STUDIES OF SMALL BUSINESS FINANCE

Small Business Access to Capital Markets Through Pension Funds

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THE INTERAGENCY TASK FORCE ON SMALL BUSINESS FINANCE

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Bureau of the Census
Small Business Administration
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Paper completed June 1980.

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This study was prepared for the Interagency Task Force. Funding was provided by the Small Business Administration. The views expressed are those of the author and not necessarily those of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Bureau of the Census or the Small Business Administration.
While the 1974 passage of the Employee Retirement Income Security Act (ERISA) has generated considerable controversy among all parties concerned with the private pension system, smaller business entities have been especially impacted by the act and have strongly expressed their displeasure with various restrictive aspects of the legislation. Although the manner in which private retirement plans are operated under the law is of vital interest to most employees, employers and the capital markets, this study focuses more narrowly on the impact of ERISA and more recent proposed regulations on small business, and specifically on legislation's effect(s) on small business access to capital markets.

BACKGROUND

Looking back at the period immediately following the signing of ERISA, it is evident that the prudent man rule incorporated within the act produced unique difficulties for smaller firms. Inasmuch as the public new issue equity market had virtually dried up between 1969 and 1974, it became especially important to small business that their accessibility to institutional capital, e.g. private pension funds, not be impaired by new rulings on permissible investments for those funds. Indeed, ERISA's definition of prudence did alter the perception of many pension trust managers according to 1976 and 1977 surveys conducted by the International Foundation of Employee Benefit Plans. They concluded that private pension portfolio managers had grown very cautious about any investment alternatives other than blue chip securities since ERISA's passage. Small business, deprived of pension capital, was seen to be seriously disadvantaged by the legislation.

On January 18, 1977, Senator Lloyd Bentsen introduced proposed
legislation (S.285) which would place investment limitations on large pension managers to preclude pension funds being tied up in a very limited number of corporate stocks. The intent was to mitigate the effect of ERISA's prudent man rule and benefit small and medium-sized businesses by freeing up more pension monies for investment in their ventures; however, the bill died in committee.

In an effort to explore further the relative importance of small business holdings in private retirement plan portfolios, a detailed examination was conducted of two of the largest pension plans in U.S. industry, i.e., General Motors' Retirement Program for Salaried Employees and the GM Plan for Hourly Rate Employees. The latest reporting date submitted to the Labor Department was found to be September 30, 1977. As of that date, GM's salaried plan held equities valued at $1.011 billion (market) with 98.67% of those holdings attributable to firms having sales greater than $300 million. In the corporate bond portfolio, 94.52% of the $541.9 million holdings (at book) represented debt of firms with sales exceeding $300 million. Review of GM's even larger $3.9 billion Hourly Rate Employees' Plan reveals portfolio composition very similar to that of the Retirement Program for Salaried Employees. See Appendix A for a more detailed summary of these holdings.

The investment community interpretation of the Act's prudence requirements may have been excessively rigid and not properly reflective of congressional intent, but the evidence seems to bear out the very real avoidance of smaller firm securities by pension managers after 1974. The fact that the Act held individuals under the law responsible for imprudent investments apparently inclined fund managers'
interpretations of prudence toward greater risk aversion. With the virtual non-existence of a new equity issue market during that period, small business supporters voiced major objection to these interpretations of the law as applied by the financial institutions responsible for pension portfolio decisions. Consequently, Labor Department officials were pressed to clarify the appropriateness of certain types of investments for retirement funds under ERISA. In June of 1979, the Department of Labor (DOL) issued a ruling which expressed official cognizance of the trend toward risk-reward analysis as articulated in capital market theory. DOL's amended regulation suggested that:

"...The prudence of an investment decision should not be judged without regard to the role that the proposed investment or investment course of action plays within the overall plan portfolio."5

It further tempered the original impact of the Act with the following:

"Investments permissible under the 'prudence' rule (are) not necessarily limited to those permitted at common law."6

In attempts to provide additional clarification of the new ground rules, Ian Lanoff, DOL Pension Administrator, has asserted:

"If pension fiduciaries follow the interpretation that we provided in our regulation, then the Labor Department will assume that they complied with the law. On the other hand, if investors do not follow the interpretation to the letter, it does not necessarily mean that they violated the law. The DOL recognizes that there are other ways to invest pension assets...that are sophisticated and perhaps quite successful."

In essence, the prudence regulations say that "under a given set of circumstances, any kind of investment" -- including art, precious metals, venture capital or index funds -- "May be appropriate for a particular pension fund."7
Finally, Lanoff contends that "money managers are responsible only for that portion of the portfolio for which they have been assigned investment authority."

One would expect that this regulatory vote of confidence for modern portfolio theory and the explicit investment latitude to operationalize it, would provide to small business the needed window on the capital market through pension funds. The evidence is, however, mixed as to whether this access has, in fact, been successfully achieved.

