

SURVEY - MASTERING INVESTMENT: The bottom line to a social conscience

Financial Times; Jul 02, 2001

By GEOFFREY HEAL

Restrictions on socially responsible investors appear to limit their potential financial success. However, Geoffrey Heal finds that ethical funds may in fact perform better than average

Socially responsible investors hope to do well by doing good. They seek to harness their influence in capital markets to social goals that transcend return on investments, so strengthening incentives for ethical fund management. Socially responsible investing (SRI) is widespread and growing in the US and trends appear to be similar in other markets. According to criteria set out by the Social Investment Forum, in 1999 one dollar in every eight under professional management in the US was invested in an SRI fund, a total of Dollars 2,160bn, up more than 80 per cent from Dollars 1,185bn only two years earlier. Already large enough to be influential, SRI funds could soon become a major factor in capital markets at anything like recent growth rates.

The growth of these funds raises two major issues. How well are they doing and are they doing good? This article addresses these issues.

Socially responsible investing

Socially responsible investors have diverse goals and correspondingly varied definitions of social responsibility. Although the movement originated in the campaign to divest from South Africa, where the anti-apartheid campaign emerged as the first political movement to enlist investors ideologically, current targets of SRI funds typically go beyond a single issue.

Most SRI funds do not invest in companies that make or sell armaments, alcoholic drinks or tobacco products. Many funds avoid companies with a poor environmental record or those thought to exploit labour in developing countries. Funds with investors of a religious persuasion eschew companies promoting gambling or running casinos. Animal rights also affect the targets to be avoided. Indeed, it is safe to say that each ethical viewpoint championed by an active non-governmental organisation has an investment fund to support its aims.

This is a new and growing source of business and of competitive advantage. It has reached the point where a management company without an SRI fund is at a disadvantage in the US pension fund market.

The best employers have traditionally offered staff a choice of methods for investing defined contribution funds and understand that many value the ability to choose an SRI fund. A fund manager whose product line includes growth, income, international and large-cap but no SRI fund is unable to offer the full range, so we see a proliferation of offerings. This is a business move and does not imply that the management companies sympathise with the social aims of the funds. To most of them, social goals are just constraints placed on their portfolio choices. Indeed, a management company may run funds with contradictory goals.

The growth of SRI is a natural extension of a phenomenon already well established in retail markets to capital markets - the use of consumer buying power to attain social goals. Anita Roddick popularised this trend in the UK with the Body Shop and the US outdoor clothing brand Patagonia has had similar success. McDonald's and Nike have suffered from it and learned to come to terms with it. This movement is particularly influential in the human rights and environmental fields, where major clothing and shoe brands, Nike prominent among them, have been boycotted for their use of sweatshop

labour and oil companies such as Shell have been punished for their alleged environmental transgressions.

Companies selling to highly educated and socially aware customers with a global viewpoint can expect this to continue and indeed become more widespread: it is natural for these customers to link consumption choices to political beliefs and actions.

In 1994, The Economist spoke of "the era of the corporate image, in which consumers will increasingly make purchases on the basis of a firm's role in society: how it treats its employees, shareholders, and local neighbourhoods..." In many respects SRI is simply an extension of this process to capital markets: aware investors are looking at all dimensions of their choices.

These developments have led to the growth of a closely linked industry providing the data on which socially responsible funds base their choices. Until recently a manager could not look up a company's environmental or human rights record online in the same way as its credit rating or its earnings forecasts. Now this is possible through companies that specialise in providing the data for managers to screen investments and assess their consistency with a fund's goals. Some go beyond this and compile lists of companies rated by financial and environmental performance, for example, the Innovest group. Dow Jones, the doyen of financial indices, joined this trend several years ago by introducing its Sustainability Index. This ranks companies according to criteria believed to assess the sustainability of their contributions to society. The Financial Times has recently announced that the FTSE will introduce a range of indices covering corporate performance on environmental issues, human rights, social issues and relations with stakeholders. Even for managers not running SRI funds, this extra information adds value. It provides a broader picture of a company and its relationship to the outside world than is available through conventional financial indices.

The cost of virtue

Economists might think that there would be a cost to the limitations imposed by an SRI approach. After all, they believe there is no free lunch - everything good comes at a cost. So SRI funds should in principle offer lower returns than those without any constraints on their portfolio choices. Surprisingly, this does not seem to be the case.

Several studies claim to show that SRI funds offer returns as good as those on other funds and, indeed, that performance on environmental and human rights criteria is a good predictor of the overall financial performance of companies. The studies supporting the stronger of these claims leave something to be desired in terms of statistical rigour, but the basic data do, to a considerable extent, speak for themselves.

