



What is Socially Responsible Investing?

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Socially Responsible Investing (SRI) is the practice of taking “social” benefits into account when investing; or put positively, following practices that will lead to making investments expected to realize social benefits.¹ Interest in SRI is not limited to the US, but is international: the United Nations has itself sponsored work on drafting SRI principles. Broadly construed, the range of SRI concerns extends beyond what some may consider purely “social” matters to include environmental and governance issues. “ESG” is the acronym for this more inclusive set of environmental, social and governance factors. However, defined, SRI deals with all types of investments - stocks, corporate and public entity bonds, mortgages, etc. To keep the discussion manageable, though, I limit my remarks to SRI (or ESG) in the corporate equity market. Currently, this takes several forms:

1. Applying screens to identify companies which:
 - a. Are in objectionable lines of business (e.g. tobacco) and/or engage in unacceptable activities (e.g., abuse of worker rights). There is often disagreement within the SRI community whether one should avoid investing in (or dis-invest from) these companies or whether one should instead invest in (or in SRI parlance, “engage” with) these companies in order to try to influence their behavior.
 - b. Are socially responsible because of their lines of business (e.g., green power) and/or follow responsible corporate policies.
2. Using share ownership (e.g., shareholder initiatives, proxies) to influence company behavior and corporate governance and
3. Making “targeted” investments designed to promote particular social goals, e.g., financing affordable housing.

Up to now, the leading SRI practitioners have been foundations and endowments and public pension plans. For the most part, private individuals participate by investing personal money or self-directed defined contribution assets in SRI mutual funds. Corporate and Taft-Hartley defined benefit plans have been less involved, largely because ERISA requires that they put financial considerations (expected returns, risk and diversification value) first and treat potential social benefits only as strictly ancillary factors. This however is changing. For example, following the lead of assertive public plans like CalPERS, individual unions and

¹ “SRI” sometimes also denotes not a process but actual socially responsible *investments*. Since one can make socially responsible investments without following socially responsible investing practices, and vice versa, this usage can be confusing.

union organizations (e.g., the Change to Win coalition) are encouraging Taft-Hartley defined benefit plans to coordinate their activities so that they can use their combined equity ownership positions to press for reforms in the areas of corporate governance and shareholder rights. Early indications are that these efforts are bearing fruit.

How did SRI develop?

In the U.S., SRI has several sources, all rooted in different versions of social activism, some based in religion (e.g., opposition to contraception), some more overtly political. The social investing issue that first drew widespread public attention, though, were the demands by Vietnam war protesters institutional investors sell their shares in Dow Chemical because it produced napalm, whose horrific effects were widely reported in the media. Though the effort had little success and was dismissed by many investment professionals as left-wing, radical fringe agitation, it made SRI front page news.

The next important development took place in the 1980's. Under the leadership of "Big Daddy" Jess Unruh, California State Treasurer, CalPERS, the largest public pension plan in the country, played a key role in organizing the Council of Institutional Investors (CII). Abandoning the long established unwritten "Wall Street Rule" that the proper recourse for a shareholder who was unhappy with how a company was being run was simply to sell the stock and buy another, CII took an activist stance. Rather than sell such stock, CII used the leverage of its members' collective voting power to improve corporate governance and to defend shareholder rights. CII's first targets were "greenmail" and company mergers and acquisitions that benefited corporate raiders at the expense of public shareholders and lower-level employees. Subsequently it targeted devices (e.g., "poison pills") that served to entrench management at shareholders' expense and also acted to block mergers that threatened the value of its members' investments. Finally, in 1988, CalPERS led California's other public pension funds to decide to divest stock in all companies doing business with South Africa. With this, SRI in the U.S. came of age.

By the 1990's SRI was respectable; today it is well in the mainstream. For example, according to a recent survey by Mercer Investment Consulting and Plan Sponsor magazine, more than 20% of mid-sized institutions and 19% of DC plans now include an SRI option. More striking is that the survey data suggests that over 40% of all DC plan sponsors not currently offering SRI fund options expect to do so within the next few years. If this projection is realized, within 5 years approximately 60% of all DC plans would be offering participants at least one SRI investment option.

With respect to assets the pace of SRI market penetration is not nearly so dramatic. Highlighting this, several foundations have recently joined together in a campaign to urge foundations to increase social investing activity to 2 percent of all U.S. foundation assets over the next five years! This may increase SRI investments by \$10 billion or so, but is hardly earth shaking. Further, even if SRI options are available in 60% of DC plans, this does not imply that anything close to 60% of total DC plan assets will actually be invested in SRI funds anytime soon. Currently only about 30 mutual fund groups even offer SRI funds. SRI mutual fund assets represent less than 1% of the domestic mutual fund market.

Several reasons have been advanced as to why for the foreseeable future DC participant utilization is likely to remain low relative to other DC plan options. First, many people are reluctant to delegate social, moral or political policymaking to third parties, especially investment managers whom they don't personally know. Second, the SRI policies of the funds made available to DC plan participants may not match their own concerns or preferences. Third, participants (like many DC plan trustees) suffer a nagging fear that because of their very nature, SRI funds will underperform funds that do not employ explicit SRI criteria. The first point requires no comment, but the others do.

What investments are socially responsible?

Though SRI is a process, not a well defined set of investments, it is meant to lead practitioners to make investments in socially responsible companies. But which companies are these? It should come as no surprise that in a country as diverse as the US, there is limited consensus about the criteria one should employ in an SRI process and even less agreement as to which companies are in fact socially responsible. There are two main (and several subsidiary) reasons why agreement about the importance about SRI in the abstract rapidly erodes when one gets down to specifics.