**Emergence of Social Investing**

Clouding the issue has been the concurrent development of another cause, closely related to the question of availability and appropriateness of pension monies flowing to small business. The movement is "socially responsible investment" of pension funds, or, as it is often termed, the application of "non-economic criteria" to pension portfolio decisions. The campaign initially received widespread attention with the appearance of The Peoples' Business Commission publication entitled, *The North Will Rise Again: Pensions, Politics and Power in the 1980s.* It is a thesis which argues that pension monies, as deferred wages, properly belong to the workers and the retirees, and as such should be invested in vehicles which benefit their interests. This contention, strongly articulated by consumer advocacy groups such as The Pension Rights Center, suggests that nontraditional investment objectives should be pursued in the interests of social responsibility. It further suggests that it is feasible to apply non-economic criteria to pension portfolio selections without risk/return sacrifice.

The confluence of small business financing requirements and the perceived need to direct beneficiaries' trust funds toward socially
desirable investments becomes obvious when one considers how many socially responsible investments would logically coincide with funding of smaller enterprises. For example, minority-owned banks, local residential mortgage pooling, minority-owned firms, for-profit hospitals and regional/urban development projects all are potential qualifiers for financing assistance on grounds of either small business support or social investing. Indeed, financing of small, local business has been put forth specifically as one of the defensible, socially responsible investments to which some portion of total pension assets should be directed. Illustrative of the facility with which small business investments are considered similar to (or part of) social investments is a statement drawn from a recent working paper addressing the use of pension fund capital:

The fear of capital shortages, decline in underwriting small businesses, decay of regional areas and the need for urban revitalization cause some to turn to pension fund capital as a possible solution.

The dialogue on directing pension funds into social alternatives has been extensive and the growing stature of the concept is reflected in the fact that the recently organized Presidential Commission on Pension Policy has devoted an entire two day hearing to "Ownership and Control of Pension Assets" (December 10 and 11, 1979). Much of the testimony dealt with targeting of retirement funds toward activities which would directly benefit the workers and retirees of a firm or governmental agency. In many cases, suggested investments included smaller enterprises, often located in the immediate area from which most employees commute. Comments on the thesis were solicited from organized labor, industry trade associations, pension managers, academicians and
consumer advocacy groups. Testimony ranged from strong objection to non-economic criteria to vigorous support. Representative of the former is the following statement by Charles A. Moran of The American Bankers Association:

In our view, the conceptual weakness in the argument for non-traditional criteria is that they invariably involve some financial risk to be measured against some potential non-financial gain. Very often, those whose interests are exposed to the risk have no commensurate interest in the potential benefit to be derived.10

Taking the opposing position in defense of departures from purely financial/economic criteria in portfolio selection, a number of witnesses supported some form of social investing from either a legal or theoretical viewpoint. A discussion of social/small business investments and the theoretical implications of non-traditional (divergent) investment criteria is found in a later section of this paper labelled "Theoretical Aspects."

The Role of Venture Capital

Still another recent phenomenon, impacting on small business access to capital markets in the post-ERISA era, is the resurgence of venture capital pools. These institutions, organized to direct investor capital into new, small, relatively high risk ventures, operate largely on the basis of substantial equity participation in return for their underwriting. Popular and often highly successful in the late 1960s, the venture firms fell into decline from 1973-1977 due to rapidly rising interest rates and shortage of capital. More recently, however, due to reductions in capital gains tax rates and the June, 1979 Labor Department ruling on permissible investment vehicles for ERISA funds,
the venture pools have experienced considerable new growth. Pension plan managers have shown increasing interest in the venture firms and on diversification grounds, had begun to place some small percentage of their plan contribution inflows into the ventures. In many cases, the funds' investments into venture capital were not direct and readily visible, but were rather accomplished through an intermediary bank or insurance company-pooled fund. The gradual growth of retirement plan involvement with venture pools provided demonstrable evidence that small business was in fact receiving some nominal injections of pension dollars... and more importantly, the trend was growing...a very positive sign for small, capital deficient establishments.

Then, in the wake of the DOL liberalized interpretation of prudence, described earlier, the Department proposed a new regulation relating to the definition of (pension) plan assets. At issue, with respect to venture capital pools, was the fact that the pooled vehicles are not registered investment companies (and therefore not subject to the Investment Company Act of 1940). Pension fund holdings of investment companies are considered plan assets only to the extent of the investment company shares held. DOL's ruling on venture pool vehicles, however, was that the venture firm's total assets would be considered as retirement plan assets if the plan invested at all in the pool, i.e., "looking through" to the assets of the firm whose shares are held. Thus, all of the venture firm's assets would be subject to ERISA prudence requirements. Furthermore, if the venture firm registered as an investment company, to regain eligibility for inclusion in pension fund portfolios, its investment advisers would no longer be permitted to levy fees based on profits of the venture pool. This proposed
II regulation re-enstated many pension managers' reluctance to acquire any interest at all in venture capital firms. Among the firms whose pension plans were reported to have reversed themselves on venture capital investments were Boeing, GT&E, Hughes Aircraft, Allied Chemical, B.F. Goodrich and General Electric. In the case of the Boeing decision, the amount withdrawn exceeded $20 million.

