

SOUTH AFRICA: A CASE FOR TOTAL DIVESTMENT

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My belief is that it is in the best short-term as well as long-term economic interests of U.S. corporations to disengage from South Africa. South African corporations are no longer profitable in most cases and there is an immediate risk that product imports, capital investment or sales will be lost or adversely affected by continued military and police action, domestic or foreign embargoes or government expropriation. This is in addition to normal risks of currency fluctuation and unstable commodity prices. In the long-term, a new majority-ruled government may look elsewhere for investments and trade, or will extract a very high price for foreign corporate involvement. At worst, corporate support of the white-minority will rule out any access in the future to South African strategic resources and play into the hands of U.S. corporate enemies around the world. A short-term loss may also be more than offset by substantial long-term gains if U.S. corporations disengage.

This paper argues for total U.S. corporate disengagement from South Africa and total divestment of U.S. capital to achieve disengagement. The first part of the paper presents background information on the South African political economy. The second part examines the state of high risk in the current South African economy. The third part presents and responds to the arguments against disengagement. The final section examines the issue of divestment with particular reference to the University of California's divestment controversy.

Background

A state of war presently exists in South Africa. The government has announced a state of emergency and the white minority's authority over its black townships has collapsed.¹

The government of South Africa maintains the most sophisticated and highly technological and industrial police state since Nazi Germany. This terrorist government carries out its apartheid policy through torture, mass arrests, bannings, detention and its illegal military occupation of Namibia. The government has repeatedly invaded the neighboring countries of Angola, Botswana, Lesotho, Swaziland, and Mozambique with military or police forces, killing hundreds of innocent men, women and children. South Africa also financially and militarily supports armed insurgents in Angola and Mozambique in an effort to overthrow those governments and disrupt their fragile economies.

Reliance on Western multinational corporate capital provides the underpinning of a unique blend of national socialism and controlled capitalism. U.S. based multinational corporations, many

of which have been in South Africa since the early 1900s, provide strategic materials, capital, technology, and other vital resources to strengthen the apartheid government. According to a U.S. Senate Subcommittee report:

"The net effect of American investment has been to strengthen the economic and military self-sufficiency of South Africa's apartheid regime."²

The United States is the largest trading partner of South Africa and while sales of South Africa's Krugerrand in the United States have recently decreased, over the last ten years South Africa has produced 40 million ounces of Krugerrands, most purchased in the U.S. and Western Europe. U.S. sales account for 80% of total world-wide sales, while Krugerrand sales comprise 10% of South Africa's total sales of gold bullion, which in turn accounts for over half of the nation's overall export earnings.³

Historically, U.S. banks have had little trouble lending to South Africa. Loans are made in four broad general categories: (a) directly to the South African government; (b) directly to government agencies or enterprises; (c) indirectly through other bank branches, i.e., Barclays; and (d) through trade-related loans made to U.S. corporations operating in South Africa. As of March 1984, U.S. banks had \$4.6 billion in outstanding loans to South Africa.⁴

In 1960, following the Sharpeville massacre and in the mid-seventies after the Soweto uprising, U.S. banks came to the aid of the South African economy. Recently, however, many banks are refusing to lend directly to the government or government agencies, while others lend short-term at high interest rates in categories (c) and (d) above.

While banks have lent the capital, American companies have historically provided the most strategic technological and industrial support to apartheid. U.S. companies control over 70% of the computer market in South Africa and include IBM, Burroughs, NCR, Control Data, Hewlett Packard, Wang Labs, Mohawk Data Science, Sperry Rand, Computer Sciences Corporations, 3M, Kodak and Tron Systems.⁵ The IBM computer used by the Department of Interior facilitates the very system of racial classification that undergirds apartheid. It also provides an efficient method of tracking South Africans' movement for security purposes.⁶ Computer technology is utilized for internal security, the nuclear industry, transportation, defense and police, and to support security forces illegally occupying Namibia and operating in Angola.

Computers provide the answer for one of the great bottlenecks in the South African economy; the need for skilled white labor. Another great bottleneck in the South African economy is energy. South Africa has no petroleum resources. Here again, United States firms are the key to white rule. Almost two-thirds of South

Africa's oil is refined by Mobil and Caltex (Chevron and Texaco). Nuclear power has been supplied by Westinghouse Electric and Allis Chalmers. IT&T has provided the telecommunications network and General Electric, the electrical machinery and diesel engines. The automotive industry is also dominated by General Motors and Ford. Bechtel and Fluor Corporations have also helped South Africa develop the synthetic fuels industry.

All firms operating there are supplying badly needed tax revenue for defense and internal security. Taxes paid in South Africa are deducted from the companies' federal and California state tax liability. (U.S. and California tax payers are actually indirectly subsidizing the South African government.)

U.S. firms primarily employ white South Africans, are capital intensive and provide American legitimacy and respectability. Many also supply materials primarily to industrial and commercial facilities and focus their attention on supplying government agencies with key materials, services and maintenance of equipment, i.e., computers. Some of these companies also export minerals and other South African commodities which are vital in both providing South Africa foreign exchange and in comprising the dominant revenue for resource-based American companies. All in all, U.S. companies are responsible for approximately \$2.3 billion in direct investments in South Africa,⁷ and an estimated \$10-12 billion in indirect investments.

