SRI: An Exploration of Social Responsibility in the Investments Landscape

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Introduction

Social responsibility and ethics have been knitting themselves into the fabric of economics and investments for generations; however, like the evolution of the modern computer, the velocity at which this has happened has increased exponentially over the past few decades. Despite the fact that the popularity and high availability of socially responsible investments are more recent than not, the roots of social responsibility within investing are planted in biblical times where Jewish law dictated guidelines on how to invest ethically.1

The concept of socially responsible investing, or SRI, was likely brought to America by Methodist immigrants, who have been observed using “social screens” for over two hundred years, advocating against investing into such societal afflictions as slavery and war. The modern roots of SRI, however, can be found in the twentieth century. Societal turbulence at both the domestic and international levels throughout the century led to a public outlash against war and led to a push for such issues as human rights and equality for women.2 As time went on, the scope of social responsibility propagated to smaller, more specific issues, such as human working conditions and environmental health.

The period between the 1970s and the present day is when the concept of SRI truly started to spread rapidly. One powerful example spawned from the apartheid in South Africa. This dark time in South Africa’s history can be viewed as one of the first phenomena that caused large, globalized corporations to re-route investment flows for ethical reasoning. This economic boycott lasted for two decades, until the first democratic elections were held in South Africa, and had a great impact on the transformation of the region.

In 1982, Trillium Asset Management opened its doors in the United States as the oldest independent investment advisor devoted exclusively to sustainable and responsible investing. This can be seen as a landmark achievement in the field of SRI, as it set the standard for all devoted SRI firms that followed.

More recently, between 1995 and 2000, the amount of money professionally managed in the United States that employed any type of social investment strategy increased 900% from $162 billion to $1.5 trillion and represented 1 in every 8 dollars under professional management in the U.S at that time.3 Since then, the amount has doubled, crossing the $3 trillion mark in 2010.4

The conclusion is clear; SRI has emerged as a legitimate investment priority for many, but what does socially responsible investing truly mean? What are the different types? Are there differences in SRI as we traverse the globe? How successful has SRI been for its investors? This paper investigates all of these elements and aims to produce a better

understanding of the global SRI phenomenon, as the rapid proliferation of social responsibility leads one to believe that it will have an even larger role in the future investment landscape.

Socially Responsible Investing Explained

The definition of socially responsible investing might seem rather intuitive and uniform; the goal of this section is to prove that it is not. The array of different genres, ideologies and titles that are used to define SRI are vast. Why is it necessary to better understand SRI? In the words of Elaine Sternberg, the president of a consulting firm specialized in business ethics, “The broad range of everyday business decisions are simultaneously economic and ethical ones”\(^5\). Investments have the power to change the world, but it is important to understand the direction and magnitude of these changes.

One complete definition does not exist, but the core creed of SRI is the following: invest in companies or activities that can benefit a community or society in general; do not invest in companies that somehow detract from society, such as support for pornography, offensive advertising, environmentally damaging practices, countries with oppressive regimes, tobacco, alcohol, gambling, unnecessary exploitation of animals, abortions, armaments, unsafe products and services, or other ideals that are generally accepted to be detrimental to the human race. Also, one can observe from the chart below that there can sometimes be semi-permanent themes that will eventually cycle out. For instance, as of 2010, the Sudan conflict led all SRI criteria in net assets, but in the 1970s, the South African apartheid probably took priority over most. Other ideals, like tobacco and gambling, permanently reside in this definition for many people and organizations. The definition of SRI and the manners in which SRI are upheld by investors get more complicated, however, as will be observed in the next section. As it turns out, socially responsible investing may not even be an appropriate title at all.

![Most Avoided Topics in SRI](image)

**Source:** Social Investment Forum Foundation  
**Note:** Data are aggregated across all investment vehicle types, including separate account vehicles.

There are essentially three main ways to invest with social responsibility in mind. The first is exclusionary investing, where investors refuse to give money to companies that represent values contradictory to those of the investor. The second is activist investing, where an investor can either take the approach of investing in a company whose ideals he agrees with, or investing in a company that he does not agree with in order to become a shareholder in that company and therefore have an influence (even though most likely a small one) in the activities of that company. Finally, there is community investing, where money is invested into a community investment group, and unlike charity, produces an interest payout to the investor. The order in which these are explained reflects their popularity, as exclusionary investing is far and away the go-to method of the current SRI trend.

The concept of “screening” is closely tied with each of these investment methods, as screening pre-selects criteria that will either eliminate an investment from contention or identify it as worthy. Screening decisions, however, are completely dictated by the goals of the investment. One investment may run screens to avoid tobacco companies while another may invest heavily in tobacco, as long as it is made without the use of nuclear power. So, what is it that drives people to invest “responsibly” in the first place?