Recent Developments

In Labor Department hearings on the proposed DOL regulation regarding the definition of plan assets (February 27-28, 1980), several witnesses expressed strong objection to the "look-through" rule on pension holdings of venture capital securities. The general tenor of the comments was critical of the Labor Department and the controversial rule was declared as "unnecessary, inconsistent with congressional intent and would preclude pension plan investment in venture capital firms." Testifying in opposition to the proposed regulation were the National Venture Capital Association, The National Association of Small Business Investment Companies, The Association of Private Pension and Welfare Plans, The Council on Wage and Price Stability and The Small Business Administration Office of Advocacy. The Labor Department position, on the other hand, as stated by Administrator Ian Lanoff, has been that the proposed regulation would not render venture capital "illegal" for retirement funds. Rather it has been described as merely a measure which places fiduciary responsibility; the Department's view held that venture capital is simply another form of pooled investment capital. Furthermore, DOL did not agree that venture firms were "widely held" while investment companies under the 1940 Act were so viewed. This additional distinction between the two types of
institutions would render one immune to the "look-through" while the other would be held to it.

As a result of the numerous comments (over 200) submitted in opposition to the proposed DOL regulation, on June 6, 1980, the Department proposed for comment a revised version of the "Definition of Plan Assets." Only one subsection of the proposed regulation has been changed but this modification holds considerable promise for the reinstitution of pension flows to small business. Briefly, the proposed revision would permit pension investments in equity securities of venture capital companies under certain conditions. These are stipulated as follows:

1. The venture capital firm (issuer) must have at its inception commitments of at least $5 million from at least 10 investors unaffiliated with the plan, each other or the issuer.

2. The issuer must agree to provide to the plan annual financial statements and other information upon request.

3. Venture capital firm managers may not acquire or hold any securities of any company in which the issuer has invested; neither may they borrow nor obtain credit from the issuer, sell/lease property to the issuer nor lease property from the issuer.

4. Issuer must allow any security holder to sell the security to a third party and upon request, repurchase the security at a fair and reasonable price or use its best efforts to secure a suitable purchaser.

Effectively, the revised DOL proposal would consider venture capital firms as operating companies by virtue of the fact that their investment of capital is in enterprises in which the venture firm has obtained the right to substantially participate in/influence the conduct of that enterprise and its management.
Small Business Tie-In to Social Investment and Venture Capital

It seems clear that small business access to pension monies will be closely tied to both of the factors described above, i.e., the success of the social investing cause and the ultimate ruling on the legitimacy of venture pools as inclusions in retirement plan portfolios. To the extent that "socially responsible investments" have been defined to include underwriting of smaller (often local) establishments, the outcome of the current debate could be of considerable importance to firms outside the S&P 500. By the same token, a final ruling which reaffirms the permissability of venture pools in pension portfolios while preserving the venture capitalists' method of compensation would substantially strengthen the small business gateway to capital markets.

THEORETICAL ASPECTS

Clearly the questions of pension plan investment of funds into small, non-publicly traded stock, venture capital pools and investment alternatives based upon socially responsible (non-economic) criteria lead to questions of portfolio risk. There is a contention that permitting retirement plans to invest in small business or socially responsible investments would increase the portfolio risk borne by the funds on the grounds that the individual security risk is high and therefore must raise the risk of the portfolio package. Modern portfolio theory, however, does not support this view. When adding to a portfolio a security whose standard deviation of returns, \( \sigma \), (the measure of security risk) exceeds the portfolio \( \sigma \), the effect on overall portfolio risk depends partially upon the degree of correlation between the respective securities' returns. If the returns of the new portfolio entry are highly negatively correlated with the returns on
other securities, portfolio risk can, in fact, be reduced. By the same
token, to the extent that low risk, low return securities are strongly
positively correlated, little to no risk reduction is achieved by
expanding the number of such securities held.

Concentration on the risk element to the exclusion of any measure
of expected returns is, of course, also inconsistent with accepted
portfolio theory. The inclusion of high risk/high expected return
alternatives in the permissible array of investments is absolutely
necessary to enable construction of the feasible set of portfolios
comprising the efficient frontier. Restricting pension funds from
investing in certain alternatives (such as venture capital firms)
reduces the number of feasible portfolios which make up the investor's
efficient set. Such a prohibition excludes from the array of attainable
portfolios certain combinations of securities producing higher expected
portfolio returns for a given risk level than would be attainable from
the restricted subset of alternatives. For example, prohibiting
high $\sigma$, high expected return ($\mu$) securities can eliminate portfolio
combinations such as $X$, $Y$ and $Z$ and thus lower the efficient frontier
for that investor to $E'F'$ in Figure 1.
In this case, EF defines the market and contains points (portfolios) which dominate the "permissible set" faced by the constrained investor.