1. The range of potential social concerns is too large for there to be anything like universal agreement on the list of socially responsible companies or industries. The most common screens are those related to liquor, weapons/defense, animal testing, environmental damage, gambling, human rights, labor relations/working conditions, corporate governance and shareholder rights. But if there is consensus that tobacco companies are bad actors, there is none about defense contractors or weapons manufacturers. A basic issue facing SRI is simply that on many issues there is no agreement as to what action to take. Examples of deep disagreements are not hard to find.
 - South Africa - Institutions that followed the Sullivan principles shunned investing in most if not all companies doing business in South Africa so long as it practiced apartheid. Others, however, argued that this sort of capital blockade hurt the wrong people and that to stimulate political reform one should practice "engagement" by investing in progressive companies doing business there. Today the countries are different (e.g., Iran, Sudan, Myanmar, China) but the division of opinion is the same.
 - Weapons - Should one shun weapons manufacturers or rather invest in them as essential for the defense of the country?
 - "Green" industries - Should one not invest in companies that manufacture or own atomic power plants? Is it acceptable to invest in power companies running even highly efficient coal fired plants whose emissions contribute to global warming? Should one invest in ethanol producers if a likely consequence of moving to agri-fuels is higher cost food ?
 - Emerging markets - Does investing in companies doing business in (or based in) countries with sub-standard labor conditions encourage labor exploitation or does it rather foster rising living standards? What if it helps companies that destroy American jobs but promote economic efficiency?
 - Retail - Do the benefits of low everyday prices outweigh the social costs of sub-standard wages, skimpy benefits and virulent opposition to unionization?
 - Liquor - Is it responsible to invest in companies whose products are popular but are often abused and are implicated in a large percent of automobile deaths?
 - Drug companies - Is it responsible to invest in companies that charge extremely high prices for new drugs but that develop life-saving therapies? What if they engage in animal testing?
 - The list can easily be expanded: lumber companies, contraceptive manufacturers, rap music producers, etc..

2. Investors differ in their social concerns, priorities and tactics.

- The range of concerns is frequently quite narrow. No investor considers (or could possibly consider) every conceivable investment related social issue. Most focus on just a handful. E.g., those who aim to invest in “green” companies may not have the slightest interest in companies that are anti-union; others may have vital concerns about labor rights and foreign competition, but at the same time have no particular interest in whether the companies in which they invest are particularly environmental friendly.
- Investors differ on their priorities. The longer the list of SRI criteria that a company has to meet before qualifying for investment, the more restricted is the universe of eligible companies. So as not to unduly limit their opportunities, in addition to limiting the number of social criteria they employ, most investors formally or informally rank order them. Thus, one investor may decide that labor conditions outweigh environmental factors so that employers of slave labor are automatically excluded no matter how well they score on other tests, but coal mining companies are ineligible for investment only if all other considerations are equal. Another might be so opposed to contraception that a drug company producing vaccines might not be acceptable.
- Another way in which investors differ in how they express their priorities whether they emphasize negative screens (avoiding bad companies or “engaging” with them) or positive screens (seeking out good ones). E.g., one might not be willing to invest in power companies operating coal fired plants but have no particular desire to invest in “clean” energy.
- Finally, they differ on tactics. E.g., some will not invest in companies which fail to pass their SRI screens; others deliberately invest in such companies to have “a seat at the table”.

In short, even if investors had identical social concerns and identical investment policies and objectives the way in which they implement SRI may lead them to very different portfolios.

Do SRI investors pay performance penalties?

According to finance theory, reducing the universe of eligible securities on nonfinancial grounds is sub-optimal since the smaller the universe of choice, the fewer opportunities there are to increase returns or to diversify risk. But theory tells us nothing about whether actual SRI portfolios do worse than less constrained ones. The data is mixed. Depending on construction and time period, some SRI accounts have outperformed less constrained ones, some haven't; some SRI managers have done better than appropriate unconstrained benchmarks, some haven't. The variables are so many and the number of SRI portfolios still so (relatively) small that the evidence is simply inconclusive.

Is SRI a new investing paradigm?

Given the impediments outlined, SRI it is not likely to become a major factor in participant directed DC plans anytime soon. In the U.S. at least, for the foreseeable future the greatest growth will continue to come from foundations, endowments and public defined benefit pension plans.

Though these institutions may (and almost certainly will) disagree on just which companies and practices are acceptable, there is hope that consensus can be reached on general investment procedures and objectives. Efforts to develop voluntary, aspirational, high level guiding principles that investors should follow in addressing social issues, broadly construed are ongoing. Most notably, the United Nations has sponsored

development of basic SRI/ESG principles. Under the aegis of the U.N. Secretary General, a working group of 20 major institutional investment organizations from 12 countries has issued statement of Principles for Responsible Investment. The Principles ask institutional investors, investment managers and related financial professionals (e.g., investment consultants) to commit themselves publicly to six procedural principles relating to environmental, social and governance issues. The six (each of which is detailed in the document) are:

1. To incorporate ESG into investment analysis and decision-making procedures
2. To be active owners and to incorporate ESG issues into ownership policies and practices
3. To seek appropriate disclosure on ESG issues by the entities in which they invest
4. To promote acceptance and implementation of the Principles by institutional investors
5. To work together to enhance the effectiveness of the Principles
6. To report on their activities and progress toward implementing the Principles.

The list of signatories - already several hundred names long - includes many of the world's largest institutional investors.² What is especially noteworthy is that the signatories embrace the Principles view that investors worldwide should engage with companies, industries or countries with which they have problems rather than to screen them out. Strong evidence, if any was needed, that the new SRI paradigm is active engagement. Though it is as yet unclear how deeply and broadly SRI will inform or change actual investment decision making is yet unclear, what is clear is that like rock and roll, active, engaged SRI is here to stay.

² For the list of signatories as of mid-July 2007 see the Appendix.