For example, the Dow Jones Sustainability Index outperformed the Standard & Poor's 500 over the 1990s by about 15 per cent. Innovest's website reviews performance data and concludes that, "depending upon the sector, companies with above average EcoValue '21 ratings have consistently outperformed lower-rated companies by 300 to 2,500 basis points per year." Data from Morningstar, a company that rates mutual funds, show that SRI funds on average have earned higher returns than others.

Figure 1 on page 4 shows the Goodmoney Industrial Average and the Dow Jones Industrial Average since 1977. Goodmoney is an index of 30 shares chosen to cover the same industries as the shares in the DJIA but screened according to ethical criteria. The picture here is similar.

Each of these numbers refers to averages. They suggest there is no cost to socially responsible investing. On average, there may even be a gain. But few investors or managers aim for average performance, whatever they eventually attain. And the very top performers are usually not SRI funds, so there may possibly be some cost in terms

of a reduced probability of a very high return.

The performance of SRI funds is a puzzle. While they are not among the top performers, they do perform above average. Given the constraints on stock selection posed by ethical guidelines, this is surprising. As noted, several recent studies report that environmental and human rights performance is a good predictor of overall performance. This is an interesting and suggestive point. There are several possible reasons for the performance edge that SRI funds appear to provide.

One is that technology stocks meet their screening criteria - the likes of Intel and Microsoft are free from association with pollution, exploitation, alcohol and tobacco - so SRI managers have inadvertently been steered towards the sector that has performed best in the recent bull market.

If this were the entire explanation, it would imply that the superior performance is a coincidence that may not be repeated. However, data indicate that there is more than an accident at work here. Even on a sector-by-sector basis, shares of companies with a superior environmental or human rights record appear to outperform. Clean chemical companies will outperform dirty ones, clean oil companies will outperform dirty oil companies.

This type of finding suggests a deeper and more intrinsic connection between responsible management and superior returns. In the case of the environment, academic Geoffrey Heal has pointed to evidence that superior performance is indeed linked to higher profits. Pollution is waste, and cutting back on or finding ways to reuse waste feeds back to reduced inputs and higher profits. Dow Chemicals, DuPont and Anheuser-Busch have all found improved environmental performance to be a source of profits.

A similar effect may be at work with human rights: paying workers a living wage and protecting them from harassment may cost a little more in the short run, but if it improves morale and reduces turnover then it may still be good for profits after a few years. So socially responsible management practices may contribute directly to profits.

A recent statistical study by academics Glen Dowell, Stuart Hart and Bernard Yeung is consistent with this interpretation. They looked at the environmental performance of US companies operating in developing countries, where environmental standards are lower than in the US. They divided the companies into three groups that:

- * use US standards in their home operations and lower standards in developing countries;

- * use US standards worldwide;

- * adopt a standard worldwide higher than that mandated in the US.

If environmental compliance were a cost, other things being equal, one would expect the first group to be the most profitable and the third the least. In fact the authors found the opposite to be true.

This and similar findings lead them to suggest that capital market valuations incorporate the negative social costs of a company's operations. To Dowell, Hart and Yeung, higher environmental standards are a sign of state-of-the-art equipment and of alert management, all presumably contributing to financial performance.

A rather different argument for superior performance of SRI funds stems from consumer behaviour, suggests academic Peter Singer. The increasing use of consumer buying power to attain social goals has already been mentioned. The obvious implication for

profits is that companies boycotted by consumers will lose market share to competitors who enjoy a better image.

Socially responsible buying is thus able to lay the foundations for successful socially responsible investing. Companies failing ethical screens will lose sales and at the same time, and for the same reason, SRI funds will stay away from them. Socially responsible investors reaping what they have sown as socially responsible consumers produce a self-reinforcing process.

This makes sense from another perspective. Standard advice to individual investors is to invest in companies whose products you know and like. It is a simple step from this sound and sensible advice to saying "Don't invest in companies that people like you will shun."

The impact of SRI

Socially responsible investors appear to be attaining their goal of doing well. The performance of SRI funds seems to be at least above-average. But are they also doing good? Are they attaining their ethical goals? What may seem like a rhetorical question in fact requires examination. Assume that SRI funds attained their above-average returns simply by investing substantially in technology stocks. In this case their ethical leverage has been minimal. They have run with a successful sector, delivering no specific ethical message to managers.

