader diplomatic strategies) to understand how a particular economic action (here, divestment from, for example, European companies) could affect United States foreign policy with European governments on Darfur and other issues. Put simply, State and local governments lack both the Federal government's ability to know when it is necessary to approach an issue with kid gloves rather than an iron fist, and the Federal government's obligation to ensure that the proper approach is used when necessary to protect national interests. Federal legislation that broadly authorizes States to approach with an "iron fist" foreign policy issues that the President (or Congress) may find to require "kid gloves," now or in the future, is inconsistent with this obligation. Garamendi, 539 U.S. at 424 & n.14,427. And it is inconsistent with all of the reasons that the Constitution rests foreign affairs authority with Congress and the President - and not the States - in the first place."

When you consider what is being said by federal officials and compare it with what you have been hearing from divestment advocates, you would logically reach one of the two following conclusions – which one will drive your position on the issues?

1. The administration is not concerned about terrorism, genocide, or the well being of our men and women in the armed forces so their position should be disregarded – it is thus clearly up to state and local officials to take matters into their own hands; or,
2. State and local officials do not have the information gathering networks or the necessary resources to get involved in highly sensitive foreign affairs. While divesting has superficial appeal, its potential for doing irreparable harm to US foreign affairs and to the US role in the ever expanding global economy is quite evident.

There is ample academic and common sense evidence to support a finding that divesting will have a negative impact on investment performance and that it conflicts with the basic fiduciary responsibility of those charged with the awesome task of investing other people's money – every foregone dollar of investment income has to be replaced with a taxpayer dollar. When this position is put forward by fiduciaries, it is typically countered by the proponents of divesting with something like, “But this is really important and look how effective we were with similar strategies in ending apartheid in South Africa.” Those who make that claim should revisit the facts regarding South Africa, the critical points of which are covered in the final article in this document.

Let there be no doubt about the fact that ***public pension fund trustees and staff members do not support genocide or terrorism.*** The pushback you are seeing and hearing from them is driven simply by their recognition of the points covered in the articles that follow

Fallacies on divestment

Policy won't sway companies or help oppressed

By **Cody Ferguson**

Posted: January 7, 2008, 6:01 AM EST

The current geopolitical institutional divesting discussion that is garnering national attention is predicated on a fallacy that, for the most part, has gone unchallenged. The commentary regarding divestment, dripping with emotion, urges investors to either avoid investing money in companies that do business in rogue or terrorist nations or, even more to the point, demands that investors take money away from said companies by way of strategic divestment. The fallacy is revealed by a simple review of the following facts:

Fact: When an institutional investor sells a company's stock it does not result in money being taken away from that company. The companies in question are usually very large multinational organizations. When investors sell or divest of their stock, it is being sold to other investors at no loss to the target company. If a large institutional investor wishes to influence the future direction of a company, the proper course of action is to increase the position held, not reduce it. An investor with no stock has no seat at the bargaining table. If you are serious about politically influencing a company's behavior, corporate governance initiatives, not divestment, can produce real results.

Fact: It is not likely that strategic divesting will influence company stock prices. In order for that to happen, the activity would have to be well coordinated among large institutional investors and completed within a very short time frame. If that could be accomplished it would probably cause only a short-term, momentum-driven decline in stock prices. And those who are last to divest would be selling into a down market, losing money for the fund. Of course, the price decline would have nothing to do with underlying value, so the most logical buyers would be the company whose shares were being sold and/or hedge funds, meaning many of the shares would be returning to the very funds that originally sold them. The market has a way of correcting for momentum-driven price changes and frequently does it in short order. Strategic divestment would not be an exception.

There is, of course, also the issue of fiduciary responsibility and the dilemma faced by trustees who are directed to arbitrarily divest regardless of the financial consequences. Interestingly enough, that matter seems to only be of interest to those who are, in fact, fiduciaries. Proponents of divestment who have no responsibility or liability seem perfectly happy to see actual fiduciaries expose themselves to risk. This argument, however true, seems to be a non-starter when it comes to today's divesting discussions.

