

## Socially Responsible Investing: History, Policy, and Definitions\*

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### Introduction.

Socially responsible investing (SRI) is an increasingly discussed and often controversial topic. Previously advocated primarily by religious organizations, environmentalists, and labor groups, it is now entering the mainstream of investing. According to the Social Investment Forum, assets being managed using SRI techniques now total over \$2.7 trillion, 11% of the entire marketplace of assets under management.<sup>1</sup> Moreover, this level of penetration into the investment marketplace has been accompanied by significant growth: over the past three years, SRI assets have grown at six times the rate of conventionally managed assets.<sup>2</sup>

The growth of SRI has been accompanied by increased attention from investors – both individual and institutional – and a variety of investment industry observers. Many have questioned both the efficacy and the propriety of constraining portfolios using “non-financial” criteria. In this paper, I will give some background on the history, evolution, and strategies underlying socially responsible investing, and will attempt to draw some insight and conclusions into how SRI can be used in the future.

### A Brief History Of Socially Responsible Investing.

It is not clear exactly how and where socially responsible investing got its start. What is clear is that its roots lie in religious ethics and in the application of moral principles to commercial behavior. One early instance of this premise was the mid-18<sup>th</sup> century decision by the Quakers to prohibit members from participating in any business associated with

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<sup>1</sup> <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=108>

<sup>2</sup> Ibid.

slavery. Later in the same century, John Wesley, one of the founders of the Methodist Church, preached a sermon entitled “The Use of Money.” In this sermon, Wesley exhorted his followers with the following words:

“We ought to gain all we can but this is certain we ought not to do; we ought not to gain money at the expense of life, nor at the expense of our health.”<sup>3</sup>

For approximately the next 200 years, SRI was largely limited to the realm of individuals who practiced religions that preached similarly, and to the management of endowments and funds of such religious institutions.

The field of SRI expanded significantly in the wake of the Vietnam War. In part due to outrage in over what some perceived to be war profiteering on the part of arms manufacturers and chemical companies, anti-war activists began to advocate aggressively for avoiding certain companies’ stock as a means of both protesting the war and of ensuring social value in investments. Further – and more visible – momentum developed in the late 1970s and early 1980s with the anti-apartheid divestiture movement. Indeed, divestment is often credited with being the “tipping point” of the fall of apartheid.<sup>4</sup> Importantly, because the divestiture movement specifically targeted large university and pension fund endowments, this period represents the introduction of SRI into the institutional investment landscape.

Since the divestment movement of the 1980s, SRI techniques – as applied by both individuals and institutions – have expanded to include a multitude of social issues. Today, there is a vast array of funds by which investors can apply their personal or institutional

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<sup>3</sup> <http://new.gbgm-umc.org/umhistory/wesley/sermons/50/>

<sup>4</sup> While divestment of the stocks of U.S. companies arguably had little direct effect on the apartheid policies of the South African government, the pressure to divest led to over 125 companies adopting the “Sullivan Principles.” The vast majority of these companies eventually withdrew their operations from South Africa.

philosophy to their investments. Examples of specific aspects of the social agenda for which investments are now screened include:

- Alcohol
- Tobacco
- Gambling
- Weapons
- Animal testing
- The environment
- Human rights
- Employment practices
- Community investment
- Religion

It is important to note that, while stock selection – and avoidance – represents the majority of activity and discussion around SRI, socially responsible investing is a three-legged tripod.<sup>5</sup> The other two legs – community investing and shareholder advocacy – are much less discussed but certainly as important and perhaps more effective. In particular, shareholder advocacy is a strategy that has been arguably at least as effective, if not more so, than screened portfolios in affecting corporate behavior (see below).

Over the past 15 years, there has been significant discussion by government agencies and in the legal community regarding the propriety of applying social criteria to institutional funds. Many have argued that artificially constraining portfolios on non-financial criteria violates a trustee's fiduciary responsibility to the beneficiaries of that portfolio.<sup>6</sup>

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<sup>5</sup> <http://www.socialinvest.org/resources/sriguide/srifacts.cfm>

<sup>6</sup> The reason for this has less to do with nominal returns than it does risk. Investment professionals most often measure risk as the standard deviation of a portfolio. Higher standard deviations mean more variability and therefore a greater chance that the value of the portfolio will decline; in other words, more risk. As the number of stocks in a portfolio declines – due to exclusionary screens – the standard deviation must necessarily risk. This results in lower risk-adjusted returns, even when the nominal return remains constant.