Country Risk

No one needs to remind corporate management these days that South Africa is undergoing a recession--a 16% inflation rate, 50% of the black African labor force is unemployed and South Africa's prime rate is 18.5%. South Africa is in great need of capital, while still one of the largest debtor nations in the world (\$24 billion). To sustain its industrial growth the government is attempting to borrow great sums of capital at premium interest rates. The South African government has also recently had to step-in and protect the South African Rand from losing its value in the international currency market. The government has already begun to take drastic measures to halt the flight of the capital leaving South Africa.

Not only has the South African government defaulted on its short-term bank debt, but the economy since 1980 has been stagnant. The GNP has shown a -2.5% growth rate for the first half of 1985.

There is great economic, social and political risk in South Africa. Since the late 1970s major corporate risk analysts such as Business Environment Risk Information (BERI), a Geneva-based firm, have warned corporate decision makers that investing in South Africa is extremely risky. In fact, in late 1982 BERI recommended to the management of firms operating in South Africa that they should:

- Deemphasize South Africa and prepare to shift production elsewhere, if possible.
- Protect industrial sites and personnel against violence.
- Consider the costs of exclusion from other African markets because of the South African operations, and the costs of management difficulties in handling stockholders initiatives and adverse publicity from anti-apartheid advocacy groups.
- Examine the possibility of an orderly withdrawal early in the decade to avoid financial losses.⁸

In addition, in mid-June 1985, Frost and Sullivan, another risk analyst, concluded that "South Africa is showing a deteriorating risk picture, in both the short and long term."⁹

Many American firms recognize the risk of losing their South African facilities and have pulled out of the country, selling their subsidiaries or affiliates to South African firms. In fact, within the last five years, thirty American firms have withdrawn.¹⁰ Some firms, however, are staying in South Africa to take advantage of a business opportunity. According to a recent *Wall Street Journal* article:

"Given the current mood, few U.S. firms are beginning new enterprises there these days. There are exceptions, like Alexander and Alexander Services, Inc., an insurance brokerage firm. Our clients have greater need for our services in South Africa now, says Peter Reid, Senior Vice President, describing his firm's ability to put together protection packages against fires, revolutions and other calamities. 'They're concerned about getting wiped out,' he explains."¹¹

The degree and recognition of risk in South Africa has become so intense, that several major brokerage firms that cover South Africa gold stocks are either refusing to rank stock performance and safety or temporarily suspending coverage. This action is based on the prices of South Africa gold shares that dropped 80% following both the violence of Sharpeville and Soweto. According to one major brokerage firm's research department:

"Although no sign of a pull-out from the South African gold shares is evident to date and foreigners remain net buyers, we believe the perception of the political situation there is deteriorating and could lead to significant upheaval. In addition to current unrest stemming from the Blacks' dissatisfaction with the educational opportunities for them, we believe the questionable state of the country's economy, inflation this year of about 15% and coming wage negotiations for the gold mining industry all represent the potential for growing unrest. We would

definitely avoid the high-cost marginal producers."¹²

Several American corporate facilities have been damaged by bomb explosions and many more have been targeted by the African National Congress (ANC). Urban warfare is seen as one of the most effective weapons in battling white minority rule by destabilizing key economic sectors. In addition, the ANC has called for a general uprising in South Africa, and in April the military wing of the ANC, Umkhonto we Sizwe (Spear of the Nation), issued a "call to the nation, urging fighting youth to organize themselves into small mobile units and to act in an organized way . . . against the enemy and its agents."¹³

Corporate Code of Conduct

In March 1985, the American Chamber of Commerce in South Africa after years of violence and state terrorism asked the South African government for "visible expression" of reforms in order to defuse the disinvestment campaign in the U.S.¹⁴

Many of the companies comprising the Chamber have signed the Sullivan Code of Conduct, a voluntary corporate code, that pledges that a company will move toward desegregating restrooms and dining facilities, providing equal pay for equal work, and financially supporting African education, housing and other reforms within the context of apartheid.

Approximately one-half of the 300 United States firms in South Africa have signed the code and are rated on compliance by Arthur D. Little & Company. Most of these firms, however, have opposed Congressional action requiring statutory compliance.

Since mid-1977, the South African government has supported the objectives of Sullivan's original six principles or code of conduct and has never attempted to discourage U.S. corporate compliance with it.¹⁵ This shows that the Sullivan Code is not a threat to apartheid and white rule. In fact, it aids the South African government in accomplishing several goals:

- It legitimizes the United States' and corporate support of the government.
- It allows U.S. firms to continue supplying high technology, capital and revenue that is necessary for the whites to survive.
- It softens opposition to apartheid in the United States by appealing to workplace discrimination issues.
- It affects only 70,000 African workers or 1% of the African labor force, and actually affects only about 26,000 Africans employed by U.S. firms rated in the top categories by Arthur D. Little. (U.S. companies are capital intensive.)
- It provides an excuse for institutional investors to maintain the status-quo while appealing for code compliance, thus avoiding effective institutional action.

- It has the advantage of getting U.S. firms to use some of their capital to build a few houses, education centers and hospitals, while the South Africans can divert their funds to internal security, defense and weapons. This allows them to expand and intensify repression while supplementing corporate funds to "keep the lid on" the non-white majority.