Unlike traditional investments that have responsibilities limited to simply making a profit in one way or another, socially responsible investments transcend the realm of finance and delve into our physical and emotional makeup. There is a piece of each investor in every socially responsible investment; therefore there is almost always some level of emotional involvement with SRI. A survey conducted on 660 members of an SRI organization revealed a variety of reasons behind investing motives, but three main groups of reasoning were represented. Deontological reasons were mentioned, where a religion or defining characteristic of ones self makes it his or her “duty” to invest responsibly. Consequentialist thinking was also uncovered, where people are attracted to a final result that can come from the investment, such as the alleviation of poverty in a certain region. Also, Eudaimonic reasons, where it is simply a good thing to do, were cited6. What the three reasons hold in common is the fact that the investor bases his or her investment decision on values that were instilled through upbringing, religion, life experiences, etc.

So, what exactly is fueling this growing trend of SRI? Did humans’ ethics and beliefs not have an impact on decisions in the past? Although it is most likely impossible to pinpoint an exact answer, a variety of partial answers exist. Easy access to information is probably the most important factor in the rapid-fire proliferation of SRI. Investors are better educated and informed today than in the past, and it is only rational to believe this trend will continue. Social research organizations observe that the better informed investors are, the more responsible their actions tend to be. In addition to abundant levels of information, women have been gradually moving away from a domestic existence to the workforce, into higher education programs and have generally been working their way up the ladder in organizations. It has been observed that women bring with them a natural affinity to SRI, as women comprise the majority of socially responsible investors. A third partial answer is the fact that investors no

longer need to separate the concepts of helping society and investing for a return, since there is 
abundant evidence that socially responsible investment performances keeps up with those of 
non-socially responsible investments⁷, as will be seen later.

Although socially responsible companies are now receiving more investment than ever 
before, which is a nice reward for simply being socially responsible in one way or another, 
Harvard Professor Michael Porter’s Theory of Shared Value states why all companies should 
have some form of social overlay in their practices and management. In short, as illustrated 
below, corporations need healthy vibrant communities to create demand, just as much as these 
communities need healthy competitive companies to create the jobs and support the 
community.

![The Big Idea - Creating Shared Value](image)

Source: Harvard Business Review - Creating Shared Value

**Definition Challenged**

Briefly returning to the ideals and goals of socially responsible investments, it has already been 
highlighted that the definition is broad. It has also been outlined that various SRI goals can 
differ greatly from one another, depending on the underlying motivation, religion or other driving 
force. A general sense of what it means to be socially responsible is rather universal, whether 
or not people choose to partake in the effort. So, with all of this money, energy and sentiment 
dedicated to the phenomenon, are socially responsible managers and investors truly devoted to 
the cause and doing it right?

To start, the words ethical and socially responsible are often used interchangeably, yet 
they have very different connotations. For example, investing in a condom company may be 
socially responsible since it has the ability to abate the transmission of life threatening diseases

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and therefore increase the wellbeing of populations. However, condoms would most certainly challenge many religious people’s definition of what is ethical because it effectively neutralizes life. It is therefore important to realize that wording alone can change the definition, and there will be times when one has to choose whether he or she wants to invest ethically or in a socially responsible manner.

It is relatively easy to prove that socially responsible investors are not fully devoted to the cause of social responsibility or the collective human condition. For one thing, they are called socially responsible investments for a reason: the investors are not willing to simply make a charitable donation; they want their money to return a profit. This is, of course, very understandable, as people can not afford to give away all of their money. However, how dedicated to the cause are they really? A study was conducted in Europe in the 1990s that sought to investigate the growing trend of “ethical” investing by interviewing members of two social investment funds. In one of the funds, all of the participants described themselves as Christians and highlighted that their faith was the driving force behind their investment choices. Although a variety of reasons were mentioned as motivations, many rooted in Christian teachings, it was apparent from the interviews that their motives were, at best, mixed with self-interested return motives. In addition, for the majority of those interviewed, 5% or less of their savings was dedicated to the cause\(^8\), which would hardly qualify as substantial. The investors were then asked about corporate behaviors that they found to be reprehensible and many of the criteria in our working definition were uncovered. For example, one investor finds it to be unethical to invest in an arms company and consequently decided to invest £25,000 in Friends Provident Stewardship, an ethical trust that does not invest in arms companies. Upon closer examination, this investor also has substantial holdings in the Foreign and Colonial investment trust, which invests in arms manufacturers. Although only one in ten investors actually admitted to having a contradicting investment pattern, nearly 50% admitted to investing in companies that are very clearly perceived as non-ethical. A justification was attempted by members of one of the investment funds to explain the contradictory behavior. These investors stated that their values had changed over time, for the better, and that they had not yet gone through the process of divesting from their old unethical assets, for one reason or another\(^9\). Some of the participants in the survey went even as far as to say that they would be fine taking a loss on their ethical investments and actually expected this to occur. Rational choice theory, which refers to maximizing one's efforts through a clear headed, rational process, would scold this type of behavior, as would most investors.

