Investing for Change: Profit from Socially Responsible Investment

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Introduction

Many investors want their investments to reflect their values; some have begun a journey to discover what their money is doing. With our book, *Investing for Change*[1], we hope to encourage many more. The purpose of the book is two-fold: to help investors consider the values their investments express, and to show how they can put their money to work for the changes they desire. In the limited space allowed here, we propose to outline our main investment theses for socially responsible investing (SRI).

For many of us, giving significant money away for promoting change is not a practical option. But investing for change -- otherwise known as SRI -- is something all of us can consider. Still, a number of questions come up when we consider what it means to invest "responsibly," including:

- Is it possible to "express values" through one's investments?
- How easy is it to rank companies along standards of social rather financial value? Wouldn't such standards be subjective?
- Does "responsible investing" imply taking more financial risks, resulting in poor performance?
- Does SRI help "virtuous" companies compete more vigorously with less socially responsible corporations? Does it force less virtuous companies to improve their behavior?

This paper — drawn from the key arguments presented in *Investing for Change* — provides some answers to these questions while outlining our approach to SRI. We hope to provide investors with a realistic idea of the promise and an assessment of the limitations that responsible investment holds with regard to the issues they care about. For some basic and important values, we believe, responsible investing can have a positive impact on both investors' portfolios and the world around them.

A Growing Trend that's Unlikely to Reverse

Socially responsible investors want all aspects of their life, including investing, to be in harmony with their beliefs.

Socially responsible investors are among a growing category of individuals who feel strongly about several core values — such as environmental friendliness and human rights. People in this group want all aspects of their life, including investing, to be in harmony with their beliefs. Described in 2000 as "cultural creatives" by sociologist Paul H. Ray and psychologist Sherry R. Anderson[2], they number around 50 million in the U.S. today; that is one in six people. And this number is growing.

Not surprisingly, the rise of this population has spawned significant growth in SRI over the past several years:

- The Social Investment Forum[3] reports that at the end of 2005, in the United States, SRI involved nearly $2.3 trillion, 10% of assets under management in the U.S. This represents an annual 25% growth rate in the 1995-2005 decade, slightly higher than the growth of assets under management in the U.S.
- Approximately $1.2 trillion of public pension fund assets are invested according to a social responsibility framework that takes into account the impact of companies on their social and natural environment. This figure accounts for roughly 45% of total state and local pension holdings.
- About 200 mutual funds with social screens held $179 billion in 2005. This segment of SRI assets has increased 15-fold since 1995.

SRI is a worldwide phenomenon, as is clear from its growing popularity in Europe, despite different regulation and institutions. SRI assets under management in that continent reached €1.03 trillion by 2005. The growth of the SRI market between 2003 and 2006 has been 106%. During this period, European stocks grew at a rate of 70%, so the real growth of SRI assets has been an impressive 36%. As in the U.S., most (94%) of these assets are from institutional clients and the highest growth has come from mutual funds.

The UN Principles of Responsible Investment spell another milestone in the global growth of SRI. Published in 2006, these principles aim to produce a common ground for responsible investment and define a set of

1 *Investing For Change, Oxford University Press, Forthcoming, 2008.*
2 *P. Ray and S. Anderson, The Cultural Creatives. How 50 Million People Are Changing the World, Harmony Books, 2000.*
3 *The Social Investment Forum is the U.S. SRI industry association.*

universal values and guidelines around which investors can organize their responsibility policy. By January 2008, financial services firms managing more than $10 trillion in assets have subscribed to the UN guidelines. As an indicator of current interest in responsible investment, this is a very encouraging sign.

But will the trend continue? Several factors point towards an increase in the scope of SRI in upcoming years, including the boom of retail SRI, the lower cost of new SRI products, the standardization of non-financial reporting by companies, the viral nature of SRI propagation, the entry of sovereign wealth funds into the SRI arena, the movement toward responsible options in 401K plans and alternative investments, and the increasingly important role of women — who represent roughly 60% of socially conscious investors — in corporate America.

The adoption of SRI is also mutually reinforcing: more institutions joining will boost the returns of SRI portfolios, which will make even more investors interested in SRI. More people interested in SRI increases demand for high quality responsibility ratings, which in turn help making SRI more credible. This "snowballing" effect has begun and is unlikely to reverse.