The Sullivan Code and the European Economic Community Code of Conduct are both voluntary corporate codes, and as such have been excellent public relations for foreign firms in South Africa. After seven unsuccessful years, the Reverend Leon Sullivan, the author of the American corporate code, has finally given U.S. firms another 18 months to bring about change in South Africa or he will call for disengagement. Rev. Sullivan has already called for no new investments or bank loans.¹⁶

Disengagement

If it is true that American firms can only have a minimal, if any, positive impact on the South African government, what are the arguments against total U.S. corporate disengagement from the country?

One often hears the argument that, "blacks will be hurt if United States firms pull out." However, this argument is often voiced by U.S. firms that employ few Africans but that are strategic to the survival of white rule. It is ironic that many of the firms that use this argument regarding black African jobs are moving at will in this country and around the world, destroying thousands of jobs and dozens of communities. They often oppose public notification of plant closure that is geared to give communities lead time to deal with major displacement and job loss. "Runaway shop" is the rule, not the exception, except when it is expedient for profit.

Another commonly heard argument is that the majority of people in South Africa want us to stay. Such arguments are given credibility by the American Chamber of Commerce, the South African Foundation and the American Manufacturers' Association who spend thousands of dollars to bring Bantustan, labor, and community leaders to the United States to publicly denounce the divestment campaign. They call for more investment to create more jobs.

Most of the people representing this point of view are on the payroll of the South African government and their economic and political position is assured only if the white-minority continues in power and the status-quo is maintained or fundamentally unaltered. Every major African nationalist organization has called for disengagement. Even though it is against South African law, many domestic labor organizations and nonwhite political leaders have called for United States firms to withdraw. "... Markinor,

an affiliate of Gallup, conducted a poll of urban black opinion for the *Sunday Times* of London and found that 77% of blacks support economic sanctions against South Africa to bring about the dismantling of apartheid. Fifty black pollsters personally interviewed a sample of 400 people in the Johannesburg-Pretoria and Durban areas.¹⁷

The African National Congress (ANC) has been calling for economic sanctions for decades. Chief Albert Lutuli, then President of the ANC, who in 1960 was the first black South African to win the Nobel Peace Prize said:

"The economic boycott of South Africa will entail undoubted hardships for Africans. We do not doubt that. But if it is a method which shortens the day of bloodshed, the suffering to us will be a price we are willing to pay. In any case, we suffer already."¹⁸

The Federation of South African Trade Unions (FOSATU), the largest federation of black trade unions in South Africa has come out in full support of disinvestment and the application of international pressure on South Africa to bring about "social justice and democracy."¹⁹

Another argument is that American firms are forces of progress in the country and if they leave, they will only be replaced with less progressive businesses. This simplistic argument is not borne out by facts. While U.S. firms have been somewhat more liberal in the workplace, they have never challenged the government, either politically or financially. Many of these companies have the government as their largest customer in South Africa, while many U.S. corporate managers and supervisors are Afrikaners who defend apartheid.

The larger and more strategic companies have been in South Africa for almost eighty years and have provided the Nationalist Government, which came to power in 1948, with undisputed support. It has only been within the last year, with repression and violence at high levels in the country and increasing pressure being put on parent companies from divestment forces in the United States, that American subsidiaries have voiced their concern about apartheid. There is no evidence to suggest that U.S. firms have applied any political or financial pressure on the ruling Afrikaner National Party.

Opponents of United States corporate disengagement argue that other foreign governments and multinationals would step in and take the place of American firms. This is unlikely.

American firms such as IBM, Hewlett-Packard, Chevron, Mobil and IT&T cannot be replaced overnight. Foreign firms simply do not have the capacity to make massive changes involving products, services, marketing and personnel. Such capital, technological, manufacturing and industrial changes defy corporate planning and risk and market analysis.

In addition, disengagement will have long term consequences for other foreign investors. The divestment campaign in the United States has already resulted in a reduction of trade and of new corporate investment. More importantly, looking at the American subsidiaries that have disengaged over the last decade, almost all were sold to local South African interests. According to a January 4, 1985 article in the *Rand Daily Mail*:

Business leaders are deeply worried that once the United States has begun to disinvest it will pressure other members of the Western alliance to follow suit. Dr. Albert Wessels, a member of the South African business community through his Toyota links, who is in close touch with the Japanese business world believes that Japan would find it exceedingly difficult to stay in South Africa once the Americans have gone.

It is equally dangerous to assume that South African companies would step into the breach and negate any possible damage following from American disinvestment. As important as the \$2.3 billion which some 300 United States corporations have in fixed South African investments, is the new technology expertise and management skills which they introduce.

There are crucial contributions to South African economic strength which South African companies cannot hope to substitute adequately. Moreover, American disinvestment would be such a hammer blow to business confidence that South African companies may feel rather jittery about making substantial new investments.

Gross domestic fixed investments have been in decline since the end of 1981 and, while this is partly due to the business cycle, business confidence and fear of disinvestment have also played an important role.²⁰

Total economic disengagement from South Africa is the most effective weapon against apartheid and white rule because it cuts the life blood to the heart: *capital and technology*. Moral outrage and condemnations fall on deaf ears.

