

CHAPTER 1

Getting Started with Socially Responsible Investing

This chapter lays out some basics for getting started with Socially Responsible Investing (SRI), from definitions of common terms to the workings and logic behind the main SRI strategies. It also explores how SRI has developed and what types of people are, or are not interested in SRI.

Toward the end of the chapter, there is a discussion of financial returns from the various SRI strategies. There is debate surrounding the relationship between financial returns and social impact in certain areas of SRI and some comments are in order.

The key questions guiding this debate include: Can I get competitive returns from SRI strategies? Do I need to give up some return to achieve positive social impact? Could some SRI strategies actually do better than “mainstream” investment strategies? Answers to these questions also shape the remainder of the book.

The Key SRI Strategies

Compelling Returns uses a commonly accepted definition of *Socially Responsible Investing*, regarding it as including those investment strategies that consistently and explicitly consider social factors as part of the investment process. I believe this definition continues to work well even as the field evolves. Similarly, the general strategies for employing SRI continue to fall into three broad strategies, even as each evolves to include new investment techniques and

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reflect new social issues. The three main SRI strategies are essentially as follows.

- *Social Screening.* Generally found mainly in SR stock or bond funds, *social screening* means that the underlying stocks, bonds, or cash investments have been chosen at least in part based on the environmental, social, or governance (ESG) criteria of the issuer. For example, a socially screened stock mutual fund might elect not to own certain stocks (e.g., tobacco companies) on social grounds. In addition, that same fund may also select stocks that have strong track records on certain social or environmental factors, such as having a diverse workforce or smaller environmental footprint, relative to their peers. *Socially screened stock and bond funds have provided performance on par with conventionally managed mutual funds and are widely available.*
- *Community or Proactive Investing.* In this investment strategy, funds are directed toward companies or projects geared toward some positive social or environmental impact, such as increasing the supply of affordable housing or promoting the development of energy-saving technologies. For example, an investor could allocate part of his or her fixed income investments to certificates of deposits in a local community bank that emphasizes lending and financial services in underserved neighborhoods. As one example, *deposits in community development banks and credit unions can provide government-insured returns on par with deposits at other banks and are easy to do.*
- *Shareholder Activism.* Shareholder activism occurs when owners of a stock attempt to influence the behavior of companies through either talking directly to the company or by voting to support or defeat certain proposals that require shareholder votes or through the election of directors. Importantly, shareholder activism is an option whether you own stock directly or through a fund such as a mutual fund. *Shareholder activism can influence corporate behavior and need not require any other change in investment strategy. Also, all investors should be aware of how investment companies vote on their behalf.*

These three broad strategies continue to provide a comprehensive framework for discussing the SRI options available to most

individual investors. Though the increase in SRI-related terms has made it a bit more confusing to sort out the SRI landscape, most of these terms can still be used within this framework.

The following terms are commonly used among socially oriented investors and will help in understanding the three main SRI strategies.

- *Environmental Social Governance (ESG) factors.* ESG refers to the broad range of environmental, social, or governance factors related to company performance that can be considered in the investment process. As examples, *environmental* factors might include how extensively a company reports on its carbon emissions; *social* factors might include policies related to workers' rights; and *governance* factors might include the degree to which the members of the board are independent of the management of a company.
- *Corporate Social Responsibility (CSR).* CSR refers to how a company considers a broader range of factors or stakeholders as part of its business strategy. While most companies would focus on traditional financial measures of their performance, companies with a distinct CSR effort would also consider the impact of their operations on a wide range of environmental and social factors. In this sense, there is some overlap between CSR and ESG as possible measures of performance. For example, assessments of either could be used in picking stocks for a socially screened mutual fund. Also, various SRI strategies often act to stimulate improved CSR performance by corporations.
- *Sustainability.* Sustainability refers to the degree to which a company's business model can be operated indefinitely based on its use of renewable resources or processes, while the concept of sustainability can have a specific environmental meaning (e.g., to companies that do not rely on continual environmental degradation to produce products) or it can be interpreted more broadly. For example, the broader interpretation of sustainability might include factors such as sustainable relationships with suppliers that would also be found in an assessment of CSR.
- *Faith-Based Investing.* Faith-based investing typically refers to any of the three SRI strategies that stem from specific religious

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or ethical beliefs. Specific examples unique to faith-based investing would include a religious values investment fund with stocks or bonds selected specifically with religious social screens. Importantly, there are also more general examples that overlap with a broader range of investors, such as the presence of faith-based investment funds as major depositors in community development banks.

