# Socially responsible investing – doing good and making money

**CHRISTIAN KEMPE, CFA**
Portfolio Manager
Berlin & Co, Frankfurt, Germany
Website: www.berlin-co.com
E-mail: ckempe@berlin-co.com

**Socially responsible investing is increasingly popular and the three main strategies are social screening, shareholder activism and community investing. Investors selecting socially conscious funds need not settle for meagre returns and major investment themes include environmental protection, alternative energy, eco-efficiency and climate change**

In June 2006 the Norwegian Government Pension Fund decided to exclude Wal-Mart Stores, the world's largest retailer, from its investment universe due to serious violations of human and labour rights. Investors, both institutional and private, are increasingly turning to so-called "socially responsible investing" or simply SRI. Other terms used synonymously include "ethical investment" and "sustainable investment". The general underlying concept is the same: for investors to look for investments that incorporate their social, environmental and governance concerns into their investment decisions.

## SOCIAL INVESTING HAS A LONG HISTORY

The concept of social investing has a long tradition in the US, stretching over several centuries. In the American colonies, Quakers and Methodists often refused to make investments that could benefit the slave trade. In the 1920s, churches were reluctant to invest in so-called "sin stocks", that is alcohol, tobacco and gambling stocks. The first mutual fund to incorporate "sin-stock screening" was the Pioneer Fund, which opened in 1928 and has been screening since 1950. The Pioneer Fund continues to exclude alcohol, tobacco and gambling stocks from its portfolio.

From the 1970s until the early 1990s, large institutions avoided investment in companies that were related to the governmental and apartheid policies of The Republic of South Africa. As a consequence of a massive outflow of investment dollars, a group of businesses, representing 75% of South African employers, were forced to draft a charter calling for an end to apartheid. Finally, in 1994, apartheid was ended and everyone in the country was eligible to vote for the first time in 50 years.

Catastrophes at Chernobyl and Bhopal, and the Exxon Valdez oil spill have served as flashpoints for investor concerns over environmental issues. The Vietnam War also gave rise to SRI-related discussions. In June 1972 a photo of a naked 9-year-old girl shown screaming with her back burning from the napalm dropped on her village was broadcast around the world. The ensuing revulsion led to widespread protests against Dow Chemical – the maker of napalm – and other companies that profited from the Vietnam War. All these issues have served to establish the groundwork for SRI as it is practiced today.

## SRI IS INCREASINGLY POPULAR

With growing social and environmental awareness among individual and institutional investors, SRI is a dynamic and quickly growing segment of the finance industry. On the back of this trend, assets in socially screened mutual funds in Germany, Austria and Switzerland rose to €9.2 billion by mid 2006, a 73.6% increase over the €5.3 billion recorded in 2004.

In a European context, SRI is more popular in the UK and France than in Germany. French and British state pension asset managers have been, for several years now, under legal mandates to disclose their consideration of sustainability factors. In addition, on a private investor level, a recent study commissioned by ABN AMRO Asset Management, which surveyed over 900 individuals, showed that only one in four German private investors is familiar with socially responsible investing and that only 1% chose to invest in sustainable funds. In contrast, in the UK and France around 10% of private customers invest in socially responsible funds. In Europe €24 billion was invested in 375 SRI funds at the end of 2005. In comparison, in the US socially conscious mutual funds assets under management were more than €150 billion. Overall, in the US it is estimated that $2.3 trillion, either in mutual funds or separate accounts, is invested according to SRI principles; this sum represents nearly one of every US$10 under professional management.

## THREE KEY STRATEGIES ARE USED IN SRI

Broadly there are three key strategies for selecting socially responsible investments: social screening, shareholder activism and community investing.

Social screening is the most common approach. Social screening describes the inclusion (positive screening) or exclusion (negative screening) of corporate securities in investment portfolios based on social or environmental criteria. Applying negative screening can exclude companies engaged in the production and selling of, for example, alcohol, tobacco, nuclear energy, firearms, military weapons, gambling and pornography. Avoidance screening has become one of the basic strategies of SRI. Obviously, this approach raises the issue of diversification because it excludes certain industries. In contrast to merely not considering "socially irresponsible" companies, positive screening actively searches for companies that reflect social values related to, for example, strong records of community involvement, no negative environmental impact, responsible employment policies and consumer-product safety.

Over the course of years, it has become a more common practice for investors to seek companies that meet, or exceed, certain standards for social conduct and that stand out as "best in class" in their particular industry. The primary advantage of this methodology is that it is designed to provide a consistent selection process, based on defined criteria, across all sectors. As regards screening, critics claim that it has no direct effect on a company because screening involves "secondary" transactions that the company is typically unaware of.