A modern dictatorship controlling an industrial economy cannot endure without increasing capital, technology, trade and sustainable growth. A general African uprising in the townships, South African foreign adventures,²¹ a decrease in foreign investments and loans, increasing labor and civil unrest and a coordinated urban guerrilla campaign, will inevitably lead to a continual cycle of death, destruction and open warfare in South Africa. This is totally destabilizing to an economy and to a society.

American corporate disengagement is in some ways already a fait accompli according to a *Financial Mail* article:

"In one respect at least, the divestment forces have already won. They have prevented, discouraged, dissuaded, whatever you call it, billions of new United States investments in South Africa. They have discouraged new companies, new investors who were looking for foreign opportunities from coming to South Africa."²²

Divestment

If disengagement is the only effective force available to us to counter apartheid and bring about change in South Africa, what action is most effective in convincing corporate management to withdraw and totally disengage from South Africa?

In California alone, over \$100 billion is invested by public agencies, including the California State Treasurer, the Public Employees Retirement System (PERS), the California State Teachers Retirement System (STRS), the University of California (UC), twenty counties and dozens of cities and special districts throughout the state. Every public agency invests short-term assets, and with very few exceptions, all of the entities described invest in corporations and financial institutions economically supporting the South African apartheid regime. In addition, almost every private profit and non-profit organization invests or deposits funds in corporations or banks operating in South Africa. Such organizations include pension funds, businesses, unions, public interest organizations and others. Finally, of course, there are billions of dollars in individual investments.

For over a decade major church organizations and some institutional investors have corresponded with corporate management, voted their stock and introduced shareholder resolutions as responsible owners to fully disclose South African operations, limit investments, discourage or prohibit loans to the government or public agencies, fully implement a code of conduct for corporations in South Africa and restrict sales to the military and police. While some companies have agreed to limited reforms, no resolution has ever been adopted over the objection of management.

While shareholder activity has been responsible for additional disclosure, the primary success has been to publicize corporate involvement in South Africa and encourage positive parent influence on corporate subsidiaries. There is little, if any evidence to support major corporate shifts in South African policy caused by shareholder pressure.

Corporate management will never be truly challenged by their shareholders, unless and until large institutional investors take their ownership roles much more seriously. Management dominates and controls the overwhelming majority of proxies. A real challenge

by institutional investors on South Africa at one corporate annual shareholders' meeting today would take years to coordinate and involve enormous costs. Corporate democracy in the case of South Africa is a cruel hoax.

Few institutional shareholders exercise their ownership responsibilities by communicating with corporate management or voting their shares against management. The majority of large institutions continue to "vote with management or sell."²³ For example, the University of California Board of Regents have voted against corporate management on only two occasions on a South Africa resolution in the history of the University as a corporate shareholder.

Very few institutions have ever seriously corresponded with management on South Africa. In case of the University of California, the University of Maryland, the California State Teachers Retirement Systems (STRS) and the California Public Employees Retirement System (PERS), form letters were mailed and the companies responded with form letters. It was an exercise in public relations for all concerned.

California PERS and STRS on one occasion introduced a South Africa resolution at Xerox which was defeated by 90% of the vote. That action was taken only after considerable pressure was exerted by the Brown Administration. Since that time, the state retirement funds have been less active and have even dropped their subscription to the Interfaith Center on Corporate Responsibility (ICCR), which provides information on corporate responsibility issues.

Corresponding with corporate management, voting common stock at annual shareholders' meetings and introducing resolutions have had a limited impact on corporate management. These actions, as well as divestment efforts, however, have influenced American business and have had a direct impact on the South African government. Such activity has also led numerous public agencies to refuse to purchase goods and services from many corporations and financial institutions operating in South Africa.

Since 1976, seven states, three counties, twenty-eight cities and one U.S. territory (Virgin Islands) have enacted divestment proposals mandating the divestment of over \$1.8 billion from U.S. corporations and banks involved in the South African economy.²⁴ Another forty-three educational institutions have fully or partially divested,²⁵ and as many as twenty California State University and College (CSUC) auxiliary organizations have enacted socially responsible investment guidelines.²⁶ According to the Social Investment Forum, of the approximately \$40 billion in assets of "socially screened" portfolios managed by professional fund managers, \$12 billion has been divested or has been prohibited from investment in firms operating in South Africa.²⁷

The withdrawal or prohibition on new investments results in the denial of capital. In a capital market economy, this is the overriding concern of corporate management. The same is certainly true of the refusal to purchase goods and services. These actions represent market forces that cannot be ignored.

A "capital strike" cuts to the heart of corporate management because it is the "bottom line." It is the only morality understood in the corporate boardroom when it comes to South Africa. This is the reason the South African government, business organizations and the South African Foundation are spending unlimited sums of money in the United States to lobby against divestiture. It is also the reason that the South African government has assigned a senior official in the Foreign Affairs Department, Dr. Mark Burgher, to coordinate a major lobbying effort in the United States against divestment.²⁸

Divestment or the denial of capital is not an idle weapon in our capital market. Presently over 80% of the stock and 60-70% of corporate bonds traded every day on major exchanges are traded by pension funds. This percentage is larger if we include other institutional investors, such as local governments, college and university endowments and public interest organizations managing smaller "cash" portfolios.