When examining this question, it is important to distinguish between two distinctly separate types of portfolios managed by institutions: foundation and university endowments on the one hand and pension funds on the other. In the case of foundation and university endowments, a trustee has parallel duties to the institution: that of a fiduciary and that of loyalty to the institution's mission or purpose. These two duties sit side-by-side and one does not supersede the other. In the case where the trustees of an institution determine that their duty of loyalty requires the constraining of investment choices based upon mission-related criteria, it is reasonably clear that they can do so. In other words, if the trustees of a philanthropic institution decide to adopt social criteria in their investment choices, they can almost certainly do so as long as they decide that the social criteria further the institution's mission.

In the case of pension funds, however, the investment management process has an inter-generational challenge. In order for all beneficiaries of a pension fund to receive their due, the assets must be managed to ensure thousands of streams of payments to thousands of individuals with varying life-spans over long periods of time. Therefore, the ability of trustees to adopt non-financial criteria in their investment choices is significantly more limited and is governed by specific bodies of regulation and law. This is particularly the case with respect to defined-benefit pension plans; for defined-contribution pension plans, there is greater latitude -- latitude that can be exercised by the beneficiary in choosing to incorporate social criteria in her/his investment choices. In the discussion that follows, I will focus my analysis and commentary not on the pension marketplace, but on the assets managed for philanthropic and educational endowments as well as for individuals.<sup>7</sup>

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<sup>7</sup> NB: The above discussion of the duties of trustees and the legal framework of charitable funds comes from the author's notes and recollections of the discussions at a "mini-conference" on socially responsible investing co-hosted by the TIEF Education Foundation and the National Center on Philanthropy and the Law at NYU. Any errors or omissions are the author's.

### A Critique Of Current Practices.

Given this background, it is important to examine the degree to which socially responsible investing has been, and indeed can be, effective in changing corporate behavior from socially destructive to socially constructive. It is this writer's view that SRI has underperformed on the central aspect of its mission. This underperformance stems from two primary causes: exclusionary screens and backward looking analysis.

The vast majority of SRI investments are screened for individual companies' participation in one or more of the behaviors listed above. More specifically, if a company were to participate, for example, in gambling, it would be excluded from the portfolio of a socially responsible investment that screened for gaming. These negative screens often serve as the dominant criteria in selecting securities for inclusion in an SRI portfolio.<sup>8</sup>

Negative screens carry with them several problems in effecting social change. The first of these is that investors, by completely avoiding the security of a company deemed to be socially "irresponsible," cede their place at the table of discussion about how best to change the company's behavior. Some have argued that "constructive engagement" is a far more effective strategy at not only getting companies to change their behavior, but also in educating companies, their management, and their employees as to why that behavior needs to change. However, eschewing ownership in the company at least implicitly, if not explicitly, forgoes this possibility.

This problem is exacerbated when it comes to issues of shareholder advocacy and proxy voting. As mentioned above, one of the three legs of the tripod on which SRI stands is shareholder advocacy. This is manifested in two ways, the first being the development and filing of shareholder advocacy petitions, and second through voting on those petitions (as well as other proxy matters). While many shareholder advocacy organizations have successfully filed petitions by owning a minimal number of shares, negatively screened

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<sup>8</sup> It is important to note that a number of socially responsible investments do, in fact, use positive screens – selecting companies for their positive contribution to the social issue in question. This trend appears to be growing.

portfolios dramatically diminish the potential votes for such proxies. Indeed, especially over the past 10 years when social shareholder resolutions grew by over 20%<sup>9</sup>, advocacy through the proxy process has been responsible for dramatically elevating the importance in the executive suite of issues such as climate change, employment equity, executive compensation, and child labor overseas. The presence of negative screens in many SRI portfolios may well have, at least marginally, decreased the effectiveness and power of advocacy on these issues.

Another issue with negative screening goes to the heart of engaging in the capital markets for advocacy. Many SRI investors seek to penalize companies through lower stock prices for their negative social behavior. While refusing to buy a stock may decrease, at the margin, the pool of available buyers for security, it is unlikely that sitting on the sidelines will change the stock's price. Downward movement in an individual stock's price is caused by selling pressure, not by avoidance of the stock. Therefore, exclusionary screens are unlikely to penalize the company for bad behavior unless they are utilized by numbers of investors far greater than even the most optimistic estimates of socially responsible investing suggest.

The second major problem with current screening practices is that they are almost exclusively backward looking. The information-gathering process generally consists of detailed questionnaires being sent to hundreds of companies asking for historical information about their activities. These data are then used to determine whether individual companies' past practices qualify them for inclusion in a portfolio. Typically, SRI investment analysts do not look at future plans or forward-looking statements about social issues because they either don't believe company statements or because they believe performance is more important than intentions.

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<sup>9</sup> [http://www.socialinvest.org/pdf/SRI\\_Trends\\_ExecSummary\\_2007.pdf](http://www.socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf); <http://www.socialinvest.org/pdf/research/Trends/1997%20Trends%20Report.PDF>. Importantly, support for the shareholder resolutions is increasing. In 2007, the average level of shareholder support and for social and environmental resolutions was 15.4%; up from 9.8% in 2005.

