1 Socially responsible investing

This introductory chapter argues that socially responsible investing cannot be effectively pursued through mutual funds. Separate accounts are the only practical vehicle to align one's investment portfolio with one's principles or one's mission, because only individually managed portfolios can precisely reflect an investor's core convictions. The chapter goes on to describe the socially responsible investor's opportunities to effect change in the boardroom, by securities screening, shareholder advocacy, and community investing. It then looks at the role of corporate governance as a social responsibility screen, and concludes with a definition of the vexing issue which dominates all the chapters to follow: how does socially responsible investing impact portfolio returns?

"Socially responsible investing" ("SRI") goes by many other names. For example, individuals and family foundations might prefer to call it "socially conscious investing," "value-based investing," or "principle-focused investing." Charities, religious organizations, governments, unions, pensions, hospitals, universities, colleges and other nonprofit institutions might see it as "mission-based investing." By whatever name, SRI, it is fair to say, is taking on the momentum of a movement.

Yet, for individuals, fiduciaries, and investment advisors who seek to align investment portfolios with principles, the process is intensely personalized, synthesizing the deeply felt but often competing values that each of us struggles to identify. These values are also difficult to articulate clearly enough for others to adapt as their own. Consequently, the investment portfolios it impacts are highly customized, if not unique. The investment advisor is called upon to be extraordinarily skilled and acutely sensitive to each specific investor's precise and nuanced concerns about environmental stewardship, social accountability, and financial performance. This is the elusive new social contract which has been dubbed the "triple bottom line."

Mutual funds v. separate accounts

Socially responsible mutual funds, accounting for about US$127 billion in U.S. assets as of the end of 2003, are outside this book's scope because only individually managed portfolios can precisely reflect the investor's core convictions.

However noble their intentions, too many socially responsible mutual fund managers resort to basic formulas. They casually shun some notorious "sin" stocks, seek out some "good governance" companies' stocks, and, for good measure, add to the mix the stocks of a few "virtuous" firms which have landed on a "best employers" or "most friendly to minorities" list. Each resulting portfolio is likely to champion no investor's principles in particular, yet all the fund's investors bear whatever risks the manager assumes. The investors also suffer whatever opportunity costs and financial losses the fund incurs.

Professors Christopher C. Geczy and Robert F. Stambaugh, both of the Wharton School of the University of Pennsylvania, in their 2003 study, "Investing in Socially Responsible Mutual Funds," concluded that investment portfolios including socially responsible mutual fund positions underperform portfolios representing a broader fund universe by as much as 30 basis points per month, or 3.6% per year. The study, which has been mercilessly attacked on methodological grounds by SRI proponents,[1] measured fund managers' stock-picking skills using analytical techniques relying upon the Sharpe ratio and the Capital Asset Pricing Model.

Whether or not Geczy and Stambaugh's assertion stands the test of time, the discretionary way in which most SRI mutual fund managers select investments is tough to endorse, but easy to explain. The 109 self-styled socially responsible mutual funds we identified in the United States cater primarily to thousands of small retail investors, whose preferences, biases, and concerns are widely divergent. Of necessity, each of those funds' managers can do little more than seek the lowest, homogenized common denominator. They may also target one social problem while grudgingly tolerating, and even exacerbating, others. The result is an SRI portfolio in name only, a quilt of securities issued by companies, some of which are bound to offend different socially responsible investors for different reasons. A company known for its progressive social justice policies, for example, might pollute and disrespect the environment. Another company that is an excellent steward of the environment might have a poor record on diversity, human rights, or employee relations.

The Natural Capital Institute reported in its 2004 study that some major U.S. corporations with questionable consumer rights records are nevertheless represented in the portfolios of many self-described socially responsible mutual funds because they pass screens having nothing at all to do with consumer rights. The equities of other companies, each of which will surely outrage some socially responsible investors, are widely held in SRI mutual funds. The fund managers commend this or that aspect of their social or environmental performance, while ignoring their bad behavior in others. They include many listed blue chips commonly found in SRI mutual fund portfolios.

Applying deliberate screening criteria to an investor's portfolio to reflect his core beliefs – while disregarding a company's social or environmental underperformance where it is not a major source of concern to the investor – makes perfect sense, in that it speaks to his values. However, giving a company a pass where it could be considered to be contributing to serious social problems, just because it does a good job in promoting some other unrelated social value, is hard to justify. It is not justified even if doing so is the only practical way, vague and ill-defined as it is, to reconcile the often unstated, but always altruistic interests of a mutual fund's diverse investor-customers.