Conversely, permitting available investment alternatives raises the efficient frontier to that attainable by all other investors, since EF is, in fact, the set which comprises the market. The mere inclusion of X or Y, however, says nothing about the decisions which will be made by the pension fund or the institutional investor managing its funds. A risk averse manager is unconstrained in his selection of alternatives along the capital market line and is free to define his risk target at a low risk level such as $\sigma_i$ regardless of the high risk, high return portfolios available to him. Elimination of certain investment prohibitions, however, provides the fund with a higher expected return at any level of risk along a more steeply-sloped capital market line, CB.

The existence of proscribed investments for substantial institutional investors such as pension funds illustrates the costs associated with market imperfections. So long as pension funds are restricted, their concentration on the permissible subset of securities tends to drive up the prices of stocks within that subset relative to the market values of the excluded group, i.e., small business, venture pools, etc. This artificial expansion of demand lowers the yield of these (low risk) securities and increases the probability of achieving a negative real rate of return in an inflationary period. In a perfect market, this would cause both the restricted and the unconstrained investor to reassess his alternatives. In an equilibrium sense, ultimately, there would result a flow of investment funds out of the restricted environment and into the unrestricted market, i.e., into
institutions enabled to select from the full efficient set. The natural consequence of this scenario would be the growth of unconstrained institutions at the expense of the institutions so limited. This perhaps suggests a market inspired rationale for the increase in the rate at which already terminated defined benefit plans are being replaced by less restricted deferred profit sharing plans.

It is clear that on the grounds of capital market theory, there should be no legislated prohibitions of selected assets for pension portfolios. It follows from this reasoning that neither should there be any legislated inclusions of selected assets. If an asset proves unacceptable for a retirement plan portfolio based upon risk and return considerations, this will be revealed in the analysis which should accompany construction of the portfolio and its appropriate position along the efficient frontier (or within the feasible set). DOL announcements have supported the thesis that an asset's contribution to portfolio risk and return is the relevant measure and not the asset's \( \sigma \) and expected return measured in isolation. This endorsement of theory provides the resolution to the question of admissability of certain risky assets.

**CAPITAL SHORTAGE AND MARKET IMPERFECTIONS**

The situation with regard to pension fund reluctance to invest in smaller firms leads to the related question of capital shortage in small business. The principal source of debt financing for non-publicly traded companies continues to be short and intermediate term commercial bank loans. In fact, small firms typically have more than one third of their capital in debt of this type. Small business is said to face
enormous difficulties in acquiring long term debt (bonds) and external equity financing, a problem often attributed to capital market imperfections. This situation is illustrated in Table 1, which exhibits sources of funds for manufacturing corporations, by size, during the periods 1958-71 and 1972-76. For the smallest firms, between the earlier and the later period displayed, significant changes in external equity and long term bond sources are clearly shown.

The phenomena of transactions and information costs, serving as impediments to market efficiency, have been the subject of considerable research. Evidence of local banking market concentration and public regulation of financial intermediaries has been cited to demonstrate the hurdles faced by small business, leading to the high incidence of under-financing. That small manufacturing firms, although profitable, often opt to merge with larger corporations is often put forth as the logical result of unjustified capital availability difficulties. That these mergers do occur does not however necessarily argue that simply because small firms desire additional capital, it should be allocated to them. The market does a reasonable, if not perfectly efficient, job of allocating. As evidence of this, we observe the degree of capital shortage among small businesses varying from one area to the next and clearly varying between states. If capital deficiencies are rife, it may be largely because of substantial differences between states with respect to taxation and regulation of business. If so, part of the solution lies in overcoming non-competitive corporate and personal taxation policies.

To the extent that capital deficiencies are, in fact, attributable
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to high information costs, facilitating the flow of pension funds into smaller business may best be accomplished by investing through highly specialized institutions which are geared to this particular kind of intermediation. Venture capital pools such as Brentwood Associates of Los Angeles currently perform this function. In a similar manner, Dreyfus Third Century Fund, as described below, is preparing to increase its distribution of pension fund dollars to firms exhibiting socially responsible business conduct.

EVIDENCE OF TRENDS

As indicated in note #16 above, from 1972 to 1976, manufacturing firms with assets less than $1 million achieved an average return on equity of 16% while firms with assets exceeding $1 billion produced an ROE of 13%. If these figures can be taken as valid, they raise the question whether pension funds/investment managers are now inclined more than formerly to consider the small business risk premium as sufficient. A recent Greenwich Research Associates survey casts some light on this perception by institutional investors.