From a management standpoint, it is clear that some investment managers running socially screened portfolios are at least largely in it for the profits and not for the greater effect this type of investment may have. Out of the over 800 investment management firms in the United States that identify themselves as running socially screened portfolios, the vast majority not only did not do so a decade ago but also had no interest in doing so. The evidence points to

\(^8\) Mackenzie, C & Lewis, A, “Morals and Markets: The Case of Ethical Investing”, pg. 442.

client retention as the principal reason for developing screened portfolios\textsuperscript{10}, which is clearly a conflicting motive to the fundamental principals of SRI.

Both the definition and the process of SRI have some serious inconsistencies and are not solely based on altruism. In many cases, an investor does not come up with a clear plan on how to invest responsibly and may neutralize the benefits of his or her SRI investments with conflicting investments. Some even know and admit that their “irresponsible” portion eclipses the net benevolent effect of their responsible portion on a dollar for dollar basis. A proponent of SRI can argue, however, that baby steps forward are better than no steps at all.

Do Socially Responsible Investments Keep Up?

The last section highlighted the fact that some people actually expected to take a loss on the socially responsible portion of their portfolios, as if these investments do not have a chance of keeping up with traditional, unscreened investments. Portfolio theory seems to be on the side of these pessimistic investors, as it suggests that constraints (in this case social screens) inhibit the full potential of an investment by restricting its investment universe and would therefore interfere with the wealth maximization concept in mainstream finance\textsuperscript{11}. Some experts, however, argue that studies have shown positive relationships between corporate social responsibility and financial performance\textsuperscript{12}. Is it, therefore, possible for a socially screened investment to achieve comparable returns to unscreened investments? The evidence overwhelmingly concludes that socially responsible investment performance does actually keep up with conventional investments, both in the United States and abroad.

A study was done in Europe to support this conclusion, using a comprehensive sample of 88 socially responsible funds from seven European countries. The funds that were tested invest globally and both traditional and conditional models are used in their evaluation. The conditional model goes a step beyond traditional performance measures to incorporate the time-variation of risk and time-varying estimates of performance depending on economic conditions. The test also analyzed the funds at the individual fund level and at the portfolio level, using an equally weighted portfolio of funds for each country and fund category. The study found the performances of these socially responsible funds comparable to conventional funds. The study offered up a partial explanation as to why the funds did well despite being constrained: since there is decent evidence that social responsibility can lead to higher profits, socially responsible screening practices may allow fund managers to identify companies with the best profit potential\textsuperscript{13}. This study was published in 2009.

The performance of socially responsible mutual funds in the U.S. was analyzed in a separate study. The data used for this experiment is slightly dated, having a focus period of 1997-2005, however it also serves as evidence in support of SRI performance. A sample of 86

\textsuperscript{10} Schueth, S, “Socially Responsible Investing in the United States”, pg. 192.
\textsuperscript{12} Cortez, M. C, Silva, F & Areal, N, “The Performance of European Socially Responsible Funds”, pg. 574.
\textsuperscript{13} Cortez, M. C, Silva, F & Areal, N, “The Performance of European Socially Responsible Funds”, pg. 575.
SRI funds and 1761 conventional funds were selected from a survivor-bias\(^{14}\) free U.S. mutual fund database and were tested using a four-factor alpha model\(^{15}\). The results show that not only did SRI constraints not hold back funds’ before-fees performances, they actually helped them to outperform by 0.96-1.83% per year before expenses. Even though the results state before expense results, the study does not find statistically significant differences in the fee levels of SRI funds as compared to traditional funds. Other important observations were also derived from this study. First, SRI funds experience lower turnover, meaning they hold their investments longer. This could mean that reduced trading fees contribute to their positive outcome. Second, similar results were obtained for funds that have both heavy and light SRI screening. Third, SRI funds have a smaller exposure to the momentum factor\(^{16}\) of investing overall, suggesting that they may be a more stable investment from a risk-taking standpoint. Fourth and possibly most important, SRI funds managed by generalist companies (companies that do not specialize in SRI) actually underperform their non-screened counterparts, although not by statistically significant amounts. This translates to dedicated SRI firms’ funds outperforming by more than 2.6% annually (dedicated being defined as having 75% of total assets under management or more in socially responsible strategies)\(^{17}\).