Despite their names and glossy marketing materials, and notwithstanding the screens they apply, most socially responsible fund managers can buy the securities of virtually any public company. Pax World Funds lays out the dilemma on its web site:

> Our funds often invest in large-cap stocks. Large companies make large targets, and if we dig deep enough we're bound to find something that makes us uncomfortable. The gambling, liquor and tobacco screens are quite specific, but once we get into the qualitative screens, most companies are in a gray area. Therefore, in order to make an objective evaluation, we think it's important to look at each company as a whole.

Mutual funds' screens are more or less stringent and applied in different, one might suggest, arbitrary ways. Some companies may make the cut, and others are included or excluded because a given fund manager on a given day may react viscerally positively or negatively to the company's persona.[2]

Not surprisingly, therefore, the combined holdings of socially responsible mutual funds are nearly identical to the combined holdings of conventional mutual funds. Comparing virtually the same securities packaged in different wrappers serves no useful purpose, so trying to do market basket comparisons of different funds is an exercise in futility. For these reasons, we have confined our analysis to separate accounts, and it is to separate account holders and their investment managers that we direct our conclusions. For them, SRI is investing with a purpose to achieve the investor's narrowly defined financial goals, while encouraging a fairer, more sustainable society, consistent with the investor's unique and proprietary view of the world.

Socially responsible investing traces its roots to Biblical times, when Jewish law prescribed that one's investments must advance one's ethical values. Since the 17th century, Quakers have seen themselves as bound to invest with a view toward nonviolence and human equality. The social upheaval of the 1960s caused principled investors to rethink their portfolio decisions in light of their growing concerns about civil rights, warfare, and ecology. However, SRI drew international attention only when disinvestment in South Africa, because of that nation's then-institutionalized racial discrimination, was first seen as a powerful tool for social change. Since then, socially responsible investors have joined together to redress social and environmental wrongs symbolized by the Exxon Valdez oil spill, the Union Carbide plant disaster in Bhopal, and child abuses in sweatshops in the developing world.

SRI's 1-2-3 punch

In the 21st century, SRI is evolving into a comprehensive and systematic strategy to influence the companies we own to improve the quality of our lives and to insure the long-term health of our planet. The strategy has three components, sometimes employed independently of one another, other times in combination.

- *Securities screening*. The oldest and still the most common approach to SRI involves "negative," "avoidance," or "exclusionary" screening. Securities offered by companies engaged in controversial industries such as tobacco, alcohol, or weaponry, or whose business practices are deemed to cause harm, are rejected.

  When "positive" screening is pursued, the securities of companies whose environmental, human-rights, or diversity records, for instance, are exemplary are selected. They are then monitored for continuing compliance with the standards the investor and his investment advisor set. Since no company's social or environmental performance is likely to be flawless, the investor seeks to back the better performers, the "best in class."

  Neither negative nor positive screening takes the place of financial screening. Only those securities which exhibit attractive risk-and-reward characteristics, and which satisfy all other appropriate investment criteria, find their rightful place within the socially responsible investor's portfolio.
- *Shareholder advocacy.* Most socially responsible investors insist that the companies in which they invest be good corporate citizens. They may actively engage management in constructive dialogue to ensure that a company's behavior respects the interests of all its stakeholders – its shareholders, its creditors, its employees, its customers, and the communities in which it operates. Many socially responsible investors will also vote on, and may even initiate, proxy resolutions to encourage positive social and environmental performance and good governance. The initiatives shareholders have most frequently and successfully promoted in recent months include sexual orientation nondiscrimination policies; climate change issues, typically focusing on greenhouse gas emissions reductions and reporting, and renewable energy investments; and board diversity resolutions.
- *Community investing.* Relatively few socially responsible investors seek out high-impact investment opportunities, which support vital community services, particularly for low-income populations where credit and capital are not readily available. They may target health care, affordable housing, or other basic needs.

By the end of 2003, US$14 billion were invested in, and then invested by, U.S.-based community development financial institutions,[3] primarily of three types.