Investing, however, is an inherently forward-looking activity. Securities are selected for inclusion in an investment portfolio not because of how they have done in the past – although that is certainly a factor in the analysis – but because they are expected to outperform the market in the future. Applying this lens to social investments would suggest focusing at least partially, if not mostly, on expectations of future social performance rather than solely looking at past performance. Thus, if forward-looking analysis were utilized, advocates could reward those companies that *will* do better rather than those companies that *have* done better.

These two problems – negative screening and backward-looking analysis – create noteworthy barriers to the ability of SRI stock-picking strategies to create substantial and lasting social change.

### **Some Definitional Questions.**

Do these problems mean that SRI has no potential to effect social change? Are these criticisms sufficient to persuade organizations and individuals that investing their assets is an activity devoid of social impact or influence? In this writer's view, the answer to both questions is no. However, as investors look at social issues, they need to be clear as to what their objective is and how best to achieve it.

The genesis of exclusionary screens was an attempt to create portfolios that were consistent with individual and institutional morality. This long-standing approach was adapted, over the past generation, to the arena of social change. This adaptation has led to SRI strategies and options that are imperfect and unfocused.

Therefore, I would suggest splitting SRI investments into two distinct categories: ethical investments and social change investments. I will attempt to define each below.

Ethical investments are those that attempt to marry individual or organizational ethics, behaviors, and beliefs with those of the companies in a portfolio. Here, the investment

responsibility is dominated by ethical criteria and investment returns, while important, are not the primary focus. In institutional settings this approach places the fiduciary duties and loyalty duties of a trustee side-by-side rather than one on top of the other. There should be, in these instances, an explicit determination made by either the individual or the trustees that some sacrifice of risk-adjusted return may be required in order to achieve the ethical objectives. Performance deficits over time need not be apologized for but should be accepted as a cost of meeting the individual or institutional ethical and mission-driven standards. Social change should not be expected as the goal is to align the deployment of capital with ethical principles.

Social change investments, on the other hand, are investments explicitly intended to change corporate behavior in a manner that the investor deems more consistent with social progress. These can take several forms. First, they could be investments in companies that are central to the organization's mission with the idea of exercising shareholder power during proxy voting. For example, the American Cancer Society could purchase tobacco stocks in large quantities with the sole purpose of using that voting bloc at the annual meeting to vote for behaviors on the part of the company that discourage smoking or increase cancer research. This strategy, while admittedly controversial, may well have greater impact than if the American Cancer Society simply avoids the stock of all tobacco companies.

Another type of social change investment would be to align return-seeking behavior on the part of the investor with social issues. In order for this to occur, there must be a robust financial connection between the social behavior sought and economics of the corporation. One example of where this occurs is with environmental performance. A number of research studies have established statistically significant relationships between environmental performance and various measures of shareholder return.<sup>10</sup> In most industries, that relationship is positive; in other words, companies that do better

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<sup>10</sup> Earle, R., "The Emerging Relationship Between Environmental Performance and Shareholder Wealth," The Assabet Group, 2000.

environmentally tend to reward their shareholders with greater returns. Thus, a social change investment would buy companies that have, and are expected to have, superior environmental performance as a means of rewarding their behavior (with lower cost of capital) and producing superior financial returns. Indeed, were this strategy followed to its logical conclusion, an investor would sell short the stocks of those companies that underperform along the social dimension while purchasing those companies that outperform on the social dimension.

Whether a social investor chooses ethical investing or social change investing, significant attention must be paid to proxy voting. One of the more frequently overlooked aspects of security ownership, proxy voting is the means by which individual shareholders have a say in how companies governed. Because proxies are frequently confusingly worded, long-winded, and deal with issues that are often arcane and technical, the vast majority of investors – individual and institutional – tend to vote with management. This is, in my view, the wrong approach. Time, attention, and resources need to be dedicated to the proxy voting function in order for companies to be effectively and responsibly governed. Investors of all stripes – social or no – need to pay attention to the content and the choices offered through the proxy ballot each year. To do otherwise would be the corporate equivalent of not voting in a congressional or presidential election.

### **Thoughts For Moving Forward.**

As the field of socially responsible investing evolves, more thought needs to be given to exactly what objective an investor has when he/she/it incorporates social criteria into the investment decision-making process. First, the investor must make a clear decision as to whether their desire is to make their financial decisions consistent with their individual or institutional moral code or whether they seek to change the behavior of corporations along some social dimension. This decision has significant financial and strategy implications that should not be glossed over or ignored nearly as often as they are today.