A separate study looked at Canadian SRI mutual funds, using similar methods and a similar time frame as the European example, yields a conclusion of statistical insignificance in performance differences, consistent with the European study\(^{18}\). One done in Australia, however, over a longer timeframe (1986-2005) yielded negative results for SRI funds. Over the entire timeframe, Australian SRI fund underperformance averaged .88%, whereas underperformance was 1.52% for just the 2000-2005 period, showing that timeframe selection is most certainly a factor here and in all other studies, as it would be in the evaluation of any investment’s performance.

Regardless of timeframes, what these studies prove is that investors can certainly find SRI funds that are comparably priced or even cheaper than traditional funds\(^{19}\). The studies also prove that SRI funds have the potential to outperform traditional funds over certain meaningful timeframes. Below is an illustration that further supports this second point, as it portrays the FTSE KLD 400 Social Index\(^{20,21}\), a leading SRI index, experiencing longer term returns superior

\(^{14}\) Survivor Bias refers to the tendency for mutual funds with poor performance to be dropped by mutual fund companies, generally because of poor results or low asset accumulation.

\(^{15}\) A four factor alpha model is a financial model that employs four factors in its computations to explain market phenomena and/or equilibrium asset prices.

\(^{16}\) Less exposure to the momentum factor in this instance implies less reliance on consistently positive market movement in order to extract returns.


\(^{20}\) The FTSE KLD 400 Social Index is a social index designed to provide exposure to the common stocks of companies that KLD determines have positive Environmental, Social and Governance (ESG) characteristics. The KLD400 consists of 400 companies drawn from the universe of the 3,000 largest U.S. public equities as measured by float-adjusted market capitalization. The index is composed approximately 90% of large cap companies, 9% mid cap companies chosen for sector diversification, and 1% small cap companies with exemplary social and environmental records.
to those of the S&P 500 index. The period represented in the illustration is a 23 year period from 1990 through 2012, however it is clear that if multiple sub-periods from this range were examined separately, they would produce similar results, indicating that the outperformance in this example is not simply a long term phenomenon.

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** No dividends or coupons

### Conclusion

The paper serves to explore the growing investment trend of socially responsible investments, to shed light on their methods and facts and to assess their ability to compete with non-restricted investment vehicles and indices. Although less abundant in the mutual fund space than other investment vehicles and not always used in efficient manners, socially responsible investments, regardless of their specific screening criteria, seem to give the investor an added degree of investing purpose, since he or she now has two goals for the investment: returns and a larger-scale social impact. In some cases, this enhanced purpose reduces the return requirements of the investors and in some cases, social responsibility is used as a tool by investment management firms to target customer sensitivity and retain/augment business levels. However, just because some do not require competitive returns does not mean they cannot achieve them. This paper perused several studies that not only use significant sample sizes but also utilize several different calculation factors and countries of origin and find strong

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22 An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

23 The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.
evidence that suggests socially responsible investments are not handicapped due to their investment restrictions. In addition to this, in the first half of 2012, the Social Investment Forum released an analysis of 160 socially responsible mutual funds from 22 companies. It showed that 65% of SRI funds in all asset classes beat their benchmarks the prior year, with 72.6% of the 73 large cap funds beating the S&P 500 index by more than 6% on average. The majority beat the benchmark in 3 and 10 year periods as well. What remains a mystery is the extent to which SRI has been effective in changing the world given the near-impossible task of quantifying such an occurrence.

As society continues to amplify its level of social awareness, so too will the investment world. Given the benefits social responsibility can have at the corporate and community levels, it makes sense for socially beneficial transformations to occur on a grand scale. Of course, there will always be those opposed to this movement’s philosophy or implementation. Nobel Prize winning economist Milton Friedman once wrote in the New York Times: “The social responsibility of business is to increase its profits”. He then explained that social responsibility is a socialist tendency hostile towards free society and free markets and stated that giving money to charity or other social causes is akin to stealing from stockholders. However, as one can see from the South African Apartheid, the role of corporations in society is more important now than ever before, so the manner in which they operate affects much more than just their own balance sheets, both from an economic and cultural standpoint.

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23 “Socially Responsible Mutual Funds Outperformed in 2009”, pg 1.
24 Hellsten, S, & Mallin, C, “ Are 'Ethical' or 'Socially Responsible' Investments Socially Responsible?”, pg. 396.
Sources


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