

Advisor Intelligence

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A Closer Look at Socially Responsible Investing

SUMMARY:

- Socially Responsible Investing (SRI) has grown significantly over the past two decades.
- A goal of SRI is to raise the cost of capital for companies that are insensitive to certain social issues.
- A variety of quantitative and qualitative screens may be used in developing a set of socially responsible companies. Investors wishing to pursue a SRI strategy need to consider what screens are used and weigh them against their own values.
- There is no conclusive evidence that reducing the investment set through social screening helps or hurts very much.
- We haven't found any outstanding managers from within the group of SRI funds, but there are index options available.
- A decision to pursue an SRI strategy should stem from personal beliefs rather than investment performance.

Like most professionals, we try to stick to what we think we're good at. We think we are good at thoroughly evaluating fund managers, and at making extremely well-informed, realistic and dispassionate investment decisions. These are reasons why we have continued to put off writing an article about a very passionate topic—socially responsible investing (SRI)—one which our readers have asked us about in a somewhat steady trickle over the years. Why not tackle the topic? Frankly, we questioned what we have to contribute. After all, SRI strikes us not as being about making the best investment decisions foremost, but about relegating performance concerns to a place immediately behind those of social concerns—an area that is well outside our professional expertise. But where we think we can contribute is in laying out the background and goals for SRI, by addressing the various methods used for screening companies, by discussing the unique investment considerations that arise in SRI (including the characteristics of this investment set), by talking about how to evaluate investments within this universe, and by presenting some of the options available to investors who decide they want to go this route. It is our hope that readers will be able to make a meaningful assessment of whether SRI is something they want to (and are willing to) pursue, and if so how they should go about it.

The Evolution of SRI

The Social Investment Forum, an advocacy group for SRI, says that assets managed under some degree of social screening reached \$2 trillion in 1999 (the latest available information). While their methodology can be questioned (the definitions are especially broad, for example) it is difficult to argue against the fact that SRI is a growing force. The origins of SRI trace back to religious organizations, many of which applied informal “sin” screens, traditionally alcohol, tobacco and gambling. Some groups, such as the Quakers, went further and omitted companies that were involved with weapons and slavery. The movement began in earnest in the 1960s, relating mainly to avoiding participation in the Vietnam War, though its participants were generally regarded as a fringe group. In the 1970s and 80s SRI gained much wider appeal as a way of applying pressure on South Africa to end apartheid by divesting holdings of companies that did business there.

While the specific aims of interest groups have changed over time and will continue to evolve in the future, there are several theoretical objectives that SRI can serve. First, investors can avoid participating in business practices they find unacceptable (principally by not owning the stocks of those companies).

Another is to create pressure for social change by raising the cost of capital for firms they view as socially irresponsible. Taken to the extreme, the second tactic could force companies to curtail objectionable business practices so as to gain access to lower-cost capital, and/or avoid negative public opinion that could stem from the activism (consumers' opinions probably carry far more clout than a small group of potential shareholders in the eyes of most businesses). Conversely, SRI theoretically rewards companies with positive business practices by giving them lower-cost capital. In either case, the effects would probably be difficult to measure. A counterintuitive tactic employed by some proponents of social change is to invest in companies with objectionable practices and work from within to enact change. This is known as "constructive engagement" and was employed effectively to get Shell Oil to reform policies related to its planned abandonment of the Brent Spar oil rig in the mid-1990s and to end its involvement with Nigeria, where a major political party was executing dissenters.

SRI has been a growing force overseas as well. The sidebar shows three recent developments in Europe that have increased the focus on SRI.

SRI Investments

There are three main ways individuals can use their investing practices to further their social beliefs, depending on their desired level of involvement. One is direct community investment. This does not entail liquid investments in public securities markets, and is probably outside the scope of most individuals' investment universe (though it can be a highly effective means of enacting change). Shareholder advocacy is another option, where investors seek to foster change by voting proxies and gaining a large enough shareholder base to add items to the proxy that advance their agenda. Finally, and most simply, investors can limit their investment selections to the securities of companies deemed to be operating in a socially responsible fashion, and mutual funds whose portfolios are comprised of the same. The latter is the simplest way for most investors to employ SRI, and the one we will address here.