Shareholder activism is possibly more effective than social screening. The practice of shareholder activism has evolved over time. Owning shares brings with it powerful shareholder rights (e.g. access to proxies). To pursue an active shareholder approach, an investor intentionally invests in companies that violate social issues of concern and then takes an active interest in the practices of these companies. Possible actions to take range from engaging in dialogue with management, proxy voting, filing shareholder resolutions to prevent extreme undertakings and, as a last resort, joining class-action lawsuits and divestment. Ideally, these methods change a company from the inside with the ultimate goal being to encourage and improve corporate social and environmental policies and disclosures. The explosion of corporate fraud cases, after widespread disreputable corporate conduct and mismanagement in the late 1990s, and the extensive media coverage given thereto, sparked a record number of proxy votes in 2004 – 40% more than in 2002. Since then an ever increasing number of institutional investors have been practicing shareholder activism.

Community investing is perhaps the most effective strategy of SRI. Community investing generally involves lending to non-profit organisations or small businesses that work directly with low-income or disadvantaged populations, or which provide social services such as child care, day care, affordable housing and healthcare. In this context, another term used is "microfinance", which depicts offering financial services to poor people in underdeveloped countries who would otherwise have no access to loans.

## INTERESTED INVESTORS NEED TO IDENTIFY WHICH PRODUCT BEST FITS THEIR INDIVIDUAL PHILOSOPHY

There has been substantial growth in the number and diversity of SRI products available. Investors can choose from a plethora of socially and environmentally screened mutual funds, though these funds share no common investment approach.

SRI remains open to significant elements of subjectivity. In searching for an appropriate fund, investors should seek consultation. At an introductory level, interested investors can use some of the widely available online database tools, such as for European products for example, http://www.sustainable-investment.org. In addition, some dozen equity indices based on socially responsible selection criteria have been set up by different providers, for example:

- the Domini 400 Social Index, the oldest SRI index;
- Dow Jones Sustainability World Index;
- FTSE4GOOD.

In recent years, a few exchange-traded funds tracking the performance of SRI equity indices have been made available to investors. There are currently three choices with total expense ratios of 0.45% to 0.92%:

- TrackinDex DJ Stoxx Sustainability;
- EasyETF ASPI Eurozone;
- B1-Ethical Index Euro.

Community and microfinance investing is usually more difficult to set up. Investors searching for community investing or microfinance opportunities ordinarily face more difficulty in finding appropriate ways to put their money to work. In the US, in contrast to Europe, community investments are readily available, usually requiring only a minimum $1,000 commitment through a checking account, certificate of deposit or a promissory note.

Because community development financial institutions charge borrowers a low interest rate, returns are usually capped at 5% or less for 1 year. The universe of microfinance funds is nascent. Due to the high cost of capital in the developing world and low delinquency and default rates, micro-loan basis projects can deliver formidable returns if executed properly.

Since 2004, a benchmark for microfinance called Symbiotics Microfinance Index has been available. Information on webpage http://www.microcapital.org provides a starting point for interested investors.

## SRI DOES NOT LEAD TO LOW RETURNS

In contrast to purely philanthropic actions, performance is an important issue to be considered when it comes to SRI. Traditionally, there has been a widespread belief that incorporating socially responsible criteria into investment decisions comes at the cost of performance. The most common argument goes like this: the smaller universe of securities to select from, due to filters and added expense of conducting social research, makes it impossible for investors to receive competitive returns vis-à-vis traditional chosen investments. On the contrary, proponents of SRI argue that legal suits brought against corporations for infringements of social concerns, such as air and water pollution and employee discrimination have become major financial issues. Hence, they argue, excluding companies involved in such activities represents a long-term successful investment strategy.

A large body of empirical studies has focused on the question of whether investing in companies with sound social and environmental records yields inferior returns.

Most tests conducted concentrated on performance analysis of sustainability funds, and a smaller proportion of studies examined the development of sustainability equity indices.

Bauer et al. (2005) conducted a through analysis using a database of 103 German, UK and US socially conscious funds and concluded: "Even after controlling for investment style we find no significant differences in risk-adjusted returns between ethical and conventional funds". Furthermore, Schroeder (2005) investigated the performance of 29 international SRI equity indexes and summarised: "SRI screens for equities neither lead to a significant out-performance nor an underperformance compared to the benchmarks".

## CONCLUSION

Henry Ford, the legendary US automobile industrialist (1863–1947), once said: "The highest use of capital is not to make more money, but to make money do more for the betterment of life". With an ever increasing number of investors incorporating their social, environmental and governance concerns into their investment approach, SRI can be expected to leapfrog from being a niche to a mainstream money management product in Europe comparable to that in the US.