Over \$1.3 trillion in assets are controlled by pension funds and this number will grow to \$4 trillion by 1995. The present sum totals almost 28% of our GNP. In California, public agencies alone control more than \$80 billion in pension assets, and California PERS has been identified as an institutional investor that literally sets the stage for the opening of a new bond issue and its acceptability in the market place.

Pension funds are today the single largest source of domestic corporate capital, or a source providing about a quarter of all new capital available for investment. That figure will increase to about 50% by 1990. The loss of access to a portion of this capital by America's largest companies is enough cause for a reevaluation of policies in South Africa.

It would be a mistake to gauge the financial impact of divestment by the selling of stocks, bonds, or short term debt securities in the secondary market. The actual impact on corporate management is slight, since another investor will simply buy the security. An impact may result from adverse publicity, or, if the number of shares sold is large enough, price may be temporarily depressed. The real impact, however, is based upon the fact that an increasing number of institutions will not purchase a company's security in the primary or secondary market. A major corporation in our economy must have full access to capital markets to be able to compete. Again, the "bottom line" is capital and the denial of access to one-half of all corporate domestic capital will have extreme financial repercussions on a multinational firm.

Another fact that is difficult to quantify, but no less true, is that once companies have been identified by fund managers and the public as apartheid supporters in South Africa, not only will less capital be available, but corporate products will be avoided by consumers. Even after apartheid is eliminated in South Africa, those companies will long be remembered and that fact will influence future market behavior.

Arguments Against Divestment

Major arguments against divestiture or the refusal to make new investments in companies operating in South Africa have been primarily financial and fiduciary. The most commonly voiced arguments are that the divestments of South Africa Invested (SAI) corporate securities will:

- impair performance and increase risk;
- reduce diversification and liquidity;
- increase transaction costs.

Portfolio Asset Allocation: Divestment Impacts on Cash and Fixed Income Categories

Before evaluating these arguments, one must understand portfolio asset allocation. Assets of an institutional portfolio are traditionally allocated into the general categories of cash, fixed-income and equity.

There has been no detailed financial study of the impact of South African divestment relating to cash and fixed-income portions of a portfolio because it is generally accepted by investment professionals that the financial impact of divestiture will be minimal if not non-existent. The only exception is a two page discussion in a controversial and highly disputed June 1984 study by Wilshire Associates.²⁹ Wilshire argued that the universe of prime corporate commercial paper issues and large banks issuing certificates of deposits (CD's) would be reduced and that this would carry more default risk and provide lower average quality.³⁰ The Wilshire study, however, ignored the wide range of federal agency securities available for investment and neglected to cite numerous public agencies and two money market funds that not only exclude SAI securities, but have extensive exclusionary and inclusionary criteria.

Not only are there literally thousands of high quality, government-guaranteed short-term securities available, there are also more than ample prime corporate commercial paper and eligible CD's available to provide competitive yields. Quality of corporate paper is simply not affected and ample investment opportunities exist for CD investments in hundreds of large regional banks, savings and loans and credit unions. Two money market funds utilizing comprehensive social and economic, as well as financial criteria, Working Assets and Calvert Group, have been in

the top quartile of performance in 1984 and 1985. In 1983, according to the Donoghue Money Average, the Calvert Social Money Market Fund was the top performing money market fund in the country.

Wilshire also stated that the implications of divestiture for fixed-income portfolios would be a smaller universe and lower average quality. While it is certainly true that the elimination of SAI securities will reduce a small portion of the universe, it does not reduce quality. Wilshire even admitted that 85% of the South Africa Free (SAF) securities would be rated Baa or better.³¹ This rating is considered "investment grade" by investment professionals. In their analysis, Wilshire also neglected to include in the fixed income category, residential, commercial and industrial real estate, loans or private debt placements. This neglect is significant since most large institutional investors allocate the majority of their assets to fixed-income investments, including real estate. This is especially true for pension funds, which are more conservative and must meet interest rate assumptions and pay benefits to retirees every year.

Divestment Impacts on Equity Portfolios

Equity or stock is usually the most risk-oriented portion of a portfolio, and the most volatile. Most large institutional investors allocate a smaller portion of their assets to equity and many public funds severely limit stock by constitution, statute or regulation. This means that the majority of funds are not even impacted by a South African divestiture! The University of California, however, is an exception, allocating 75% of assets to equity.³² In fact, of the two largest University of California Funds, the General Endowment Pool (GEP) and the Retirement Funds (UCRS), almost 50% of the equities are in 15 large growth companies.³³ It is the portion of a portfolio allocated to equity or stocks that has received the most attention and study in the debate over divestment.