The use of screens is the primary tool for stock investors to identify companies they seek to avoid. Exclusionary screens are the easiest to employ, and involve setting up clear rules—e. g., no tobacco, no alcohol, etc. These screens seek to divide up the investment universe in a binary fashion between companies that are socially responsible and those that are not. While qualitative work can go into defining the screens, once set up, exclusionary screens are clear and simple.

Developments Overseas

In the last year there have been three major developments in the European investment community, which has increased the focus on socially responsible investing.

- In 2000, the UK passed a new law requiring pension funds to disclose policies on SRI, while Germany and France have plans to follow suit next year (2002).
- FTSE announced the launch of a new family of indexes named FTSE4Good, designed to increase awareness of SRI among businesses worldwide.
 - In addition to investing in socially responsible firms, the FTSE4Good Indexes also will be donating all licensing revenues to UNICEF.
 - The FTSE4Good will contain three exclusions: tobacco producers; manufacturers of weapon systems; owners/operators of nuclear power stations, and mainly look for companies that encourage environmental sustainability, good relations with stakeholders, and human rights.
 - FTSE plans on launching a series of indexes focusing on one of the following country/region: UK, U.S., Europe or World. The first indices to

Qualitative screens don't use a black-and-white decision variable, but involve a greater degree of subjective assessment of a company's practices. This can include community relations, the environment, labor practices, and product safety, to name a few. Assessment of these areas can be used as the basis for a rating. The assessment is done using "bellwethers," since it would not be feasible to examine every single action taken within a corporation. Bellwethers are categories of corporate practices on which verifiable information is available from public and company sources. They allow broader conclusions to be drawn.

Table 1 shows a list of qualitative screens used by KLD & Co., a leader in SRI research and consulting.

The means employed by KLD for evaluating the bellwether criteria involve assessing each area for both negatives and positives. The firm has specific things they look for, and the strengths and concerns are assigned ratings reflecting their significance.

be launched will be the FTSE4Good UK 50, FTSE4Good Europe 50, FTSE4Good US 100 and the FTSE4Good Global 100, along with two benchmark indices, the FTSE4Good UK Index and the FTSE4Good Europe Index. The benchmark indices for the U.S. and global funds will be launched later in the year.

- On July 18th the European Commission published a green paper on corporate social responsibility (CSR) that is designed to encourage European corporations to be more socially aware.
 - The green paper does not specify the specific steps the commission intends to implement, but the paper does highlight the commission's concern with unemployment in the region and how companies are dealing with issues such as human rights, diversity, and the environment.
 - The Commission has also helped finance a business organization called CSR Europe, which has launched a campaign to raise awareness on employment and labor rights issues. This organization plans on traveling through 10 European countries beginning in December to find businesses worthy of a "best practice" award as part of the European Year on CSR in 2004.

One of the obstacles Europe is facing is the conflicting definition of what is socially responsible in each country. For example, most northern European countries have an environmental bias and favor exclusions for smoking and alcohol. However, within Italy and other southern European countries, alcohol is less of an issue.

The following examples show how KLD assesses issues relating to diversity and the environment:

Diversity

Strengths

- **Board of Directors.** Women, minorities, and/or the disabled hold four seats or more (with no double counting) on the board of directors, or one-third or more of the board seats if the board numbers less than 12.
- **Family Benefits.** The company has outstanding employee benefits or other programs addressing work/family concerns, e.g., childcare, elder care, or flextime.

Concerns

- **Controversies.** The company has either paid substantial fines or civil penalties as a result of affirmative action controversies, or has otherwise been involved in major controversies related to affirmative action issues.
- **Non-Representation.** The company has no women on its board of directors or among its senior line managers.

Environment

Strengths

- **Pollution Prevention.** The company has notably strong pollution prevention programs including both emissions reductions and toxic-use reduction programs.
- **Recycling.** The company either is a substantial user of recycled materials as raw materials in its manufacturing processes, or a major factor in the recycling industry.

Concerns

- **Hazardous Waste.** The company's liabilities for hazardous waste sites exceed \$50 million, or the company has recently paid substantial fines or civil penalties for waste management violations.
- **Regulatory Problems.** The company has recently paid substantial fines or civil penalties for violations of air, water, or other environmental regulations, or it has a pattern of regulatory controversies under the Clean Air Act, Clean Water Act or other major environmental regulations.