- *Community development banks* operate essentially the same way other FDIC-insured banks operate, but they specifically seek to rebuild low- and moderate-income communities. Chicago-based ShoreBank, for example, has been a model for banks throughout the United States seeking to meet the needs of underserved communities. ShoreBank makes loans for multifamily rehab projects, for small minority businesses in Chicago and Detroit neighborhoods, and for African-American churches. Moreover, the bank has spread its development experience outside the United States Most recently, it has worked with the U.S. Agency for International Development to persuade Afghan farmers to stop growing opium and start growing wheat.[4] ShoreBank reports good earnings, and hopes its financial and social success will coax its competitors to meet otherwise unmet needs.[5]
- *Community development credit unions* are nonprofit, member-owned, federally insured and regulated institutions which offer savings and investment alternatives to their members, and then make loans which support economic development in a targeted locale. There are more than 100 community credit unions in the United States, and they have successfully served people who otherwise may be denied access to credit.
- *Community development loan funds* make direct, unsecured, and uninsured loans for projects designed to jumpstart or accelerate community development. The funds deploy grant money and pre-funded loss reserves to help protect their individual investor against investment loss. "Micro enterprise" loan funds help low-income individuals who are not eligible for conventional financing to buy homes and launch small businesses.

By the end of 2003, the nonprofit Social Investment Forum reported that nearly US$2 trillion (up from US$150 billion in 1995) in socially screened assets were held in the privately managed separate accounts of individuals and institutions. Between January 2001 and June 2003, shareholder advocacy resolutions increased by 15%, and the average percentage of votes received on social responsibility and so-called "crossover" resolutions (the latter involving both social responsibility and corporate governance concerns) increased from 8.7% in 2001 to 11.4% in 2003. Community investing has also spiked 84% between 2001 and 2003.[6]

Corporate governance

The Social Investment Forum's 2003 Report disclosed that a whopping US$900 billion in assets were linked to corporate governance resolutions, increasingly focusing on stock options expensing, "poison pill," and auditing issues. Greater shareholder interest in, and attention to, corporate transparency are to be expected in light of the enormous and highly publicized portfolio losses suffered in recent years by investors who relied on corporate boards and executives who proved feckless and corrupt, and financial statements which proved unreliable.[7] Some commentators look at corporate governance as a social screen: only when its management is fair to its shareholders and creditors is a company a worthy investment candidate. Others, perhaps with greater justification, see it as a financial screen: if one cannot trust the numbers, one ought not to invest in the stock. Either way, there appears to be a strong positive correlation between good corporate governance and equity prices.

Professors Paul A. Gompers and Joy L. Ishi, both of Harvard University, and Professor Andrew Metrick of the University of Pennsylvania built a "Governance Index," tracking 24 different criteria at approximately 1,500 companies to study the relationship between shareholders' rights and stock returns. They found that, if an investor had bought the common stock of firms with the strongest shareholders' rights and sold the common stock of the firms with the weakest shareholders' rights, the investor would have earned abnormal returns of 8.5% per year during the 1990s. The researchers also saw a strong correlation between a company's ranking on their Governance Index with the firm's value. In 1990 a one-point increase in the Index was associated with a 2.4 percentage point lower value for Tobin's Q. By 1999 the difference had grown enormously: a one-point increase in the Index was associated with an 8.9 percentage-point lower value for Tobin's Q. Moreover, they found that weaker shareholders' rights related to lower profits, lower sales growth, higher capital expenditures, and more corporate acquisitions.[8]

Similarly, PricewaterhouseCoopers (PwC) Malaysia Executive Director Eric Ooi Lip Aun, relying on a series of international surveys, reported at a media briefing on November 25, 2002, that the financial markets reward companies that emphasize transparency. Their stock prices, he suggested, trade at a premium of between 7% and 25% over those of their less transparent peers whose financial results are similar. At the same briefing, Aun's colleague, PwC senior fellow Dr. Robert G. Eccles, argued that people of integrity operate in a culture of accountability, and described a three-tiered model of corporate transparency. The three tiers are: (1) a global set of generally accepted accounting principles, based on principles and not rules; (2) industry-specific measurement and reporting standards, such as churn rate for telecommunications companies and R&D investments for pharmaceutical concerns; and (3) company-specific performance measures including compensation practices, risk management, and strategy. Aun and Eccles agree that misleading and fraudulent corporate reports, self-dealing directors, compromised sell-side analysts, and incompetent and dishonest auditors are to blame for an erosion of public trust in the capital markets. They also consider that strengthening all the links in the corporate-reporting supply chain will help restore that trust and materially enhance shareholder value.[9]