Even though divesting does nothing to influence the so-called errant companies in question, shouldn't we do it anyway if it makes us look or feel

good? The answer is that besides the fiduciary pitfalls, there are plenty of reasons we should not divest — not the usual fiscal arguments but rather reasons that have to do with being patriots who are concerned about the future welfare and safety of our country and our men and women in uniform. Those reasons include:

Third World countries are in dire need of infrastructure and economic development. Getting a taste of what can be rather than what is and being exposed to people from developed countries can have a very positive impact on the attitude of the general population. Terrorists, on the other hand, thrive in an environment where the general population is deprived. Keeping the masses from having basics such as water, electricity, telecommunications, roads, and health-care facilities plays right into the hands of the terrorist.

Multinational companies concerned about their reputations are the companies we should want to see operating in the sanctioned nations. Historically, most of them go the extra mile to be seen as a force for good rather than a force for evil. Divesting exposes such companies to risks to their reputations to which the good ones would rather not be exposed. Get them to pull out through divesting pressure and what is left? Companies that don't care beyond their profit margins.

Many of the multinational companies in question are domiciled in our allied countries. Denigrating such companies is tantamount to denigrating their headquarter countries. Divesting alienates current and prospective allies at a time when we need all the political friends that we can find worldwide.

Multinational companies operating in sanctioned nations can be valuable sources of information that can be critical to the potential success of U.S. political and military operations. If divesting alienates the companies, the rhetorical question is: How cooperative should we expect them to be in assisting our intelligence-gathering networks and our armed forces in times of need?

The long-term economic viability of the United States is largely dependent on our place in the global economy. Divesting smacks of the isolationist and protectionist policies that have never worked in the past and that will not work now or in the future. Such policies, however, will go a long way toward relegating the U.S. to a secondary economic influence in the world marketplace.

Complicating pension fund investment, President Bush on Dec. 31 signed into law S. 2271, the Sudan Accountability and Divestment Act of 2007, which "purports to authorize state and local governments to divest from companies" in Sudan, according to a White House statement, which added, "as the Constitution vests the exclusive authority to conduct foreign relations with the federal government, the executive branch shall construe and enforce this legislation in a manner that does not conflict with that authority."

Divest and the terrorists win.

Cody Ferguson is a former trustee of the Los Angeles County Employees Retirement Association, Pasadena, with 26 years of experience on the board dating to 1978. He was very involved in researching and writing LACERA's existing policies related to institutional strategic divestment. He was a career firefighter for the county. This article originally appeared in Pensions & Investments January 7, 2008. Copyright Crain Communications Inc. Reproductions are not permitted.

Divestment is the wrong answer

It raises costs and false expectation of accomplishment

By **Edwin T. Burton**

Posted: August 6, 2007, 6:01 AM EST

Politicians have found a new way to lower future retirement benefits for employees covered by public pension funds — divestment. Divestment laws, proposed and enacted in various state legislatures around the country, require public pension funds to divest, meaning sell, all stock holdings in companies that do business in particular countries. The current list of countries includes Sudan, Iran, North Korea and Syria. Stay tuned for updates as this list is sure to grow.

The thinking is that, in each of these countries, there are bad people doing bad things. On this, we can probably all agree. There are definitely some bad people doing some very bad things in Sudan, Iran, North Korea and Syria — no question about it. We can also agree that there are some public companies doing business in these countries and that our public pension funds own stock issued by some of these public companies.

Now here are the areas of disagreement.

What difference does it make whose name is on the stock certificate? How are the bad guys affected by who owns the stock? It seems likely the new owners could care less that the bad guys are bad guys. How does that help?

Who really knows for sure which companies are doing what? A recently released Securities and Exchange Commission website was laughed out of existence because of its ludicrous attempt to identify bad actors by looking for country names in SEC filings. In any event, companies doing business in bad countries might be providing more benefit to the good people in these countries than to the bad people — who knows? What about companies that sell cigarettes to the dictators of North Korea? Maybe we should encourage dictators to smoke.

The divestment movement, if completely successful in forcing public pension funds to divest of companies that the movement doesn't approve of, will most likely have no effect whatsoever on events transpiring in Sudan, Iran, North Korea, Syria or anywhere else. If there is any impact at all, it will probably aid the bad guys at the expense of the good guys because the ownership of the various companies involved would shift to investors with a less heightened sense of moral outrage at the activities in these countries.

But, what is the effect on our public pension funds?