Investor Categories:

Yellow: motivated by moral concerns and tolerant to deterioration in financial performance

Red: not motivated by moral concerns and not tolerant to deterioration in financial performance

Blue: motivated by change and tolerant to minor deterioration in financial performance

What Do Investors Want from SRI?

While the assets under SRI continue to grow, the fact is that not all responsible investors agree on what is "responsible." Their goals can differ significantly. In *Investing for Change*, we divide investors into three stylized color categories based on their motives. (In reality, all investors are a mixture of these categories with regard to specific values and causes.) These categories are structured according to two key questions: What are your beliefs, and how much are you willing to pay for them?

- YELLOW investors feel morally obliged to avoid companies that are incompatible with some of their values. They consider that doing otherwise would be immoral. Their decision to invest responsibly is quite insensitive to the cost for them to do so and to the impact on companies' behavior. They often avoid "sin industries," such as tobacco or gambling.
- RED investors are at the other end of the SRI spectrum, as they are not motivated by moral concerns. Instead, they will not tolerate investment strategies that negatively impact performance in any way. They believe there are profits to be made from investing in responsible companies because they will outperform their peers in the coming years.
- BLUE investors are pragmatic. They are only interested in being responsible investors if they are convinced that it can change the world in the direction of their values and that the financial cost is small.

The Trouble with Zero Tolerance

Of these types, both YELLOW and BLUE want to see their values reflected in their investment choices. But the zero-tolerance approach of YELLOW investors has significant drawbacks for anyone hoping to effect real change, as BLUE investors want to do. For moral reasons, YELLOW investors — such as those who are faith-oriented — tend to screen out entire industries from their portfolios. While providing individual satisfaction and moral clarity for these investors, such divestment is not likely to have a direct effect on corporate behavior. Tobacco, alcohol and gambling companies are unlikely to shift their line of business because of investor divestment. They are "stuck." The cost that these companies would have to incur to attract responsible investors is too high: They would simply have to give up on most of their current activities.

While these investors may be following their principles, they are not improving the world. To have an impact, their attitude would require all investors on the planet to have a similar zero-tolerance policy. This is evidently not the case — nor is it likely to become the case — because of how well "sin industries" perform, especially during economic downturns.

Moreover, BLUE investors would not be willing to pay the high price of excluding entire industries from their portfolios. If "sin industries" form a large fraction of the economy, removing them would create significant disadvantages. These would arise from the fact that the resulting portfolio would be more risky because it had fewer stocks. In financial markets — as in many other activities — not all risk is rewarded. Removing entire industries leaves one with a higher risk but no proportional reward.

One might think that this argument would hold only if we excluded large industries. In other words, removing large industries such as oil would have a high cost for a portfolio, but removing small sectors should not have a significant impact. After all, companies involved in tobacco, alcohol and gambling nowadays account for less than 10% of the S&P500 market capitalization.

Could it be that screening smaller sectors such as tobacco and alcohol might be innocuous? The answer is no. That is because these "sin industries" have some financially attractive features. For example, companies that sell tobacco or alcohol tend to have a stable (or addicted) customer base, making their profits less prone to wild gyrations. Consequently, they are a useful addition to a portfolio as they stabilize returns throughout downturns and poor economic periods.

Profits AND Values: The Industry-Agnostic Approach

To reap the benefits of diversification, socially responsible investors need to turn their attention from screens on industries to screens on companies

According to modern portfolio theory, building an efficient portfolio means diversifying, i.e., by averaging out risk within and across industries. Further, the benefits of diversification are stronger when risk is distributed over firms from different industries. To get the benefits of these insights, we emphasize that socially responsible investors need to *turn their attention from screens on industries to screens on companies.*

Instead of avoiding broad industries, an SRI investor can opt for a less drastic option: excluding within each industry the least responsible companies. This is often called the "best-in-class" approach by many responsible funds. The resulting portfolio will still have companies in industries such as tobacco.

This is the approach that we advocate in section III in *Investing for Change* ("Building a Responsible Portfolio"). As our sample portfolio in that section shows, it is possible to construct a responsible portfolio that does not give up on returns and safety while expressing strong responsibility preferences.

This "industry agnostic" approach isn't just theory, either. Recently, companies providing responsible indices and SRI asset managers have taken into account an increased demand for balanced industry composition. In 2006, Pax World, with $2.6 billion under management, decided to drop its zero-tolerance policy on alcohol and gambling after it was forced to divest from Starbucks. Similarly, Dow Jones Sustainability Indexes (DJSI) and the Sustainable Asset Management announced in 2002 they would stop excluding companies from their responsible index simply on the basis that they operate in a so-called "sin" sector such as arms or tobacco.