- *Green Investing.* Green investing involves SRI strategies that are built mainly around environmental criteria. This term includes a range of investment strategies from sector funds focused on renewable energy or environmental renewal to socially screened funds that evaluate a company's environmental footprint as part of the screening process. In some areas of green investing, such as renewable energy, the bulk of the investment dollars are already coming from mainstream investors with no specific SRI focus. In other areas, such as environmental screening, the bulk of investors do have an SRI orientation.
- *Program- and Mission-Related Investing.* Program- and mission-related investing typically refers to community and proactive investments made by philanthropic foundations where the investments are closely related to the mission of the foundation. For example, a foundation focused on community economic development might also finance affordable housing with the funds in its endowment. A key differentiator between the two terms, however, is that Program-Related Investing (PRI) usually means investing done at below market rates such that it qualifies a portion of the investment as being charitable or similar to the grant-making operations of the foundation. Mission-Related Investing (MRI) typically refers to investment strategies (typically of philanthropic foundations) that are closely related to the underlying mission of the institutional investor.
- *Double Bottom Line Investing.* Double Bottom Line Investing refers to the goal of achieving both financial and social returns through an investment strategy.
- *Triple Bottom Line Investing.* Triple Bottom Line Investing refers to the goal of achieving financial, social, and environmental returns through an investment strategy.

Socially oriented investors will see these terms used frequently and sometimes interchangeably. However, conventional investment managers may also use some of these terms and concepts in making their investment decisions. For example, stock analysts covering tobacco companies would likely understand the importance of social factors (and resulting financial liabilities) to the tobacco industry. They would analyze this information from a financial perspective and include it as part of their traditional analyses.

So what is the difference between *mainstream* or *conventional* investment strategies and SRI? Essentially, socially oriented investors are explicitly making ESG factors a core part of the investment process. Mainstream or conventional investors, however, typically only consider these factors when they have an overwhelming and obvious impact on traditional stock or bond valuations as in the tobacco example previously referred to.

The SRI Response

SRI has developed dramatically over the past 35 years from a small niche strategy practiced by a few faith-based institutions to a broad investing trend practiced by many. This development can largely be viewed as the trends stimulating SRI demand (discussed in the Preface) and the responses to that demand by managers of various SRI strategies. These responses have in turn also shaped the development of SRI over the same period.

1. *The creation of specialty SRI firms.* This response is mainly the creation of specialized investment firms with a specific focus on developing a new generation of SRI strategies. Examples of these firms include Domini Investments, Calvert Investments, Trillium Investments, Walden Asset Management, MMA Praxis, Parnassus, and Pax World. This group of firms has gone on to develop a wide range of SRI-related products and strategies, often working with other firms and networks to distribute their products.
2. *The emergence of large firms with SRI capabilities.* The creation of SRI products and services within broader investment firms such as TIAA-CREF (with the start of CREF Social Choice in 1990) or Vanguard (in conjunction with Calvert and later FTSE4Good) and distribution alliances (such as Fidelity

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offering Calvert funds in retirement plans). Also included would be the emergence of more active proxy voting by mainstream firms, even when those same firms do not engage in other SRI strategies.

3. *The extensive creation of socially oriented business models.* This would include businesses geared toward community development (e.g., ShoreBank or ProCredit) or very high levels of corporate social responsibility (e.g., Tom's of Maine or Ben and Jerry's), or those geared around specific new technologies or issues (e.g., Green Mountain Power and renewable energy).
4. *The creation of new SRI firms, products, and services.* This trend includes firms such as KLD Research and Analytics (with services to support social screening), TruCost (with services to support detailed environmental analyses), and ISS (with services to support proxy voting and analysis).
5. *The development of SRI industry associations.* A wide range of organizations have developed to bring together various stakeholders of SRI strategies. Some examples include the founding of the Social Investment Forum (SIF) and the broadening membership in the Interfaith Center on Corporate Responsibility (ICCR). In addition, certain specialized areas for community investing have formed associations such as the Federation of Community Development Credit Unions (FCDCU) or the CDFI Coalition.
6. *Growth and change in philanthropy.* The dramatic growth in philanthropic foundation assets coupled with the willingness of some leading foundations to consider SRI strategies within their investment funds is a significant response to SRI trends. More than other pools of institutional money, such as pension plans and endowments, foundations have moved closer to using SRI strategies mainly because they were created to pursue social goals.
7. *Legal and regulatory changes.* The increasing presence of government regulations related to all three strategies has elevated the demand for SRI products and increased the overall size of the SRI industry. Examples include:
 - social screening (e.g., mandatory divestments of certain target companies by state pension plans);