Well, to begin, a public pension fund that sells the stock of a company doing business in the targeted countries will probably end up owning the company anyway. Why? Most public pension funds have private equity investments and many (a growing many) have hedge fund investments. Virtually all private equity and hedge

fund investments do not allow investors to impose restrictions on their investment activity. Unless the public pension fund intends to divest its private equity (the most lucrative investment activity in the last 20 years for public pension funds) and hedge funds (the fastest growing investment area for public pension funds), then you are still going to end up owning the "divested" company anyway. You will just own it in a different part of your fund. The fund will be poorer because shifting the company from your left hand to your right hand will involve transaction costs.

It is instructive that several of the divestment initiatives expressly exclude private equity funds from their divestment regime. This means it is OK to own stocks in targeted countries in your private equity fund but not in your public equity fund. Wow! That should really scare the bad guys!

So, in all likelihood, divestment will simply mean moving an asset from one part of your portfolio to another with no real change of ownership but a reduction in fund assets to pay for the transition.

But what will be the real and lasting impact of the divestment movement? Much time and effort will have to be devoted to figuring out which stocks to sell and which to hold and, of course, this list has to be constantly updated. Companies do spinoffs and acquisitions with dizzying frequency. Therefore an entire industry must be created to analyze what company is doing what in what country. There will be some new millionaires creating these lists, producing companies to feed the demand by public pension funds to know which stocks they are permitted to own (in their public equity portfolios). These new multimillionaires created by this new research industry will be financed by a combination of higher taxes for taxpayers funding the additional contributions required to support the pension funds or, what is more likely, lower pension benefits for the working folks who are members of the public pension funds so affected.

There are no real winners in the divestment movement other than the politicians, perhaps, who might discover that this kind of wrap-yourself-in-the-flag investing will fool some voters. But, the losers for certain will be the public pension plan beneficiaries, the taxpayers who fund them and even, quite possibly, the victims of the terrible things going on in Sudan, Iran, North Korea and Syria.

The divestment movement gives the false impression that something useful is being accomplished that will prove helpful to the victims in Sudan or to retard the strength of the regimes in Iran, North Korea or Syria. But the reality is very different. The evildoers in these countries have absolutely nothing to fear from the divestment movement and potentially much to gain. It dissipates their opponent's efforts into headline-grabbing activities of no real import. If successful, it places the ownership of companies doing business in their countries into the hands of people likely to be unconcerned by the activities of the perpetrators of evil in these countries. This makes it easier for the bad guys to be bad guys.

Divesting is done at the peril of those it is intended to help, not to mention the negative ramifications for public pension plan stakeholders, the potential interference with federal international relations initiatives and the weakening of the future influence of the U.S. in our ever flattening global economy.

For every complex problem there is a simple, easy to understand, wrong answer — divesting is a prime example.

Edwin T. Burton is a trustee of the Virginia Retirement System, Richmond, and a professor of economics at the University of Virginia, Charlottesville. This article originally appeared in Pensions & Investments August 6, 2007. Copyright Crain Communications Inc. Reproductions are not permitted.

Unsuitable for public funds

By **Barry B. Burr**

Posted: August 20, 2007, 6:01 AM EST

Public pension funds are “particularly ill-suited vehicles for social investing,” according to a new analysis by Alicia H. Munnell, director of the Center for Retirement Research at Boston College and Peter F. Drucker Professor of Management at its Carroll School of Management.

Her report — “Should Public Plans Engage in Social Investing?” — is timely given recent moves by state legislatures and municipal governments to enact, or propose, divestment by public pension funds of shares of companies doing business in or with Sudan and Iran, as well as other countries accused of genocide and/or terrorism.

But as the title indicates, Ms. Munnell covers an extensive range of social investment, not just divestment. Public pension executives and state legislators should read it. How many will do so is another question.

Citing Social Investment Forum data, Ms. Munnell writes that individual and institutional investors had nearly \$1.7 billion in socially screened investments in 2005, amounting to 9.4% of all public and private assets under management. “(A)lmost none of the screened money is held in private sector defined benefit pension funds,” covered by the Employee Retirement Income Security Act, she writes, noting the Department of Labor has long “warned that the exclusion of investment options would be very hard to defend under ERISA’s prudence and loyalty tests” and prohibited fiduciaries “from subordinating the interests of participants and beneficiaries to unrelated objectives.” As a result, she writes, “ERISA fiduciary law has effectively constrained social investing in private sector defined benefit plans. Social investing is a public pension fund phenomenon.”