This news is particularly relevant for investors who are not willing to pay a cost for being socially responsible. They would be interested in SRI if doing so is not detrimental to their portfolio's performance.

What about Creating Change?

As we noted above, the zero-tolerance approach is essentially toothless when it comes to effecting corporate change. The fact is, companies might not change their business but they might change the way they do business if they see a realistic chance of attracting responsible investors. By selecting the most responsible companies from industries, the industry-agnostic approach creates such a reward program.

The industry-agnostic approach creates powerful incentives for all companies to improve their responsibility standards

Advocates of this approach argue that using industry-agnostic screens creates powerful incentives for all companies to improve their responsibility standards. Industry exclusion does not, since companies from sin sectors are banned without any possibility of "appeal". If you give them a chance to be included by getting a higher SRI rating, you give them a reason to improve. You create competition among companies in the same industry to avoid being among the least responsible in their class.

Companies in sin sectors are not all equally nocuous for society. While one alcohol company targets youth indiscriminately, another does so by providing information on the negative effects of alcohol. Most would agree they shouldn't be treated similarly. The industry-agnostic approach takes this fact into consideration and promotes the better ones as role models for that industry.

In fact, the industry-agnostic approach engages all companies to care about their impact on society and the environment. It provides them with incentives to avoid being laggards on any value dimension. It creates a standard of decency; a minimum standard.

If your vision for the future is one where all companies respect minimum responsibility standards on several core dimensions regardless of their line of business, then this form of responsible investment can contribute to your goal of winning on values, while not hurting your financial returns.

Building a Responsible Portfolio

Taking the above into consideration, here is our industry-agnostic approach for building a responsible portfolio:

The portfolio selects those S&P500 firms that have no concerns in any of the three categories – environment, product safety and employee treatment

- ***Step 1: Collect information on responsibility***
  To build our portfolio, we need to determine the social and environmental responsibility of the companies in which we are considering investing. This information is available from research companies that review U.S. corporations on social dimensions. Some of these analyze more than 3,000 U.S. companies, including every company on the S&P 500. By analyzing public sources of information, they produce scores for each company, giving the intensity of "strengths" and "concerns" for different issues: community, diversity, employee relations, human rights, product safety, pollution and climate change[4]. Using their scores, we can "rank" companies by their degree of responsibility in every industry.

- ***Step 2: Remove companies that do not pass the bar***
  Using the data above, we eliminate for each year the companies for which we observe a lack of responsibility. To be specific, starting in 1999, we keep the firms that belong to the S&P 500 index and for which the research firm reports (that year) no concerns in any of three categories – environment, product safety and employee treatment. That leaves us with about 150 firms a year. This is a selective responsibility screen, since we have "failed" three out of five companies in the S&P500. Our portfolio, however, includes hotel companies such as Marriott or Wyndham, which own casinos. Even though they generate only a minor fraction of their profits from "sin industries," all these companies would be removed if one was using traditional industry-based screening.

  To be more precise, we use only "industry-agnostic" concerns, meaning we do not base our selection on concerns that would eliminate all companies in a given industry. For example, we did not keep as a concern "the company derives substantial revenues from the sale of coal or oil" (which would eliminate the entire oil industry) but we kept concerns about the level of a company's "liabilities for hazardous waste" or about the level of "emissions of toxic chemicals," which touches some industries more than others but only some companies, not all, in every industry.

- ***Step 3: Get the right mix of industries***
  We now need to decide how much to invest in each company. At this point, we have removed firms with concerns in any of the following three categories – environment, product safety and employee treatment. In this selection, we have eliminated more firms in some industries than in others. To be concrete, in our 2007 portfolio, nine of the 15 computer companies of the S&P500 are selected. However, out of the 24 oil companies present in the S&P500, only four pass the bar of our responsibility screen.

  We invest in each industry using the same proportion as in the S&P500. The reason is to preserve a high diversification across industries, which is financially attractive as it limits risk. This means that if an industry has relatively few responsible companies, we invest relatively more in those companies. That way, the fraction of our capital in that industry is similar to the S&P500. For example, we will invest large amounts in the two oil companies we have selected to compensate for the fact that most of the oil companies have been discarded.

