SRI: A Primer

By

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Introduction

Despite the recent plethora of news on SRI, it is not an investment fad. It has been around longer than most investors realize and is constantly evolving along with the ever-changing social/environmental/ethical/human rights issues across the globe. This primer is meant to give one a historical perspective, clarify some of the terminology used in SRI, provide descriptive statistics about the current state of SRI, discuss the issues surrounding SRI, detail the performance of SRI and finally summarize with a prognosis for the future.

Historical Perspective

The earliest form of SRI dates back to Koran. The Shariah law governs how Muslims can invest. Specifically, it prohibits certain types of financial transactions such as usury and it prohibits investing in pork-related products, gambling, alcohol or weapons manufacture. The Shariah law is still honored today by devout Muslims. Considering the fact that there are 4-6 million Muslims in the nation today and that they are fastest growing segment of our population, SRI, at least in accordance with the Shariah law, is not going away.

Investing according to the principles contained in the Koran in today’s market presents challenges but is certainly achievable. One of the biggest hurdles is that the Shariah law prohibits investment in a firm that either obtains significant profits from interest-derived securities or a firm that has a high debt ratio. Despite these hurdles, mutual fund opportunities do exist for Islamic investors. Funds that invest by Islamic principles employ a Shariah Board or a group of Islamic scholars that aid in the interpretation of the Koran and monitor the investments to ensure the Shariah law is upheld. The Islamic Index, the benchmark for funds with this investment style, eliminates all companies that have more than 30% debt.

The earliest form in the United States began in the 17th century when Quakers actively practiced SRI by refusing to invest or do business with those active in slave trading and those performing war-related activities. In the 1960’s, a period characterized by Vietnam War riots, civil rights unrest, and the assassination of Dr. Martin Luther King, many people began to re-think their involvement in firms that profited from issues/practices they did not believe in. This prompted a flood of social legislation including the National Environmental Policy Act which was enacted in 1969.
Also during this time, John F. Kennedy’s Consumer Bill of Rights was enacted. It protected the right to safety, to be informed, to choose, and to be heard. Ralph Nader exposed the Covair’s hazard and published the “Unsafe at Any Speed” in 1966 which led to the enactment of the Highway Safety Act of 1970. Nader’s most important and probably least recognized contribution was that he was able to place two shareholder resolutions on the GM proxy ballot; it was the first time that social issues had been placed on a stockholder ballot. His They are not uncommon today and in fact; in 1997 “environment and energy” dominated shareholder resolutions by almost a factor of two.

Religions other than Islam advocate faith-based investing. The Interfaith Center on Corporate Responsibility (ICCR) was formed in 1971 and is composed of a Jewish, Catholic and Protestant members as well as pension funds and health care corporations. This organization adopted SRI principles as an investment style. Subsequent to the early 1970’s, SRI was adopted by investors and consumers that wanted to be a part of the solution to global social issues. One of the biggest successes was the end of Apartheid in South Africa which in part was brought about by consumers and investors voting with their dollars and supporting organizations that helped bring about change in South Africa.

SRI, while rooted in the Koran, is not limited to Islamic investors. Its principles have been embraced by nearly all religions and both political parties. Today, Christian conservatives tend to shun any firm that is either “anti-family” or in some way supports abortion. “Anti-family” firms are companies involved in alcohol, gambling, pornography, tobacco, firms that offer benefits to same-sex partners or firms that contribute to Planned Parenthood. Liberals, on the other hand, tend to exclude weapons contractors from their investment portfolios. Mutual fund families observe the popular social/environmental/human rights/ethical issues and provide investors with portfolios that are aligned with these values. SRI has become a full service product catering not only to the Shariah law but to the many different concerns investors have.

Definitions

*Corporate citizenship* – A firm exhibiting corporate citizenship aligns its interests with the public’s interests. It is to be profitable but not at the expense of society, job growth, or environmental concerns. A firm exhibiting corporate citizenship would not produce a product that would cause harm and it would provide services that meet the needs of its citizens. For example, before the buyout of Ben & Jerry’s Ice Cream, the firm was characterized as being an excellent corporate citizen because they provided excellent jobs for their employees, they partnered with independent Vermont farmers, they partnered with non-profit organizations and they donated generously to their community. Their manufacturing process did not pollute the environment and they would not do business with anyone that did. Rather, they developed ice creams that used products from the rain forest that could be harvested in a sustainable manner which helped small businesses succeed in Central and South America. It is these multidimensional, ethical, economic and philanthropic activities that define the socially responsible firm. When justice and human dignity are equal partners with profits and maximizing shareholder’s wealth, the
A firm is said to be socially responsible or exhibit corporate citizenship. It is also called corporate social responsibility (CSR).