Probing performance

The Social Investment Forum's 2003 Report concludes that:

> socially responsible investing continues to perform competitively and attract new assets. Increasingly, investors are moving assets into screened portfolios as compelling evidence mounts with each quarter that screened [investment] funds can achieve competitive performance.[10]

Truth be told, the Forum's seductive assertion may be simplistic. The tough question that principled investors and investment advisors continue to face is whether or not including social and environmental considerations in investment decision-making hurts investment returns. If so, SRI can never be expected to attract investors beyond hard-core zealots who are willing to sacrifice material gain for their deeply held convictions. If socially responsible portfolios can be shown to suffer no appreciable drag on investment performance, by backing only those companies whose social or environmental performance is exemplary – and then by voting proxies to ensure that their exemplary behavior will continue – SRI can reasonably be counted on as a sensible way for investors to hold companies accountable for their social and environmental practices. If the Forum is right, and SRI can contribute to superior investment returns, mainstream investors and their investment advisors are likely to integrate SRI screening into most portfolios.

Diehard SRI opponents observe that non-financial screening must inevitably shrink risk-adjusted returns. After all, they agree, modern portfolio theory favors a larger investment universe, and as that universe contracts, the number of investment opportunities likewise is reduced.[11] SRI proponents counter that theoretical portfolio efficiency is more than offset by screening out the securities of companies that are likely to underperform their peers.

Some less ideological commentators suggest that neither argument prevails. Their view holds that social and environmental screening, when employing a best-of-sector approach, will randomly reduce the investment universe; that the number of securities which fail screens is probably small; and that the reduced universe will not materially impact the efficiency of the resulting portfolio. Advocates of this theory would anticipate no relative financial underperformance or outperformance by socially or environmentally screened portfolios. They would judge any struggle between one's soul and one's bottom line to be a false choice. To them, SRI is nothing more or less than a personal preference.

The central question of how SRI portfolios fare compared to traditional, unscreened portfolios remains an empirical one. Researchers have approached the question in different ways, and with more or less credible results, by comparing the performance of SRI indices with traditional indices; by comparing the performance of SRI mutual funds with traditional mutual funds or indices; or by comparing the financial performance of companies that score highly on various measures of corporate social or environmental performance with those that do not.

In 2004, Professor Marc Orlitzky of the Australian Graduate School of Management and Professors Frank L. Schmidt and Sara L. Rynes, both of the University of Iowa, performed a Herculean analysis of all known studies on the relationship between corporate social performance and corporate financial performance. Their paper, the winner of the Social Investment Forum's 2004 Moskowitz Prize for outstanding research in the field of socially responsible investing, analyzed a mind-numbing 52 studies published between 1972 and 1997. Their meta-analysis – a study of studies – concluded that "there is a positive association between CSR [corporate social responsibility] and CFP [corporate financial performance] across industries and across study contexts." However, the authors went on to report that corporate social performance correlates more strongly with corporate financial performance when using accounting measures for analysis, rather than stock price or other market-based measures. They also reported that environmental performance affects corporate financial performance to a lesser degree than do other measures of corporate social performance. Another key finding was that strong corporate social performance, while leading to strong corporate financial performance, also triggers a "virtuous cycle," where positive financial performance creates more cash flow available to fund new social-responsibility initiatives.[12] Professors Orlitzky, Schmidt and Rynes' award winning paper and its conclusion – corporate social responsibility does not cost; in fact, it pays – falls far short of representing that SRI delivers greater financial returns to the investor.

It may appear intuitive that corporate social responsibility reaps its own financial rewards, including:

- the ability to attract and retain better employees;
- a more productive workforce;
- greater customer loyalty;
- less litigation;
- lower environmental remediation costs;
- improved brand reputation; and
- better risk management.

Similarly, companies known for their charitable support or initiatives seem to benefit from improved shareholder returns, probably because charitable contributions increase name recognition among consumers, boost employee morale, and overcome regulatory obstacles.[13] Their aims are largely achieved through donations to projects or organizations pursuing social justice or environmental missions. Corporate philanthropy is seen by some as an effective strategy to gain a competitive edge; and by others as often no more than "greenwashing," a hypocritical public relations counteroffensive to offset the ill-will which results from a company's perceived social or environmental underperformance.[14]

SRI remains shrouded in controversy. Some academics, famously including noted economist Milton Friedman, have argued that corporate social responsibility actually distracts management and drains corporate resources. The consequence: *reduced* shareholder value.[15] They categorically reject the notion that socially responsible investors can be effective agents of corporate change. The wiser course, they argue, is to maximize total portfolio returns and then, if they wish, to dedicate a portion of their investment profits to charities which can more predictably address society's unmet needs.