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<th>Year</th>
<th>Agree Strongly</th>
<th>Agree Somewhat</th>
<th>Disagree Somewhat</th>
<th>Disagree Strongly</th>
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<tr>
<td>1976</td>
<td>21%</td>
<td>40%</td>
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<tr>
<td>1977</td>
<td>15%</td>
<td>37%</td>
<td>32%</td>
<td>12%</td>
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<td>1978</td>
<td>12%</td>
<td>32%</td>
<td>29%</td>
<td>19%</td>
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<tr>
<td>1979</td>
<td>4%</td>
<td>22%</td>
<td>37%</td>
<td>20%</td>
<td>18%</td>
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This interesting result suggests that inclinations to invest in small business are strengthening. The doubling of the percentage responding "No Answer/Uncertain" is likely attributable to the increased doubt over permissability of such investments, investor willingness notwithstanding.

The following pair of mirror image questions explores institutional investor views of the risk/return issue from the portfolio and individual holding perspectives.

<table>
<thead>
<tr>
<th>Prudence in investing</th>
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<th>Disagree Somewhat</th>
<th>Disagree Strongly</th>
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<td>11%</td>
<td>7%</td>
<td>3%</td>
</tr>
<tr>
<td>1979 Research</td>
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<td>20%</td>
<td>4%</td>
<td>4%</td>
<td>7%</td>
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</tbody>
</table>

Prudence in investing should be determined by looking at the portfolio as a whole, not at individual holdings.

<table>
<thead>
<tr>
<th>Prudence in investing</th>
<th>Agree Strongly</th>
<th>Agree Somewhat</th>
<th>Disagree Somewhat</th>
<th>Disagree Strongly</th>
<th>No Answer/Uncertain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1978 Research</td>
<td>9%</td>
<td>8%</td>
<td>31%</td>
<td>48%</td>
<td>4%</td>
</tr>
<tr>
<td>1979 Research</td>
<td>10%</td>
<td>9%</td>
<td>37%</td>
<td>32%</td>
<td>11%</td>
</tr>
</tbody>
</table>

While modern portfolio theory seems to have made progress in the first question above, it appears to have lost some ground in the revised wording of the second statement.
The last two questions of relevance seek to identify the relative importance of certain investment policies and how they have changed between 1975 and 1979.

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>How Policies Specified by Executives</td>
<td>Minimum</td>
<td>7%</td>
<td>7%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Have Been Changing</td>
<td>size of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>companies in</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>which</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>to invest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How Policies in Which Managers</td>
<td>Minimum</td>
<td>69%</td>
<td>68%</td>
<td>70%</td>
<td>63%</td>
</tr>
<tr>
<td>Have Full Discretion Changing</td>
<td>size of</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>companies in</td>
<td></td>
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<tr>
<td></td>
<td>which</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>to invest</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Revealed by this pair of questions is the substantially greater importance placed on minimum company size by investment managers having full discretion and the uniform (although slight) turnaround in trend between 1978 and 1979. Again, the latter likely reflects the varied interpretations of legislative guidance with respect to permissability of small business investments.

From the survey highlighted above, one derives the notion of increased willingness to include small business securities in pension portfolios but an associated sense of growing caution.

An assessment of trends in the venture capital avenue of investment reveals a thrust which was clearly upward, at least until the recent pullback outlined earlier. In the first ten months of 1979, fifteen private venture partnerships and firms received commitments for $170 million, more than thirty percent of which was derived from private
pension funds. The 1979 inflow of pension dollars was notable in that it substantially outstripped the negligible annual retirement fund flows directed to the ventures during the years 1974-77. By 1979, the venture capital industry had grown to more than two hundred firms with $3.5 billion committed and available. A comparison with the pre-ERISA period, however, discloses that pension funds provided as much as thirty-three percent of venture capital's pooled funds prior to 1970. After a post-ERISA decline, the pension fund role in venture investments at first grew slowly and not until 1979 had the flow of pension monies returned to the thirty percent level.

In the same vein, Small Business Investment Corporations (SBICs) garnered $54 million in private capital in 1978, while in the first three quarters of 1979, $41.9 million more in private capital permitted the formation of thirty-three new SBICs. With SBA borrowings, investable funds in both 1978 and 1979 exceeded $200 million and contrasted sharply with the $123 million invested in 1975. This is encouraging by recent standards, but it is worth noting that in 1969, the total SBIC investment was $1.4 billion, substantially more than at any time since then.