**Negative screening** – This was the initial type of screening performed by SRI mutual funds. It is excluding those businesses that perform some activity that investors find unacceptable. For example, investing in accordance with the Shariah law, all firms involved in pork production would be excluded. Common negative screens include eliminating firms that have discriminatory labor practices, a record of violating human rights, significant operations in the defense, alcohol, gambling or tobacco industries, unethical business practices of any type, poor environmental records and a record of using animals in product testing.

**Positive screening** – Positive screening involves including firms because they perform some activity that you value. This type of screening developed after negative screening. Common positive screens include considering firms that have ethical and positive labor relations by offering equal opportunity for all employees especially minorities and women, safe work environments, a positive environmental record, a community development record, open corporate relations, a positive record of charitable giving, a positive human rights record, a code of conduct for suppliers, employee/family health benefits and that offer child/elderly care. Newer screens may include positive responses to shareholder resolutions or may involve the degree to which its products may be recycled.

**Shareholder activism** – Shareholder activism usually occurs through pension funds with the goal of forcing companies to change their actions to be more in line with the shareholders. One of the most successful examples of shareholder activism was the boycott of firms doing business in South Africa. More recently, a boycott of retail firms that used child-labor was also quite successful.

**Social Investment Forum** – This nonprofit organization supports all aspects of socially responsible investing.

**Guideline portfolio investing** – Guideline portfolio investing involves selecting investments based on expected return (almost always in relation to risk) and social/ethical factors.

**Community development investing** – Community development investing is a way to directly impact the quality of life your community by investing in organizations that positively impact your community. It often takes the form of investing in community banks, credit unions and other institutions that provide capital to homeowners, small business owners and a variety of other initiatives.

**Citizens Index** – The Citizens Index is approximately 300 primarily large cap companies that have been screened to eliminate companies involved in tobacco, oil, and weapons manufacturing.
**Domini 400 Social Index** – The Domini 400 Social Index (DSI) contains 400 firms thought to have ethical behavior after applying the screen from the Citizens Index and excluding firms involved in gambling and nuclear power. The DSI also factors in the firm’s records on diversity, employee relations and the environment.

**Dow Jones Sustainability Index** – The Dow Jones Sustainability Index (DJSI) contains firms listed on the Dow Jones Global Index (world’s 2000 largest firms) that do not generate over 50% of their revenues from alcohol, gambling or weapons. In addition, each firm is also rated on various environmental, social and human rights factors. Each corporation is scored and firms with scores in the top one-third of their industry are included in the DJSI.

**Descriptive Statistics**

- Approximately $1 out of every $7 invested in the stock market is invested using a social/ethical/environmental screen or roughly 14% of all investments are socially/environmentally/ethically invested.
- Over $2 trillion is invested using SRI screens.
- SRI investments grew 7% in 2002 and 2001 while overall investment fell 4%.
- Growth in SRI portfolios exceeded 240% as compared to 174% growth overall from 1995 to 2003.
- Shareholder advocacy grew by 15% as measured by tracking the number of shareholder resolutions filed from 2001 to 2003.
- Community investing increased by 84% from 2001 to 2003 as measured by assets held by community development financial institutions.
- SRI products are available in over 21 countries indicating global growth.
- SRI funds are more likely to earn the highest mutual fund ratings by either Morningstar or Lipper than the overall universe of funds.
- SRI funds enjoyed net inflows of $1.5 billion in 2002 while the overall universe suffered net outflows of $10.0 billion.
- SRI does not increase the expense ratios of the fund; on average SRI funds have lower expense ratios than the overall universe.
- Currently, there are over 200 different SRI funds available to investors.

**Issues**

**FOR:**

Many people believe that the world is becoming a smaller place and that each person has a responsibility to leave this world a slightly better place. Legacy planning for their children’s children and for all creatures on the planet can be accomplished by sponsoring organizations that share the same values. Traditionally accomplished by charitable
contributions, SRI creates the opportunity to earn both a social return and an investment return at the same time.

The corporate scandals of late have confirmed the suspicions that many Americans have long held; corporate America is greedy and unethical. Disabused from the notion that the government will punish white-collar crime and that upper management seeks to maximize shareholder wealth, investors seek alternative options to try to align management’s goals with their own. By investing in firms that have mission statements aligned with their own interests, investors hope to avoid investing in the next WorldCom or Enron.