Anecdotal reports, including many of those upon which Professors Orlitzky, *et al*. relied, have little empirical value, at best. Most of the studies claiming evidence of a positive link between corporate social performance and financial performance, let alone stock price, have been funded or prepared by partisans who seek to promote corporate social responsibility, SRI, or both. Most of these studies also tend to suffer from serious methodological flaws.

- Some researchers have attempted to use a specific corporate behavior as a proxy for corporate social responsibility. Others have used multiple attributes as separate independent variables; or they have converted multiple variables into an index, which they have then used as an independent variable. These unique definitional criteria make it nearly impossible to generalize from the results of many studies.
- Most studies use linear regression models which fail to take other variables into account.
- Correlation and cause are too often confused, and so are cause and effect. The relationship between corporate social responsibility and financial, or stock, performance may be driven by some other, overriding variable or variables. Alternatively, a company's excellent financial performance may not be a result of its social responsibility, after all. Instead, its strong financial results may merely free it from short-term survival tactics to pursue longer-term, socially responsible strategies.[16]

What follows is a dispassionate and pragmatic guide for the serious socially responsible investor and his or her investment advisor. It includes the author's original research and his unvarnished take on the leading secondary research, along with state-of-the-art investment tools and other resources he has developed and uses daily in his investment advisory firm, all with the object of mitigating the genuine risks of socially responsible investing while optimizing its formidable opportunities. A good place to start is exploring religion's enormous influence in socially responsible investment decision-making, so Chapter 2 looks at the relevant tenets of the major U.S. religions as SRI screens.

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[1] See Baue, William "Critics Find Study of SRI Underperformance Fundamentally Flawed," SRI-adviser.com (August 1, 2003); and Baltzell, Hewson "Refuting Media Bias Against SRI," *Business Ethics* (Fall, 2003) p.15.

[2] Reiber, Derek "How Strong a Screen?," Tidepool.com (March 4, 2003).

[3] Hawken, Paul and Natural Capital Institute "Socially Responsible Investing" (October, 2004).

[4] Social Investment Forum Industry Research Program *2003 Trends Report: 2003 Report on Socially Responsible Investing Trends in the United States* (Washington, D.C.: Social Investment Forum, 2003) p.23.

[5] Wisniewski, Mary "South Side Bank Exports Financial Know-how," *Chicago Sun-Times* (January 24, 2005) pp.61 and 65.

[6] Allison, Melissa "Bank That Serves the Ignored" in *Chicago Tribune* (July 11, 2002) sec. 3, p.5.

[7] Social Investment Forum Industry Research Program *2003 Trends Report: 2003 Report on Socially Responsible Investing Trends in the United States* (Washington, D.C.: Social Investment Forum, 2003) p.23.

[8] Gompers, Paul A., *et al.* "Corporate Governance and Equity Prices" (July, 2001), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=278920.

[9] PricewaterhouseCoopers "Corporate Transparency Enhances Share Price Up to 25%" (press release) (November, 2002), available at www.pwc.com.

[10] Social Investment Forum Industry Research Program *2003 Trends Report: 2003 Report on Socially Responsible Investing Trends in the United States* (Washington, D.C.: Social Investment Forum, 2003) p.12.

[11] Geczy, Christopher C., *et al*. “Investing in Socially Responsible Mutual Funds” (May 26, 2003) (unpublished manuscript).

[12] Orlitzky, Marc, *et al.* “Corporate Social and Financial Performance: A Meta-analysis,” *Organizational Studies* vol. 24 (March, 2003) pp.403–441.

[13] Smith, Craig “The New Corporate Philanthropy,” *Harvard Business Review* (May–June, 1994) pp.105–116.

[14] See Nace, Ted *Gangs of America: The Rise of Corporate Power and the Disabling of Democracy* (San Francisco: Berrett-Koehler Publishers, 2003).

[15] Friedman, Milton “The Social Responsibility of Business Is to Increase Its Profits,” *The New York Times Magazine* (September 13, 1970) pp.122–26.

[16] See Phillips, Hager & North Investment Management Ltd. “Does Socially Responsible Investing Hurt Investment Returns?” (September, 2003).