It is evident that the resurgence of venture capital and the SBICs has been relatively slow since the end of the equity boom and the passage of ERISA. Nevertheless, the recent re-entry of large pension plan sponsors such as Atlantic Richfield, Stauffer Chemical and General Mills has signalled a potential growing source of capital for small business. Table 2 outlines the total amounts supplied to venture partnerships and firms by various sources during the five year pre-ERISA period and the later 1978-79 experience. The declining importance of
<table>
<thead>
<tr>
<th>Year</th>
<th>Pension Funds $(Mill.)</th>
<th>Individuals &amp; Families $(Mill.)</th>
<th>Major Corporations $(Mill.)</th>
<th>Foreign $(Mill.)</th>
<th>Endowments $(Mill.)</th>
<th>Insurance Companies $(Mill.)</th>
<th>Total $(Mill.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>69-74</td>
<td>63</td>
<td>24</td>
<td>58</td>
<td>22</td>
<td>13</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>1977</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>32</td>
<td>15</td>
<td>69</td>
<td>32</td>
<td>22</td>
<td>10</td>
<td>37.5</td>
</tr>
<tr>
<td>1979</td>
<td>53</td>
<td>31</td>
<td>39</td>
<td>23</td>
<td>27</td>
<td>16</td>
<td>26</td>
</tr>
</tbody>
</table>


* Percentages may not add exactly to 100% due to rounding.
** May not exactly equal sum of commitments from various sources due to rounding.
*** First nine months.

**TABLE 2**

**TOTAL SUPPLIED TO PRIVATE VENTURE PARTNERSHIPS AND FIRMS**

**DETAIl OF PENSION FUND COMMITMENTS**

<table>
<thead>
<tr>
<th>Year</th>
<th>$(Mill.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1969</td>
<td>30.0</td>
</tr>
<tr>
<td>1970</td>
<td>15.5</td>
</tr>
<tr>
<td>1971</td>
<td>7.8</td>
</tr>
<tr>
<td>1972</td>
<td>10.0</td>
</tr>
<tr>
<td>1973</td>
<td>-</td>
</tr>
<tr>
<td>1974</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>63.3</td>
</tr>
</tbody>
</table>
insurance companies contrasts with the increasing prominence of private pension plans and foreign suppliers of venture capital funds.

Numerous examples can be cited of investments of retirement funds directly into the ventures and directly into small firms. The former is illustrated by the 1978 floating of a new venture pool by Brentwood Associates of Los Angeles with fifty percent underwritten by pension plans. The latter is exemplified by Textron whose pension fund has made loans, both senior and subordinated, directly into developing companies. Textron has also made several direct private placements to small business.

A slightly different approach being taken by some pension managers is an indirect routing of funds to venture pools through pooled funds of major banks and insurance companies. This practice is, of course, considerably more difficult to track and it is conceivable that substantially more pension money has been directed toward small business via this mode than is generally known. Illustrative of the indirect line to venture pools is the Brentwood Associates' recent partnership offering:

A major investor was the common equity fund of Girard Bank of Philadelphia in which several pension funds are invested.25

Additionally, Citibank has directed a portion of its special equity fund to venture firms.26 Bank of America and Chase were selected by several pension funds to commit to venture capital pools.27 First National Bank of Chicago provides a portion of the funds contributed by participating institutional trusts to venture capital firms and makes some direct investments into small firms. They accomplish diversification among these specialized vehicles by dividing the pool according to several
categories, e.g., leveraged buy-outs, start-ups, industrial classifications and geographical breakdowns. The above is indicative of the rapidly growing list of banks engaged in this indirect routing of pension funds to venture capital organizations.

**Regional Pools**

Still another positive sign for smaller enterprises is the appearance of regional equity pools in which bank trust departments apply nominal portions of corporate pension trust assets to equity investments in a bank's local area. Examples include First National Bank of Minneapolis with $2 million in regional pools out of $1.5 billion in corporate trust assets under management. Another is Investment Advisors, a Minneapolis mutual fund which places 80 percent of its assets into firms located in a seven state area with up to 10 percent to be directed into venture capital pools. Expectations are for $10-15 million under management by April, 1981.

**Social Investing**

As outlined earlier, social investing is now being actively debated in Congressional hearings, before the President's Commission on Pension Policy and within labor organizations. Despite its tenuous and controversial status, there is already spotty but growing evidence of its implementation. Discussion earlier in this paper recognized the likely positive spillover to small business if this concept should be widely applied. There follows a brief listing of the most notable cases in which this phenomenon is, in some fashion, becoming a reality.

-- Teachers Insurance and Annuity Association (TIAA), with assets of over $7 billion at the end of 1978, has engaged in a program
to direct investments toward socially responsible alternatives. These include minority owned banks and broadcast stations as well as loans to urban renewal projects.  

-- The Dreyfus Third Century Fund, a $23 million open end diversified investment company as of November, 1978, "was created by The Dreyfus Corporation in the early 1970s to provide a vehicle for investors who are concerned that the companies in which they are investing meet not only the traditional investment standards, but also show evidence in the conduct of their business of contributing to the quality of life in America." Jeffrey J. Friedman, Vice President of the Fund, has testified before a congressional subcommittee that:

"...Our hopes that a fund with these social objectives could provide good performance for our investors have been realized."  