Review of Studies on the Impact of Divestment on Financial Performance

Over a dozen major financial studies on the financial impact of divestiture on equity portfolios have concluded that with a slight increase in risk and volatility, South Africa Free (SAF) outperformed South Africa Invested (SAI) portfolios. In April 1982, at the request of the Connecticut State Treasurer, Daniel and Bell Capital Management completed a study of the Connecticut Mutual Equity Fund, comparing SAI and SAF portfolios for five years (1977-1981). The SAF portfolio outperformed the SAI portfolio by an average annual basis of 6.3%, was 89% as diversified as the Standard & Poor's 500, and was 1.26% times as volatile as the S&P 500. The study concluded that the "sanitized" portfolio

outperformed both the original portfolio and the market.³⁴ Daniel and Bell also found that four of the six current Connecticut portfolio managers would have improved their rates of return with SAF portfolios and that the elimination of such securities would not have any appreciable effect on their management styles.³⁵

United States Trust Company, Boston, which is a leading manager of "socially screened" accounts, also provided the State of Connecticut with important performance data. United States Trust's study covered a ten year period (1972-1981) and found that the SAF portfolio outperformed the SAI portfolio by an average of 1.6% a year during the ten years.³⁶

In 1983, The Boston Company conducted a ten year study comparing S&P 500 companies in SAF and SAI portfolios. Although companies with strategic investment in South Africa or poor employee relations in the U.S. were excluded from the study, SAF outperformed SAI by over 17% annually.³⁷

In December 1984, Robert Schwartz of Shearson/Lehman/American Express testified as an expert witness in an Oregon divestment case that between 1977 and 1984, companies identified for divestment appreciated in value by 40%, while SAF equities in the portfolios increased by 57%.³⁸

In a recent five year study by Ted Brown, sponsored by the Africa Fund and the New World Foundation, S&P companies rated A- or above and SAF provided an average annual return of 29.2% higher than the SAI.³⁹ In addition, Favia Hill Associates, an affiliate of Chemical Bank, has been tracking SAF vs. SAI stocks on their "buy" list since 1981. They have found that there are ample equity choices, and there is no difference in the rates of return or the relative risk and liquidity of both groups of stocks.⁴⁰

Impact of Divestment on Diversification, Liquidity and Risk

In addition to performance, diversification and liquidity are other major questions raised in divestiture debates. If one were to divest or refuse to invest in the equity of every company operating in South Africa (approximately 284), this would eliminate over half of the capitalization of the S&P 500, and one-half of the largest 100 companies. Of the S&P 500, it would also eliminate large portions of at least ten industry sectors in the S&P 500. This argument also suggests that since major institutional investors need liquidity, and only larger capitalized firms whose stock volume is great can provide such liquidity, divestiture would harm portfolio performance.

These may sound like big numbers to exclude, but current portfolio management indicates otherwise. It is true that large institutional investors, such as the University of California, have an appetite for larger capitalized companies with large stock liquidity such as IBM, Eastman Kodak, 3M, and General Motors. Unfortunately, the University of California is involved in a zero sum

game where literally hundreds of other large institutions are trading the same stocks, listening to the same analysts and hearing the same earnings reports. Instead of having a high degree of diversification, University of California portfolios are poorly diversified, heavily concentrated in large corporate growth stocks and have underperformed the S&P 500 since 1983. In addition, because market trading is dominated by large institutional investors like UC, these heavily traded stocks become extremely volatile and prices fluctuate. Institutional owners dominate the stock of such companies, and institutional portfolio restructuring significantly affects price and volatility.

The University of California, while holding less than 90 stocks, is critical of the elimination of 284 out of a market of several thousand securities. Almost all investment management organizations limit their attention to a tiny fraction of the universe of possible stocks. Approved lists of most banks and advisors contain between 50 and 250 names. Typically, fewer than ten names are under active consideration for addition to an approved list at any particular time.

Investment restrictions or limitations of various sorts are numerous and designed to eliminate unpromising investments or represent a sample of a large universe concentrating on a group of stocks in which an organization has more expertise. That is why some advisors eliminate small firms, while others eliminate large ones or eliminate companies with erratic dividend or earnings records, while others specialize in "turn arounds." The standard practice by prudent fiduciaries is to establish *a priori* restrictions on their choices that are much narrower than any South African exclusion.⁴¹

The elimination of several S&P 500 industry groups is also irrelevant. In what institutional portfolio is every industry sector in the S&P represented? The objective of diversification is to reduce risk. This does not require investments in all industry sectors. Should an advisor have every industry sector represented in the Wilshire 5000? Of course not. Based upon the market, interest rates and the economy, there are numerous industry sectors a prudent manager will want to avoid.

SAF portfolios are slightly riskier than SAI portfolios. On the other hand, this increased risk is exceptionally low. For example, in a study by Mark Rudd, it was found that the effect on portfolio risk of excluding companies operating in South Africa was, "contrary to intuition, not particularly important."⁴² Other financial studies indicate that divestment will slightly increase risk, but such risk is offset by increased performance.

Impact of Divestment on Transaction Costs

Wilshire Associates as well as the University of California Treasurer have estimated the transaction costs of divestment to be

in the millions of dollars and commissions to average from 1-6% of round-trip trades. This is a claim not substantiated by data or current experience. The University of California Treasurer made an undocumented estimate that the cost of divestment of the University of California's SAI stocks would amount to \$100 million. These figures ignore the reality of trading, normal portfolio turn-over, the present deregulated brokerage industry where commissions are highly competitive and negotiated (the larger the institution, the stronger the negotiating position), block/trades and Fourth Market transactions, or institution to institution trading. These high transaction cost estimates also ignore the projected increased returns of SAF stocks.