  This portfolio retains the properties of industry diversification that the S&P500 possesses, for two reasons. First, we look at each company independently of its industry to evaluate its level of responsibility (as described in step two above). Second, we decide the amount invested in each company to obtain a portfolio with the same industry mix as the S&P500. Relative to the S&P500, we do not "over-invest" or "under-invest" in any industry. This means we are not forced to "bet" on one industry versus another.

Relative to the S&P500, the portfolio does not over-invest or under-invest in any industry

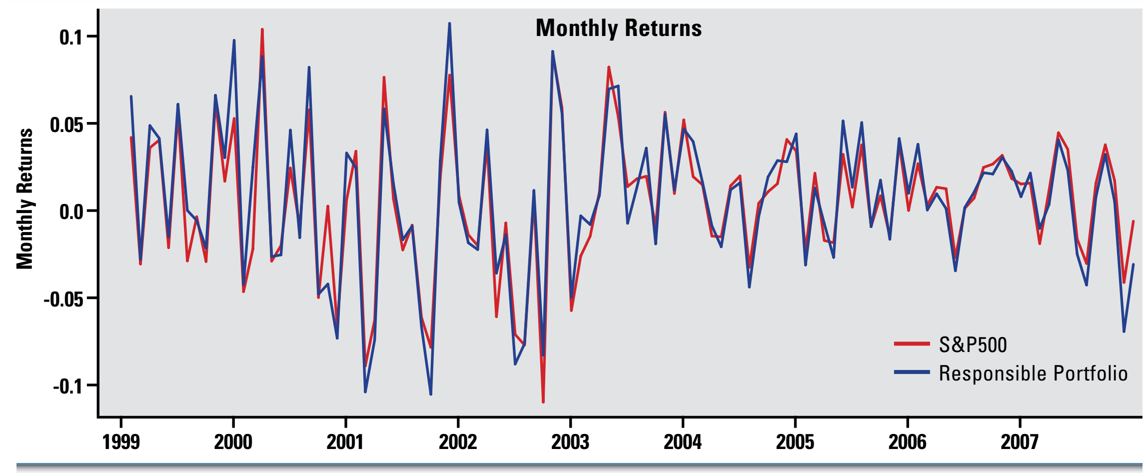
Measuring Performance

How would this "industry-agnostic" responsible portfolio have behaved during the last decade compared to the S&P500? As the monthly returns chart demonstrates, these two portfolios are strikingly similar, to the point where they are difficult to distinguish visually:

4 *One such company is KLD Analytics.*

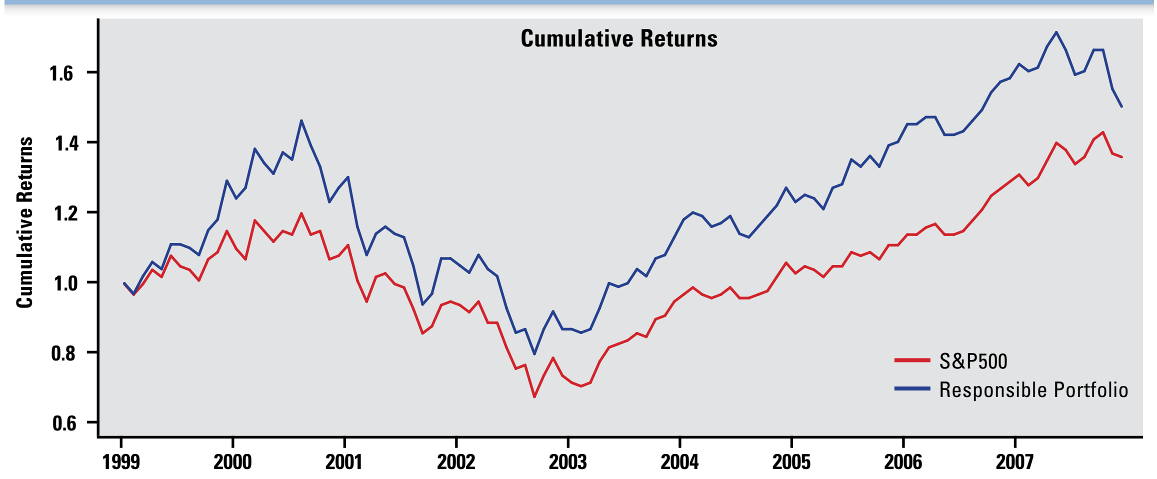
Industry-agnostic approach is "risk-preserving" compared to an approach that excludes industries