At the time of his testimony, Mr. Friedman indicated that (they) "...do not really manage very much pension money. The fund has, I believe, 85 small pension and profit sharing plans, mostly from smaller companies and only $1.5 million (out of $23 million) in that kind of money."  

-- There are, of course, the recent, widely publicized concessions made by the Chrysler Corporation in which the company gained United Auto Worker (UAW) agreement to a one-year deferment of a scheduled $200 million funding payment to the Chrysler retirement plan. The union's price was corporate willingness to permit a joint management/labor advisory board to invest 10 percent of each year's net increment in pension money into "socially desirable areas." The funds will be directed into low to middle income housing,
nursing homes and child care centers. Control Data soon followed with a similar pact. In 1980, The United Steelworkers, representing labor in aluminum, cans, copper and steel industries are expected to bid for agreements resembling the Chrysler contract.

-- The New York State Common Retirement Fund has assets of $11.6 billion. The trustee of the fund testified in late 1979 that he is investigating "newly introduced small business federally guaranteed certificates that would be comprised of New York state pooled small business loans." 35

-- Additionally, the AFL/CIO Convention in November, 1979 approved a resolution calling for "a concerted effort to greatly increase investment of union negotiated pension funds in both union construction projects and nonconstruction industries to provide work for union members." 36

**Profit Sharing Trusts**

Finally, as still another source of funds available to small business, profit sharing trusts deserve mention. The Profit Sharing Council of America's 1979 Annual Survey (reflecting 1978 experience) indicates that in that year, 35% of aggregate plan assets were invested in the stock of the plan sponsor corporation. This capability permitting the trust fund to supply equity capital to the sponsoring corporation is unique to profit sharing trusts and, except to a very limited extent, does not apply to defined benefit pension plans. It does represent a significant source of long term capital for firms with plans of this nature. It must be added, however, that this percentage (35%) is almost entirely attributable to firms with plan assets in
excess of $10 million. For firms with plans valued at less than this amount, the highest percentage of assets invested in the company stock fund was 5.5%.  

CONCLUSIONS

This paper has attempted to uncover some insights into small business access to capital markets. Major emphasis has been on trends in private pension fund investment flows to small business before and after the passage of ERISA. The paper also contains a brief exploration of retirement fund investment(s) into securities of firms whose products and corporate behavior have been consistent with socially responsible conduct. Emerging applications of this new (non-economic) investment criterion have been documented and related to small business accessibility to capital markets. The paper does illustrate the recent growth in pension (and other) flows to smaller firms, largely through the venture capital intermediary. It also points out the sudden stoppage of those investments due to a DOL proposed regulation on definition of (pension) plan assets. A revised DOL proposal has been published which tempers the impact of the original issuance; at this time, comments are being solicited by the Department.

The research effort displayed herein, however, is deficient in many respects. It falls short by failing to probe into meaningful relationships between small business investments by retirement funds and measures of small business success/growth. It does not provide a model which specifies the relationship between capital structure of smaller firms and profitability/growth measures. This important examination could be accomplished given sufficient data on the relevant variables.
Unfortunately, the data required to strengthen this anecdotal product are not available. In a March 14, 1980 response to a request for access to the DOL private pension fund data base, Ian Lanoff, the Labor Department's Pension & Welfare Benefits Administrator, replied with the following:

For disclosure purposes, current regulations require all pension plans to attach to their annual 5500 financial report an investment schedule identifying individual holdings of the plans. The availability of such information permits the development of a data base providing a wealth of detail on pension plan investment policy. As yet, however, no such data base has been developed by the Department of Labor, primarily because of the enormous effort involved in identifying and classifying the thousands of firms in which private pension plans invest.

While collection of data from plan investment schedules has not proved feasible, the Department of Labor has sought to collect data on plan investment policies through smaller scale efforts. Data will shortly be available on pension plan assets disaggregated by the categories listed on item 13 of the 5500 (government securities, corporate debt instrument, corporate stocks, etc.).

He also pointed out certain related research efforts now underway which would augment the DOL work described above.

After a review of item 13 (Form 5500), it becomes clear that the smaller scale efforts of DOL will be of little help in strengthening a study with the focus of this paper. Pension assets disaggregated into government securities, bonds, equities and cash equivalents will provide no insight into whose securities are held by the funds. The DOL product will differ little if at all from the disaggregated pension asset data formerly provided by the SEC. Unless portfolio holdings are catalogued in terms of company size (assets, sales, or earnings), there will be no way of distinguishing favorite fifty holdings from securities of smaller businesses. Unless the contracted research being performed for DOL addresses the raw data from this perspective, there will be little to be gained by those interested in fund holdings of small firm securities.
If, on the other hand, contract research does generate a data base which permits identification of plan holdings, it will become increasingly feasible to specify important relationships such as the following:

-- Pension fund flows to smaller business related to ROI/ROE
-- Pension fund flows to smaller business related to small business failure rates
-- Small business capital structure ratios related to ROI/ROE
-- Small business capital structure ratios related to small business failure rates
-- Pension fund flows to small business related to capital structure ratios

Disclosed relationships such as these would contribute to a capability to model small business dependence on capital market access.