- community investing (e.g., the passing of the Community Reinvestment Act in 1977 to increase bank lending and investment in underserved areas); and
 - shareholder activism (e.g., through the requirement for investment managers to disclose their proxy voting policies and records).
8. *The rise of SRI standards.* The significant rise in various SRI-related standards for investors has also been a response to rapid SRI growth. Two examples are the Principles for Responsible Investing (PRI) started by the UNEP Finance Initiative that encourages use of ESG factors by investment managers and the Enhanced Analytics Initiative (EAI) to promote research by investment banks on ESG factors such as value drivers in the investment process or Leader in Energy and Environmental Design (LEED) certification of commercial buildings.

These responses by SRI firms and practitioners have generally meant more options being made available to investors considering SRI, including:

- more SRI investment options with greater differentiation in terms of structure and pricing
- more places to get SRI funds or products
- more social, environmental, and governance issues considered by the various SRI strategies

Beyond the growth in options, the combination of trends and responses has brought SRI increased recognition, economies of scale, broader social impact, and more competitive returns. The relationship between these last two factors (social impact and returns) has also emerged as an area of debate.

Perspectives on SRI Returns

The evolution of SRI described previously has paralleled a debate about the relationship between the investment returns of SRI strategies and the positive social impact those strategies hope to achieve. The central question is: Do investors need to sacrifice financial returns to achieve positive social results? A range of perspectives on this question has emerged and is shown in Figure 1.1.

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Perspective 1	Perspective 2 (<i>Compelling Returns'</i> Philosophy)	Perspective 3
<p>SRI Approaches Should Generate <i>Below</i> Market Returns</p> <p><i>High-impact social change requires a sacrifice of investment returns to achieve positive social impact.</i></p>	<p>SRI Approaches Can Generate <i>Competitive</i> Market Returns</p> <p><i>Social change can be affected by investment strategies that target and achieve competitive returns.</i></p> <p>Examples</p> <p>Social Screening through <i>Lower cost socially screened funds (see Chapter 4)</i></p> <p>Community Investing through <i>FDIC insured community bank CDs (see Chapter 5)</i></p> <p>Shareholder Activism through <i>Active proxy voting (see Chapter 6)</i></p>	<p>SRI Approaches Will Generate <i>Above</i> Market Returns</p> <p><i>Environmental, social, and governance factors within companies are such important drivers of performance that investing based on these factors can generate market-beating returns in the process of affecting positive social change.</i></p>

Figure 1.1 Three Perspectives on SRI Returns

Source: TIAA-CREF

On the far left of Figure 1.1 Perspective 1 describes positive social impact requiring sacrificing returns to some degree. Examples of this perspective would be some of the community or microfinance investments that pay investors 0 to 5 percent interest. This type of return is below what a market rate of return would generate for the structure and level of risk of these investments. The perspective of the managers of these investments is simply that the investor needs to give up some level of return to achieve the positive social impact of these investments. One possibility for this scenario might include investments that target populations or geographies that could not readily be served if higher rates were paid to investors.

On the far right of Figure 1.1 Perspective 3 describes positive social impact generating returns that are better than market averages. Examples of this perspective would be a socially screened fund that focuses on good corporate governance practices. The supposition for such a fund might be that investors could reap returns better than the broad market from which the fund is considering investments by selecting only stocks of companies with

strong corporate governance records. Similar examples could come from looking at a wide range of ESG factors in social screening strategies or in community investing options that might generate market-beating returns through investing in highly profitable projects or institutions that are simply overlooked by the mainstream, possibly even because of their positive social impact.

Perspective 2 in the middle of Figure 1.1 describes positive social impact being achieved through SRI strategies with generally competitive returns that are essentially on par with comparable non-SRI alternatives. This is the balanced perspective of *Compelling Returns* discussed in Chapters 4 through 6 on specific SRI strategies. In addition to the evidence presented in these chapters, I believe there are significant drawbacks to the other two perspectives.