Figure 1. Industry-balanced Responsible Portfolio versus S&P500



Over this period, the responsible portfolio actually has a superior average monthly return (.52%) than the S&P500 (.40%) for a level of risk which is slightly higher. To gain a clearer picture of the comparative performance of both portfolios, we can also look at the cumulative returns:

Figure 2. Industry-balanced Responsible Portfolio versus S&P500



The responsible portfolio has slightly superior average returns and only marginally more risk despite having 70% less stocks

This graph shows that $100 invested in the S&P500 in 1999 would have yielded $135 at the end of 2007, while the same amount invested in the responsible portfolio would have yielded $150. What is noticeable in this graph is that during the downturn of 2001-2003, the responsible portfolio does not behave worse than the S&P500. Indeed, when the market falls by 1%, the responsible portfolio does not tend to fall by more than 1%. All in all, the responsible portfolio has slightly superior average returns and only marginally more risk despite having 70% less stocks.

This was possible because the industry-agnostic portfolio represented each industry in balanced proportions and consequently did not suffer from a lack of diversification. Using industry-agnostic screens, every industry has companies left after the screening. Because these companies have the "flavor" of their industry in terms of risks and returns, we can use them to "represent" their industry. This possibility to preserve industry balance makes the industry-agnostic selection "risk-preserving" compared to an approach that excludes industries.

Which Values?

As we noted previously, for YELLOW investors, the lines drawn regarding values are quite simple: investing is a strict 'yes' or 'no' proposition. But for BLUE investors, the case is not so clear-cut. Because BLUE investors are also concerned with their potential to create change in the world, they need to carefully consider which values they want to express through their portfolios. Unlike YELLOW investors, they care whether their investment decisions will ultimately be ignored by corporations.

In *Investing for Change*, we guide readers through a process of assigning each of their values to the BLUE or YELLOW categories. Following that step, we ask them to rate these values in terms of two key conditions:

- Can one reliably measure which company is currently violating or promoting that cause?
- Is the value consensual enough to have significant support and little opposition?

An SRI portfolio can be tailor-made to fit an investor's personal desires to create change. However, it will not reflect the whole spectrum of his or her opinions and values because some values will not be reliably measured, ruling them out for both YELLOW and BLUE investors. Further, some others will not be shared by a large enough population to have an impact through investments, ruling it out for BLUE investors. This restricts the set of values that can meaningfully be expressed by an SRI investor.

An SRI portfolio can be tailor-made to fit an investor's personal desires to create change

Using these two criteria – measurability and consensus – we have determined that the following values are the pillars of a BLUE SRI portfolio:

- Environment
- Employee relations
- Customer safety

To ascertain consensus around these causes, we reviewed recent shareholder resolutions reported by FundVotes[5] as well as surveys on global social attitudes by World Values Survey[6]. For measurement, we turned to social ratings firms. We discovered that all three of these concerns are shared by a majority, and the performance of firms along these dimensions can be measured in a relatively non-arbitrary way.

If one decides to express oneself and promote change along these values, we propose selecting a combination of three portfolios — one for each category mentioned previously. Each portfolio selects firms that have no concerns along that specific dimension. The specific combination of the three portfolios would reflect an individual's subjective tastes. If one cares about the environment more strongly than employee relations, a larger part of one's portfolio could be allocated to the environmental portfolio than to the employee relations portfolio. This will result in a balanced portfolio with risk properties comparable to the market.

If one is further YELLOW along some value, a "zero-tolerance" portfolio along that value will further exclude violating companies from each social portfolio. But this will come at the expense of higher financial risk.

Conclusion

Beyond the many myths and veils of investment management is a simple fact: investment consistent with one's values is possible. Several firms that rate companies and several funds that form portfolios along these dimensions make this a reality for interested investors.

Can SRI provide competitive returns? Can it change the world? That depends on which values the investor wishes to incorporate in the portfolio. Values that are sustainable — values that companies can incorporate at a reasonable cost — will cause changes in corporate behavior. Such values can also be incorporated into the portfolio without hurting financial performance, and, in the long term, they could even lead to superior returns. As the case we present in *Investing for Change* illustrates, money can be put at work for a dual purpose: changing the world and building investor financial wealth.

5 *FundVotes analysis of proxy votes of mutual funds and other large institutions.*

6 *Every year, the World Values Survey (WVS) asks households from more than 80 countries to answer several questions. The WVS provides a unique insight into values and attitudes of the world population.*