Source: KLD (<http://www.kld.com/>)

SRI Indexes

KLD created and maintains two widely used SRI indexes, one covering 400 mostly larger-cap stocks and the other the broader market. The indexes serve as both a universe of socially screened companies, as well as a benchmark against which to measure investment performance of SRI investment strategies.

The Domini 400 (DSI) was formed in 1990. It is comprised of 250 companies from the S&P 500 that passed exclusionary screens for alcohol, tobacco, gambling, military contracting, nuclear power, opera-

tions in South Africa, as well as qualitative screens on community, diversity, employee relations, environment, and product safety. An additional 100 larger-cap companies not in the S&P but passing the screens were added, as well as 50 other firms that were chosen on the basis of their “exceptional social characteristics,” rather than size.

The KLD Broad Market Social Index (BMSI) is a socially screened subset of the Russell 3000 that was launched in January 2001. It includes about 2200 companies, all passing the same exclusionary and qualitative screens (see above). Companies whose policies no longer qualify are dropped from the index monthly, and the overall index will be reconstituted to reflect market cap changes, etc. each June.

The Citizens Index is another SRI benchmark. It was created at the end of 1994, and consists of 300 large-cap companies that have been screened for social criteria that include tobacco, alcohol, gambling, weapons, nuclear power, environmental performance, product quality, and employment practices. There is also a Citizens Small Cap Growth Index, consisting of 300 smaller-cap companies.

Investment Impact of SRI

Proponents of SRI argue that the company set resulting from SRI screens makes for an inherently better investment universe, since these companies have less liability risk, happier employees, better public perception, etc. This may be true as it relates to the companies themselves, but investment is about valuation (how much you pay to get earnings) and a larger opportunity set will always yield at least as many opportunities as a subset of itself (by definition). So for a manager, SRI reduces the opportunity set. Taken as a group, it is possible that the subset of socially responsible companies will perform better on a passive basis than a broader set including all companies (though we have seen no convincing evidence of this). But even if it is true, it could be explained by reasons other than corporate practices as they relate to social issues. For example, companies that qualify for SRI indexes tend to have certain characteristics that impact the performance profile.

One observation we have made is that the Domini Social Index is overweighted to financials and technology, and underweighted to energy and utilities. We have also observed this with many—but not all—SR funds. Financial and technology companies have certain inherent characteristics that would probably lead them to score fairly well on SR qualitative criteria. In the case of financial companies, this could be for a couple of reasons: 1) the product they deliver—which is really a service—is not generally considered to be harmful, does not have a major impact on the environment (compared to manufacturers and industrial businesses), and does not involve the exploitation of slave labor overseas. Federal lending and consumer laws also mandate fairness in many cases.

In the case of technology, there are also several inherent qualities that would lead them to score well on screens: 1) in most cases, their “manufacturing process” does not involve very much waste and doesn’t have a big environmental impact (unless you consider the Jolt cola cans and candy wrappers disposed of by programmers), 2) many tech companies have younger employees, many of whom are highly educated, in high demand, and are probably more sensitive to gender issues. As such, these companies are probably somewhat more likely to have good gender policies, and 3) these companies not only do not exploit workers overseas, they in fact import foreign talent to work as programmers, which would give the companies higher diversity scores.

Companies such as utilities (many of which score poorly because of nuclear power facilities) and energy (which have bad pollution/environmental scores) will often be underweighted in SR portfolios.

Table 2 shows key sector weightings, as of 6/30/01, of the Citizens Index and the S&P 500. Sectors that

are significantly overweight (by at least 20%) relative to the S&P 500 are in bold; those significantly underweight are in italics:

The performance characteristics of the Citizens Index are also consistent with what would be expected of a universe that is overweighted to technology—during the large-growth/tech run up of 1995-1999, the Citizens Index outperformed the S&P 500 by a wide margin, then trailed sharply since valuations began to crash in 2000 (see Table 3).