For the perspective that high social impact will or should entail sacrificing returns, I see two main limitations:

- First, while the underlying social need may be valid, below market returning investment strategies cannot attract capital from many types of investors. Certain institutional investors, such as many pension funds, for example, simply cannot consider below market rate options for their portfolios (e.g., in the case of pension funds, for regulatory reasons). Also, many individual investors may simply find the trade-off of returns financially difficult to accept or justify. Thus, the resulting pool of funds willing to accept below market returns is vastly smaller than the pool available from mainstream investors and the capital markets. The scope of many social and environmental problems, however, will remain large.
- Second, in my experience, it is often unclear whether the subsidy (i.e., the amount of return an investor is giving up versus a “market” rate of return) does in fact achieve higher social impact. Within microfinance investing, for example, there is frequent lending to microfinance institutions (MFIs) at below market rates. It is not clear, however, whether these subsidies are used by the MFIs to further specific social goals that would not otherwise be met. It is possible, for example, that the subsidy simply compensates for other factors such as high loss rates or low efficiency within a poorly run lending model.

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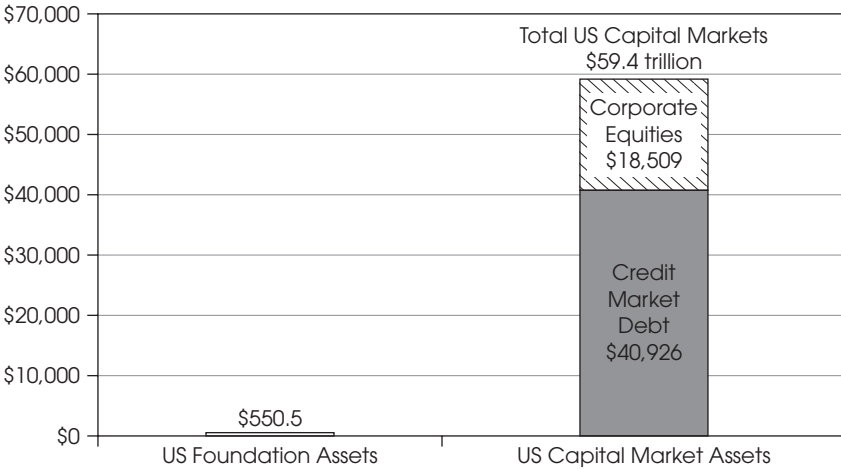


Figure 1.2 Foundation Assets versus Capital Markets

Source: Foundation Growth and Giving Estimates: Current Outlook, 2007, The Foundation Center Flow of Funds Accounts of the United States, 1995–2006, Board of Governors of the Federal Reserve System. Data are for 2005.

Figure 1.2 provides added perspective on the issue of tapping the capital markets. Figure 1.2 shows that one of the largest pools of possible capital for below market investments—\$550 billion in invested assets of U.S. foundations—are dwarfed by the \$59 trillion in U.S. capital market assets, or more than 100 times the size of the former. However, the capital markets would not be a likely source of financing for below market rate SRI strategies. Again, given the immense nature of most social problems, SRI strategies that target the latter source of funds are more likely to achieve scale and broader social impact than those that do not.

Thus, the hypothesis that SRI strategies should entail sacrificing returns is not being covered in this book. There are however references to some of these strategies in Chapter 5 and in Appendices D and E on community investing and microfinance respectively.

The perspective that some SRI strategies, such as the use of certain ESG factors in building investment portfolios, can produce *better* returns than market averages is also not covered here. To understand this perspective, consider the case of a socially screened fund made up of companies based on how well they score on certain ESG criteria. The managers of this fund might

believe that this fund would actually generate better returns than the market overall. Most likely, they would rely on investment logic such as:

- Companies with sustainable business models may be a better financial investment than ones that are not based on sustainable practices.
- Better governed companies may have a generally better record of CSR and may be a better financial investment than ones that do not have such a record.
- Companies that make certain products (e.g., renewable energy) may be a better investment than ones that make other products (e.g., tobacco).

While I believe there is a very strong case to be made for investing in sustainable, better governed companies, this is a very different proposition than claiming that such a strategy will allow you to beat the market. To highlight the differences between these two concepts, consider the following observations.