Thus far the University of California Treasurer has failed to provide a transaction by transaction comparison of the University's costs to substantiate this overall transaction cost estimate. The Treasurer's office itself has admitted that they may have "overestimated" transaction costs, and even Wilshire Associates indicated that the Treasurer's analysis "is sort of taking one number out of context and applying it to a specific situation."⁴³

Since this earlier estimate, the Treasurer's office has provided another estimate. This latter estimate is based on a figure of \$.10 per share to divest 46 million shares, \$.10 per share to acquire an additional 46 million shares and \$.25 per share to acquire the next additional 46 million shares for a total projected cost of \$20.7 million.⁴⁴ The Treasurer's office has also indicated that transaction costs were one of the least important aspects of divestiture and that a more important consideration would be the effects of divestment on the University's long-term investment returns. The Treasurer's Report to the Regents, however, discussed, but did not quantify the issue of returns.⁴⁵

According to a United States Trust Company study, transaction cost for a round-trip of divesting and reinvesting would be approximately .4% or 10 cents a share or less than .2% on an average stock price above \$50 dollars a share.⁴⁶ This author's highest round-trip transaction costs on small even lot trades on stocks under \$20 in primarily small capitalized firms has never exceeded 2%.

The University of California Faculty for Full Divestment released an Alternative Treasurer's Report in June 1985, indicating that divestment transaction cost over a five year period would total \$3.7 million annually after allowing for normal portfolio turnover, or approximately \$18.9 million.⁴⁷ This is \$81 million less than the Treasurer's earlier undocumented estimate.

In addition, the Chesapeake Financial Group, in a letter to the University Regents indicated they had secured a commitment of a syndicate member to execute transactions for the University at \$.06 per share.⁴⁸ Chesapeake also stated:

We have assumed that the University of California had \$3,000,000,000 invested in their common stock portfolio on January 1, 1980 and have assumed that the same dollar amount was being concurrently managed by our syndicate member that is ranked in the first percentile by SEI (formerly A.G. Becker). Our study shows that while the University of California retirement and endowment funds would have appreciated to a little in excess of \$5,000,000,000, the same funds under professional management would have appreciated to a little in excess of \$12,000,000,000. *Additionally, our results are net of all brokerage costs and management fees.*

The question of "liquidity cost" as presented by the Wilshire Report and others, in light of this evidence, becomes meaningless. If the Chesapeake Group is right, the University of California has already suffered a *severe* penalty by not exploiting this alternative and it may be prudent to assume that to continue to ignore superior investment alternatives would have similar results in the future.⁴⁹

Other Arguments Against Divestment

Wilshire Associates, as well as other opponents of divestiture, have also voiced the argument that there is not only a lack of reliable data on companies operating in South Africa, but that fund managers would be faced with increasing research costs associated with evaluating smaller capitalized firms. In fact, however, there are a number of organizations already in place that provide data and information on corporations operating in South Africa.⁵⁰

Research of a "social" nature is widely available, and very inexpensive. Much of this information can be obtained at little if any cost, or through "soft-dollar" arrangements with brokerage and investment firms. Financial information is also available on smaller capitalized firms, and any increase in cost will be the price a manager pays for the increased performance associated with smaller firms.

Another argument that has been advanced by Meidinger Asset Planning Services, is that money managers will refuse to accept fiduciary responsibility for the performance of pension funds under a South African exclusion scenario.⁵¹ This argument is rebutted by current experience and the "free market economy." In the last five years, the investment community has come forward with an increasing number of investment vehicles and professional products and services providing institutional and individual investors with non-South African investment opportunities. Three mutual funds in the last three years and literally dozens of asset managers are available to manage assets utilizing a non-South African criteria.⁵² In addition, the Social Investment Forum has

identified over \$40 billion in assets that are presently socially screened portfolios under professional management.⁵³

Portfolio divestment as a strategy to influence corporate management and meet the investment objectives of fiduciaries and beneficiaries provides a high degree of flexibility in implementation. While the UC Treasurer outlined six options for UC Regents,⁵⁴ the various options in a scheduled and flexible divestment strategy were not developed. Also ignored as an option, but documented, was a scheduled or phased divestment, currently being implemented by the City of New York.⁵⁵

An obvious divestment strategy is to prohibit all new investments in all categories: cash, fixed-income and equity. This could be supplemented by an activist shareholder strategy. Within the context of divestment, distinctions could be recognized in the levels of corporate economic and financial support of the apartheid regime and divestment could be phased over a specific period of time, increasing economic pressure with each step.

Criteria for exclusion or inclusion in portfolio selection could include the strategic nature of the company (i.e. technology, nuclear power, defense, etc.), the actual number of employees in South Africa, company contracts with government agencies, loans to the government, tax and other revenue paid to the government, importance to the apartheid structure (e.g., computers and photos for the pass system), etc. Each level of "screen" would change the absolute number and kind of company included or excluded from investment consideration.⁵⁶

Conclusion

South Africa presents a great and growing risk for corporate management and for institutional investors owning securities in corporations and financial institutions operating in South Africa. In fact, many in the legal profession have stated that beneficiaries may have recourse in the courts, if trustees acting as fiduciaries for retirement funds ignore the high risk in South Africa and incur losses in corporate earnings due to investment or trade loss in South Africa as the result of military action, revolution or expropriation.⁵⁷ For example, several U.S. firms have already incurred losses in South Africa because of the political instability of apartheid and the high degree of financial risk in the country. BBDO, a large ad agency, recently wrote off \$3.2 million or \$.50 a share after transferring ownership of its subsidiary to South African local management. The company also reported a loss of \$.10 a share in South Africa during the final quarter of 1984.⁵⁸

Investors have a legal as well as a moral obligation to recognize apartheid as an economic threat. The economic, financial, social and political impacts of investing in our international economy cannot be separated today. Apartheid not only threatens the economic stability of South Africa, but could embroil the whole of

southern Africa in a racial war that could disrupt the supply of strategic minerals to many of America's most prominent multinational corporations.