Divestment, she writes, can be “complicated, costly, and ineffective.” The number of companies on lists screening for divestment varies and depends on the criteria used by the research firms employed by money managers and pension funds. Examining the results of past divestment efforts, Ms. Munnell notes public funds’ South Africa boycott in the 1980s and 1990s had “virtually no effect” on target companies.

One reason she cites for arguing against social screening by public funds is that “the decision-makers are not the people who will bear the brunt of any losses; rather they will accrue to future beneficiaries and/or taxpayers. In many instances, the environment surrounding public pension fund investing is politically charged and encouraging public pension fund trustees to take ‘their eyes off the prize’ of the maximum return for any given level of risk is asking for trouble.”

Ms. Munnell, an economist with a Ph.D. from Harvard University, has studied pension investment issues since the 1970s from various vantages. Among them, she was assistant secretary for economic policy in the Department of the Treasury and a member of the Council of Economic Advisors, both in the Clinton administration, and senior vice president and director of research at the Federal Reserve Bank of Boston.

In 1993, at her confirmation hearings for the Treasury post, Ms. Munnell allayed fears of pension fund officials on requiring social investments, a Pensions & Investments story at the time said. She said she would argue against such investments within the administration, noting, "I may win, I may lose," Ms. Munnell testified.

"Once pension fund managers took their eye off the prize, that is highest returns, for a social cause," the funds' performance suffered, she testified at the hearings. Ditto for 2007.

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The Harvard Crimson ONLINE EDITION

Opinion

Forget About Divestment

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By **DANIEL P. ROBINSON**

Targeted divestment is a popular and oft-proposed solution for some of the worst atrocities in the world. In November, Massachusetts Governor Deval L. Patrick '78 signed into law a targeted divestment bill aimed at putting pressure on the Sudanese government to cease the genocide in Darfur. In September, students marched through Harvard Square to urge the passage of a bill that would stop public pension funds from investing in companies that enable the military junta in Myanmar. These advocates apparently believe that they can make a difference by convincing financial institutions to stop investing in companies such as PetroChina and Chevron, which are linked to atrocities around the world. There is no question that the genocide in Darfur and the violent military crackdown in Myanmar are acts of brutality that should be stopped, but divestment is both an economically unsound and ineffective way of achieving these ends.

Divestment campaigns advocate the sale of shares in companies that support atrocities. Proponents of Darfur divestment argue that such "financial pressure" on companies that support the Sudanese government can help alter its political stances. While divestment is similar to traditional boycotting of products, classic economic theory predicts that it will have absolutely no effect. Unlike goods and services, whose prices can be affected by changes in demand, the price of a financial asset is determined by its expected returns. If a firm forgoes a profitable investment, then another firm will take advantage of that investment instead. In today's world of highly mobile global capital, opportunities for profit rarely go unnoticed—someone will step in as soon as we leave.

What this means is that divestment merely transfers the profits gained from one investor to another. As long as someone is willing to invest in a given company, no divestment will have any effect. Therefore, divestment campaigns only hurt the investors they go after, such as Harvard's endowment or Cambridge's pension fund, and cannot cause real change. This conclusion is backed up by empirical studies. An August study from the Center for Retirement Research at Boston College surveyed the academic literature and found that such "social investing" has no effect on the stock prices of targeted companies.

Divestment advocates claim that the South Africa divestment campaign of the 1970s and 1980s played a major role in ending apartheid. There is no empirical evidence, however, for this claim. A 1999 study in the *Journal of Business* found that the boycott had almost no impact on financial markets or corporations in South Africa. In addition, global capital markets are significantly more liquid than they were in the 1980s, so even short-term effects of divestment will revert more quickly.

Furthermore, even if Harvard or Cambridge's actions helped spark a national movement for divestment, there will always be available sources of capital—sources that do not necessarily operate from Wall Street. No publicity campaigns in the United States can change the fact that PetroChina and Chevron are incredibly profitable companies. That harsh reality means that they will always be able to find investors who are not so picky about where their money has been. Eliminating American investment in companies such as PetroChina and Chevron will only shift profits to foreign investors, including, perhaps, terrorist financiers or rogue states.