If we adopt another of the theories, that superior environmental and human rights performance pays off financially, and that ethical investors have benefited from this, it is again not clear that the success of SRI funds has given an ethical message to managers. In this case, manager's incentives to act ethically have been primarily conventional, not linked to the behaviour of SRI funds.

Finally, assume that ethical investors are reaping what they have sown as ethical consumers and that the behaviour of consumers in favouring retail companies with superior ethical records has contributed to the superior financial performance of these companies. In this case, there is an argument that the combined operations of ethical consumers and investors have had an impact on corporate behaviour. The truth probably contains some of each of the last two arguments, so that ethical investors have had an impact, possibly small, on corporate behaviour.

There are in fact two ways in which SRI might influence company behaviour. The most obvious, alluded to in the previous paragraph, is through the cost of capital. A company that is out of favour with investors will have to pay more for capital, either by issuing more shares or by paying higher interest rates. Over and above this is the mechanism of shareholder advocacy. Corporate law in the US, and indeed in most countries, allows shareholders with a minimal stake in a company (Dollars 2,000 in the US) to place items on the agenda of shareholder meetings and require that a vote be taken on these matters at meetings. This is a powerful mechanism for embarrassing management about alleged ethical failures. The annual meetings of large corporations receive wide press coverage and these critical resolutions produce negative publicity, possibly leading to boycotts and diminished retail sales.

Shareholder advocacy has been used to great effect by large institutional investors, such as the College Retirement Equities Fund in the US, as a route to more open corporate governance. Large investors have influenced corporate policies on such matters as chief executive succession, board membership and poison pills. Ethical investors can use the same route. According to a report by the Interfaith Center on Corporate Responsibility, in 1999 SRI managers filed about 220 resolutions with more than 150 US companies. The largest number covered environmental issues, with equity and corporate responsibility taking the next two places.

A notable success was the decision by Home Depot, a major US DIY outlet, to stop buying mature wood from endangered forests. In this case, shareholder activism was accompanied by a consumer boycott organised by rainforest-related NGOs. Baxter International, a maker of health care products, also agreed to stop using polyvinyl chloride in some of its products. PVC releases carcinogens when it is burnt. Chevron and Exxon are facing similar actions intended to force them to abandon plans to drill in the Alaskan Arctic wildlife refuge.

Through these and other examples, SRI funds do seem to be influencing corporate policies through shareholder advocacy, although the effect of shareholder advocacy alone is perhaps limited: it appears to be most effective when accompanied by a credible threat of consumer responses. The responsible consumer and the responsible investor form a team that is more than the sum of its parts.

Conclusions

Socially responsible investors are a significant presence in capital markets. The amounts in SRI funds are large and growing. What are SRI funds seeking, over and above a competitive return? What returns are they actually achieving? What impact have they had to date, and how might this change if the practice spreads?

The aims of SRI funds are as diverse as the aims of political pressure groups and non-governmental organisations. There are funds for all persuasions. A company might appeal to some but be anathema to others. There does seem to be general agreement among funds on a set of criteria that are used to define social responsibility. Weapons, pollution and abuse of human rights are all seen as unethical as, often, is gambling. Executives who want to court socially responsible investors should place their corporations strategically on these issues.

On average, socially responsible funds have performed well. There are several possible explanations for this and whether this is likely to continue depends on which are valid. An interesting possibility is that socially responsible behaviour proxies for general managerial competence and several studies seem to confirm this. There is also the fact that socially responsible investing interacts with similar behaviour by consumers, each reinforcing the former. This is part of the process of consumers thinking about all dimensions of their choices.

It is not clear yet what effect SRI is having. Certainly shareholder activism by socially responsible investors, along with consumer activism, has affected the choices of influential corporations. However, socially responsible funds adopting a passive role towards their shareholdings may have little influence beyond a minor reduction in the cost of capital to favoured companies.

Further reading

The Economist (1994) "Brand new day", June 19, 71-72.

Heal, G. (2000) "Environmental disaster: not all bad news", Financial Times, October 30.

Dowell, G., Hart, S. and Yeung, B. (2000) "Do corporate global environmental standards create or destroy market value?", Management Science, August, 46, 8, 1059-1074.

Singer, P. (2001) "A buoyant market for ethics", Financial Times, March 12.

Websites:

Social Investment Forum (www.socialinvest.org)

Innovest Group (www.innovestgroup.com)

Dow Jones Sustainability Index ([www.](http://www.sustainability-index.com)

[sustainability-index.com](http://www.sustainability-index.com))

Geoffrey Heal is Paul Garrett Professor of Public Policy and Corporate Responsibility and a professor of economics and finance at Columbia Business School.