The Sullivan Code of Conduct has a very limited, and in the long-term, a harmful impact on the progress of the struggle against apartheid. Disengagement will cut the lifeblood to the apartheid regime by denying capital and technology to the white minority. The Sullivan Code simply makes the chains more comfortable for less than 1% of the African population employed by U.S. firms there. It is one of the major obstacles to the dismantling of apartheid.

While shareholder voting and the initiation of resolutions raise the issue to public debate, this may not be effective in reducing corporate capital and technology to South Africa. Divestment and the refusal to purchase securities and goods and services from corporations and financial organizations operating in South Africa will deny corporate management the "bottom line" resource necessary to exist in a market economy: capital. This is the "bottom line morality" for corporate management.

Literally dozens of professional money managers, brokers, investment advisors and others managing individual and institutional assets control over \$40 billion in screened investments, of which \$12 billion has been divested from companies in South Africa. This total is growing, and with it, the understanding of socially responsible investing.

Disengagement and divestment will not only increase portfolio performance as has been shown, but reduce the risk associated with corporate involvement in South Africa. Investing in large companies operating abroad involves foreign currency fluctuations which affect corporate earnings, but also, each country in which a company operates realizes specific economic risk relevant to the local economy and the overall financial health of the company. If domestic violence and destruction of property continues in South Africa, there is direct corporate investment risk, as well as the probability that a major portion of corporate revenues and strategic mineral imports will be affected. This will undoubtedly affect earnings.

Divestment can also increase portfolio diversification by challenging fund managers to reduce their dependency on a few large capitalized growth companies and increase exposure in smaller companies which are more innovative, create employment in this country and increase portfolio performance.

It is ironic that U.S. firms in which large institutions invest are the main culprits in exporting jobs to South Africa. Chicago steelworkers discovered that steel beams being used to construct a new state building in their city were imported from South Africa. At the same time, U.S. Steel's Southworks plant in Chicago--which makes the same kind of steel beams--laid off steelworkers by the

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thousands. Meanwhile, Continental Illinois was loaning money to South Africa's ISCOR, that made the beams for the new state building. Steelworkers with their savings in Continental Illinois began questioning why they were putting their hard-earned money in a bank that was helping South Africa eliminate their jobs.⁵⁹

Investment opportunities exist for innovative fund managers that will provide competitive rates of return and similar portfolio risks in the areas of residential, commercial and industrial real estate. According to an input-output model study, for each dollar spent on construction, a total of \$1.44 in income will accrue to Californians.⁶⁰ For \$100 million of new investments California in residential real estate, 6740 new jobs would be created, \$144 million in income, \$2,350,000 in local tax revenue and \$16,650,00 in state tax revenue would be generated.⁶¹

Hundreds of new and alternative investment vehicles to SAI securities exist, which have a positive impact on our society. Such investments are available to innovative fund managers that are not afraid of hard work and the challenge of responsible investing. It is this group of professionals who understand the interdependence between portfolio management, our local economies and South Africa.

The black majority in South Africa will inevitably take control of that government. As investors, we can continue to support the white-minority and risk substantial losses, or we can become a truly progressive force in South Africa, deny capital and technology to the Afrikaner government, and force them to peacefully transfer power to the majority. In the end, it is a moral and political decision. There is no financial, economic or legal justification for investing in apartheid.⁶²

NOTES

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Are most money managers politically conservative and do they support continued U.S. corporate presence in South Africa? Money management is not a "pure science" and investment decision making is very subjective. The market is dominated by "fear" and "greed". To what extent are normal human emotions at work?
Is divestiture more work and will money managers get paid for being innovative? Although most managers are paid well for their services, it is likely that unless they are required to take action or

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paid more by trustees to be innovative, they will continue to be relatively passive.

Will most money managers challenge politically conservative trustees, administrators or treasurers with clear financial conflicts of interest if they are hired and paid by them to manage the assets of a trust or pension fund? I doubt if many money managers would find it in their best interests to be "innovative."

If the majority of a private money manager's business comes from large corporate clients, would they work to exclude such corporations from another institution's investment portfolio? The answer to this question is that many do manage exclusionary portfolios, but do it "under the table", with no publicity, so that their corporate clients will not find out. After all, how would you feel if your manager excluded your company from investment consideration in another institutional portfolio?

If a conservative and intelligent money manager understood the tremendous economic impact that divestiture could have on traditional capital markets, would he or she work to implement South African divestment? Money managers, the brokerage and investment banking industry are extremely political and self-interest oriented. Money dominates our society and asset managers are traditionally not "a force for social change." Unless there is a financial self-interest to do so, the majority will continue to oppose divestiture.