One might argue that the goal of divestment campaigns is not to hurt the targeted companies but to raise awareness, send a message, or ensure that our money in particular is not directly involved with companies that support genocide. But if that is true, then advocates are being disingenuous when they claim their campaigns can effect real change. HDAG claims that “institutions can influence the Government of Sudan” by divesting in companies such as PetroChina. Such a claim implies that divestment puts financial pressure on these companies, or can cause change itself. This idea is not only misleading, but also is harmful, since it diverts people’s attention toward ineffectual policies rather than strategies that can actually bring change on the ground.

Finally, it is questionable why our primary concern when faced with genocide should be whether our own hands are somehow dirtied by it. It makes little sense for strategies that could effect real change in Darfur, such as military intervention or humanitarian aid, to be ignored in favor of attempts to clear our own consciences. It is self-centered of students to suggest that Harvard’s portfolio matters at all to those directly affected by the genocide.

Raising awareness should be a means to an end, not an end in itself. There are things students can do to help make a difference in Darfur, such as donating money to non-governmental organizations that provide refugee relief or medical aid. We can lobby congress to accept refugees in America, to impose sanctions, or even to take military action. Some of these courses of action have downsides, but they should be our primary considerations, not the symbolic gesture of divestment. Lack of awareness is no longer a problem; a lack of progress is. Advocating for policies that do nothing but engender more advocacy is an empty form of activism.

Daniel P. Robinson '10, a Crimson editorial editor, is a social studies concentrator in Kirkland House.

The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence From the South African Boycott

Siew Hong Teoh, Ivo Welch and C. Paul Wazzan

Executive Summary by Mary Balmaceda-Roy. Original Study published in Journal of Business, 1999 vol.72, no. 1

Summary

Does shareholder pressure have the desired effect on its targets? To find an answer to this question, the authors examined what activists consider to have been the most visible and successful instance of social activism in investment policies: the boycott of South Africa designed to speed the end of apartheid.

Siew Hong Tech of the University of Michigan, Ivo Welch of the University of California, and C. Paul Wazzan of the Law and Economics Consulting Group began their study with an overview of the macroeconomic situation in South Africa. During the years of intense political pressure (1984-88), South Africa experienced a large number of divesting firms and legislative foreign sanctions. There were visible macroeconomic signs of flight of private capital from the country, measures by the South African government to combat capital flight, strikes and work stoppages, high inflation and a recession. Aside from political pressure, the period in question also coincided with a decline in the world price of gold, which could be responsible for a portion of the capital flight.

The impact of shareholder pressure in South Africa was examined through event-study methodology. Using the assumption that markets update stock prices almost immediately in reaction to new information, Teoh et. al. isolated the most significant political, legislative and activist events leading towards the fall of Apartheid. They examined the stock-price reaction during a one to three-day window around the event.

During the most significant legislative events leading up to the anti-apartheid act of 1986, a significant stock-price reaction was not detected. There was also no evidence that South African financial markets or the exchange rate were adversely impacted. Similarly, when 16 large pension funds announced their divestment from US firms with large South African operations in 1985, there was no evidence to indicate that the divestment had a negative impact on either US firms stock prices or the South African financial markets. The decreased demand for these stocks by activist shareholders seemed to have been neutralized by increased demand by indifferent institutional and non-institutional investors.

The study concludes that despite the prominence and publicity of the South African boycott, the financial markets valuation of targeted companies and the South African financial markets themselves were not affected. While the boycott raised public moral standards and awareness of the repression of the Apartheid regime, the financial markets managed to remain relatively elastic, though there was a significant change in institutional holdings.

Implications

The results of this study have important implications for the social investing community. They show that activist shareholders who chose to divest from South Africa did not suffer a subsequent loss to their portfolios. This is an important counter to the argument that activist shareholders must sacrifice performance to achieve their moral objectives. In fact, if the stock prices of companies were to fall as a result of boycotts, it would create a situation where these stocks become undervalued, creating bargains for speculators at the expense of activist shareholders.

It can also be inferred from this study that the companies that were activist targets were pressured to make the decisions to pull out of South Africa regardless of the fact that their bottom lines were not directly affected. It indicates that social considerations and issues of public image that ignite through large-scale boycotts have a true effect on corporate decision making. Further research needs to be done on this question.

This study does raise an important concern: if, as activist shareholders, the main goal is to hurt the company's profits by driving down stock prices, it could then be argued that divestment is not the best tool. If, in fact, the goal is to alter corporate behavior, then divestment is a powerful and effective means to achieve social change.