- As discussed in Chapter 2, in many stock and bond markets around the world it is difficult for investment managers to beat the market averages. In financial terms, these stock and bond markets are considered relatively “efficient” at incorporating all available information into the prices of the stocks or bonds. In these markets, achieving the average returns of the market, whether through an SRI-related strategy or not, is a good deal for most investors.
- To the extent that an SRI strategy emerges that does beat the market averages, this strategy will eventually be duplicated by pure profit-seeking investors until this “information advantage” ceases to produce added returns. As an example, mainstream institutional investors are already aware that potential environmental liabilities or assets can be a driver of stock valuations.
- Lastly, some popular mainstream investment strategies, such as “deep value investing,” may involve investing in companies with temporarily depressed stock prices, sometimes due to

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ESG issues. Most SRI strategies in public stocks would, by definition, not buy these stocks, yet this is a common investment strategy for adding some value in certain markets.

Fortunately, the middle perspective on SRI returns is well supported: many SRI strategies have delivered positive social impact and competitive returns roughly on par with conventional investments. This is a good financial deal for investors and that good deal becomes compelling when in combination with positive social impact.

Finally, Figure 1.3 summarizes why I believe this middle perspective will also lead to greater growth in SRI strategies overall. The left-hand side of Figure 1.3 shows the results of competitive returns: broader acceptance of the funds and large pools of capital. This in turn leads to economies of scale and lower costs (which helps keep returns competitive) and continues the access to larger pools of capital.

Conversely, the right-hand side of Figure 1.3 shows the limitations of below market strategies: limited acceptance and smaller pools of capital. This in turn leads to limited economies of scale

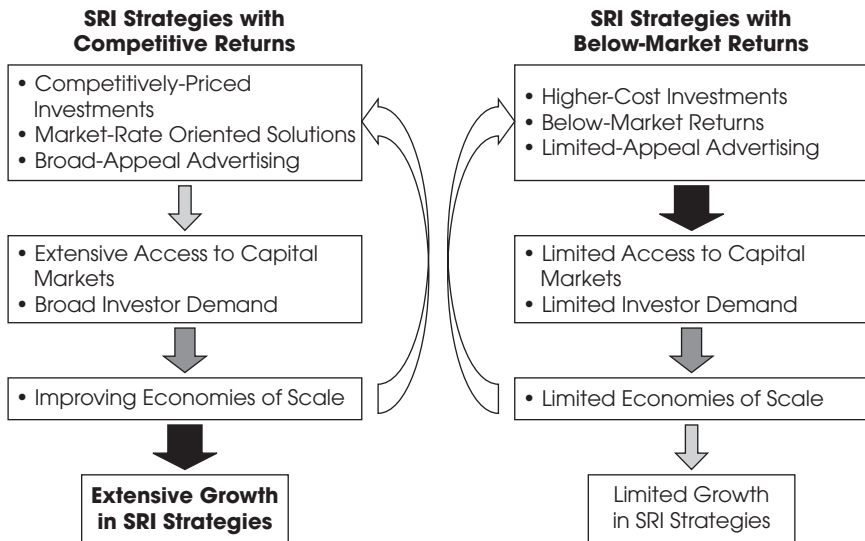


Figure 1.3 Two Routes to SRI Growth

and higher costs—both of which make generating competitive returns that much more difficult. In discounting this perspective, however, I should provide a clarification; this perspective is not the same as saying that all social and environmental problems can be solved with SRI solutions generating competitive returns. Many important social, environmental, and governance issues cannot be addressed with investment approaches geared toward competitive returns. Certain problems are simply better addressed through other strategies such as government programs or foundation grants.

Thus, while the SRI strategies discussed in Chapters 4 through 6 may not be able to address all ESG issues, I believe these are some of the strategies that will be most favored by SRI-oriented investors and will experience the most growth in coming years.

Summary and Next Steps

Chapter 1 covered the main SRI strategies available to individual investors: social screening, community investing, and shareholder activism. In response to the trends stimulating SRI growth discussed in the preface, Chapter 1 discussed the response of individuals and organizations with new companies, products, services, standards, and associations, all with an SRI focus. The result is that individual investors looking for SRI strategies have more options than ever before.

Importantly, the jury has essentially come in with the verdict that competitive returns have been achieved in these three strategies. This is fortunate for investors who do not need to face a trade-off between their SRI strategy and personal financial goals. Competitive returns are also good for the future growth of SRI as they will attract a wider range of investors and deeper pools of money.

SRI-oriented investors can now consider some investing basics (in Chapter 2), how they align with some broad SRI goals, and then each of the SRI strategies in greater detail (Chapters 4 through 6).