Using SRI in an Investment Strategy

An investor who believes strongly enough in social causes to consider using SRI as part of an investment strategy should do some homework. First, they should check to make sure that the SR investment they are considering actually uses the screens that are important to them. For example, most SR funds screen out companies that are involved in the tobacco industry. Many of them also screen out companies involved in weapons manufacturing and the defense industry. Is that something that you feel passionately about? On the other hand, fewer companies screen for animal testing and human rights, and those may be issues that are important to you. Are women's rights and employee diversity a key issue for you? Make sure the screens are reflective of your values, or you may end up unwittingly being invested in companies you find objectionable.

Also, it's worth spending some time evaluating the criteria the SR funds are using to make these determinations. Do they make sense to you? Do they accomplish the goals you think they should be accomplishing? At the end of this article are a list of more resources, which can help you do further research in these areas if you wish.

Beyond the social criteria, investment selections still must be made. Absent convincing performance data to the contrary and given the relatively short time frames involved, we see nothing to indicate that SR investing in and of itself helps or hurts much. It really comes down to the skill of the stock picker. While an SRI universe is moderately smaller, we don't think that this would preclude a skilled stock-picker from finding the opportunities required to beat an SRI or a non-SRI benchmark. Given the difficulty of consistently beating the benchmarks in the overall fund universe, and given the relatively small number of funds that practice SRI, it is no surprise that there aren't any clear standouts. Given the lack of any clearly convincing choices among active funds, we think investors wishing to pursue SRI should consider index options as well.

In our own research, we base our assessment of a manager on a variety of factors, most related to the team and the investment process. To us, SRI would simply be another data point among many. To date we have not found any managers of socially responsible funds that pass our criteria for doing more in-depth work. So the list of SRI funds provided below does not reflect any qualitative judgments from us, other than our decision to cut load funds from the list, as well as funds with expenses greater than 2% (these funds are socially irresponsible to investors' pocketbooks anyway), as well as funds with assets less than \$20 million. We would note that while we are not comfortable enough with these funds to do so, it is probably possible to create a portfolio using only socially responsible funds that at least roughly tracks the allocations of our models. An investor wishing to do so may find Table 4 helpful.

Conclusion

SRI strikes us as a pursuit that probably should not be judged on the basis of investment merit, since its practitioners (at least most of them) have made a deliberate decision to weight social concerns ahead of investment concerns. There may be some who believe that the SRI investment universe is inherently superior, but we cannot see any conclusive evidence that this is the case, so on the basis of their investment merit alone we don't think investors should favor socially responsible investments. Rather, the decision should stem from their personal beliefs. For those investors who, based on their beliefs, wish to explicitly incorporate their morals or ethics into their investments, the key issues are determining which social criteria are the most important to them and figuring out how to deploy their capital in a way that is consistent with those criteria. While we have not yet found any active SR managers for whom we would pound the table, there are at least a few index fund options that would provide broad-based exposure to SR companies. We also recognize that this is a growing area of interest and plan to continue to look for good options. While we suspect that most investors would be interested in allocating only a portion of their portfolio to SR investments, for those who would like to invest exclusively in the SR universe, we think it is probably possible to come up with a diversified investment portfolio combining active and passive funds that doesn't sacrifice an egregious amount of return in meeting its social goals. While we hope that we have provided enough information to frame the important issues, in the end the decision as to whether to pursue socially responsible investing, to make direct cash (or other) contributions to social causes, to volunteer time, or to ignore social causes entirely is one that only an individual can make.

—Josh Weiss, CFA and Stephen Savage, with research assistance from Dana Last

Resources for SRI

KLD was founded by Peter Kinder, Steven Lydenberg, and Amy Domini and provides investment research and consulting services. Much of our background information is drawn from their work. We recognize that they are advocates for SRI, and have been careful in our efforts to separate unbiased information from opinions and to form our own conclusions. KLD's website has useful information about SRI, and can be found at: <http://www.kld.com/>.

The **Social Investment Forum** (<http://www.socialinvest.org/>) is a national non-profit organization that seeks to promote SRI, and their website provides information and links on the subject.

The **Calvert** mutual fund organization has been a long-time proponent and practitioner of SRI. Their web address is: <http://www.calvertgroup.com/>.

Citizens Funds has passive funds that invest in their SRI market indexes. This link provides a list of stocks that comprise the Citizens Index.
http://www.citizensfunds.com/Live/about/approach_profiles.asp.