Any efforts by the SBA which might expand the content of the DOL data base (or others) would significantly strengthen the research community's ability to perform meaningful studies in this area.

The above recommendations notwithstanding, demonstrated prior impacts of pension flows on small business viability will prove of little use if regulatory constraints deny retirement fund investments in small business. The August 28, 1979 DOL proposed regulation on definition of plan assets, described herein, quickly threatened to impose such a barrier, at least to the extent that venture capital firms serve as a specialized investment conduit to developing companies. Testimony presented on that proposed regulation during February 27-28, 1980, DOL hearings was heavily in opposition to Labor's prospective ruling and the June 6, 1980 issuance of a significant revision reflects the Department's responsiveness to that strong dissent. Nevertheless, further commentary is being solicited and until the final regulation is issued, some doubts are likely to persist. One impact has been clear:
according to Capital Publishing Corporation's Venture Capital, since the fourth quarter of 1979, pension fund flows to venture capital firms have literally ceased. It is evident that the August 1979 proposal was responsible for the current state of affairs. Nothing less than passage of the revised proposal intact can achieve a revived flow of pension dollars into small business through venture firms.
1. In 1969, 698 initial public equity offerings were made by firms with assets of less than $5 million. By 1974, there were only 9 offerings valued at $16 million and in the three years, 1974-1976, there was a total of only 41 offerings. Some reversal is now in evidence in the new issue market with 46 public offerings in 1978 at $250 million and in the first quarter of 1979, 15 new companies acquired $68 million in equity. See Galluccio (15), pp. 31-32, and Hansen (16), p. 29.

2. In 1976, 64% of those queried indicated ERISA had promoted a more conservative approach; in 1977, the percentage selecting the above response had increased to 83%. See Blair (4), p. 20.

3. Pensions and Investments (30). Also, see Blair (4), p. 20.

4. See Holmes (17), Bentsen (3), U.S. Senate Legislative Systems (32), and Oregon Business Review (1).

5. See White (34) and Department of Labor Amendment (10).

6. See White (34) and Department of Labor Amendment (10).

7. See Brauer (5), p. 88, White (34) and Department of Labor Amendment (10).

8. Rifkin and Barber (29).


10. Moran (20).


17. Barker (2). Barker states: "For example, between 1972 and 1976, and adjusting the figures to include the impact of failure rates, manufacturing firms with less than $1 million in assets produced an average after tax return of 16 percent on equity, while firms over $1 billion in assets returned only 13 percent."
22. White (33), p. 15.
23. White (33), p. 15.
24. White (33), p. 20.
25. White (33), p. 20.
30. Raskin (27).
32. The Third Century Fund five-year record through September, 1978, stood at an advance of 78.32% against a five-year advance in the Dow of 16.91% and 17.65% in the S&P 500. See Friedman (14), p. 112.
33. Friedman (14), p. 121.
34. Raskin (27).
REFERENCES


APPENDIX A

<table>
<thead>
<tr>
<th>GM Retirement Program for Salaried Employees (as of September 30, 1977)</th>
<th>Cost</th>
<th>Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Portfolio</td>
<td>$912,642,260</td>
<td>$1,011,371,700</td>
</tr>
<tr>
<td>24 Firms with Sales less than $300 million (or sales undetermined)</td>
<td>13,461,133</td>
<td>13,449,659</td>
</tr>
<tr>
<td></td>
<td>(1.47% of equities held)</td>
<td>(1.33% of equities held)</td>
</tr>
<tr>
<td>Corporate Bond Portfolio</td>
<td>$541,892,770</td>
<td>$533,727,900</td>
</tr>
<tr>
<td>13 Firms with Sales less than $300 million</td>
<td>5,507,000</td>
<td></td>
</tr>
<tr>
<td>49 Firms with Sales undetermined</td>
<td>22,223,562</td>
<td></td>
</tr>
<tr>
<td>Sum of bond holdings of firms with undetermined sales or sales less than $300 million</td>
<td>29,730,562</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(5.48% of corporate bonds held, valued at book)</td>
<td></td>
</tr>
</tbody>
</table>

Among the $7.15 million of business mortgages held by this fund, many were quite small, ranging to as low as $13,534. Sale and leaseback holdings totalling $16.16 million were also relatively small but in most cases were claims against major corporations or their subsidiaries.

Examination of GM's even larger $3.9 billion Hourly Rate Employees' Pension Plan reveals portfolio composition very similar to that of the Retirement Program for Salaried Employees. These very large pension portfolios cannot, however, be considered representative of major plan security holdings in 1977.