Using socially responsible screens does not imply that fund managers do not perform financial analysis. Rather, fund managers continue to financially analyze and screen companies as potential investments from a subset of firms deemed to be acceptable as per the social/ethical/environmental screens that are consistent with the fund’s SRI objective. The plethora of research suggests that social indices do as well or better than the market benchmarks. That is, the overwhelming research indicates that SRI funds do not incur a “cost” for their ethical investment. In fact, some research concludes that the SRI funds outperform non-SRI funds.

Some SRI fund managers, and in particular, Amy Domini, founder of Domini Social Equity Funds, is spearheading the call for fund managers to post on their websites how they voted on shareholder resolutions. This is an important consideration given that mutual funds are one the largest institutional investors in the market. This is important because share that is owned by a mutual fund translates into a vote. For shareholder resolutions to pass, the institutional investors will need to support it. Since individual investors are purchasing mutual funds, Amy Domini feels that the mutual fund should be willing to tell its investors how it voted. This is a subtle yet extremely effective method of effecting change or maintaining certain behaviors within the company.

AGAINST:

A basic tenet of finance is that the goal of the financial manager is to maximize shareholder wealth. Mathematically, it is a simple optimization problem because there is only one goal. However, if one subscribes to CSR, there is no single clearly defined goal and therefore the problem is transformed into a multiple optimization problem. In effect, the manager has no clearly defined goal and the future of the firm becomes compromised. Proponents of this premise maintain that if CSR is implemented, social welfare will be reduced rather than increased similar to the failed communist and socialist economies in our lifetime.

One of the most hotly contested issues is that SRI is subjective at best and poorly defined, inconsistently applied and impossible to verify at worst. For example, an anti-weapons screen would screen out the defense contractor that manufactures land mines. However, to what degree is a firm labeled as a defense contractor? If weapons production accounts for 100% of the firm’s revenues there is no ambiguity. However, if weapons production represents only 30% or only 15% of the firm’s revenues, the decision is subjective.
Should the fund manager adopt a “no-tolerance” attitude? Should firms that manufacture only one bolt of the land mine be treated as if they manufactured the entire land mine? It is possible that the answer to that question is not binary and therefore leads to subjectivity in the screening process.

A recent objection of the SRI focuses on the ethical issue itself. For example, most Americans perceive child labor a human rights issue. We find it intolerable that any 10-year old child should work for a living rather than going to school like our children do. However, before arguing that child labor in a third-world country is unethical; we must also consider the possible alternatives available to that child. If the only alternatives are going hungry or being sold into sex slavery, then clearly the child is better off earning a living.

Not every SRI fund has the same objectives. It is necessary to evaluate the fund’s SRI objective to ensure that the objective is aligned with your interests. Certain funds will give more importance to certain ethical/social/environmental issues and understanding the screens a fund uses will help the investor understand the fund’s SRI objective in addition to analyzing the other variables such as the fund’s risk/return and expense ratios.

Performance

On average, SRI funds perform as well as or better than the Standard & Poor’s 500. On a risk-adjusted basis, using either the Sharpe or Treynor measure, the SRI funds outperformed the benchmark. The major reason for this is that high-quality companies tend to have larger cash-flows to support environmental, social and ethical issues and lower measures of risk. They tend to attract better quality employees and can retain them because they treat them well. Therefore, it should be no surprise that the vast majority of the firms contained in the Dow Jones Industrial Average are considered viable SRI candidates. It is these companies with significant brand images that spend money to protect their positive image in the eyes of the consumer and investor. They protect these positive images because they are so difficult and expensive to cultivate. For example, prior to the poison mysteriously put in some Tylenol bottles decades ago, Tylenol was a very trusted brand name. It was a household term used synonymously with aspirin. When several people died from poison in Tylenol tablets, most homeowners flushed their bottles down the drain. However, today few people would associate Tylenol with that tragic event. The company spent a great deal of time and money to keep the positive brand image of Tylenol. Given the circumstances, it was brilliantly accomplished.

Prognosis

The descriptive statistics presented earlier suggest that SRI is neither a fad nor has yet reached its climax. It is the author’s belief that SRI will continue to grow more rapidly than non-SRI funds both in investment dollars and number of funds. SRI funds will
become more focused, appealing to “niche” clients as they attempt to differentiate themselves from their competitors.

SRI proponents will need to address the issue of SRI’s validity. In short, are the screens employed a valid measure of a firm’s ethical behavior? For example, John Bogle, the founder of Vanguard, eloquently made this point when he stated the nuclear power plants are avoided by some investors and supported by others that feel the plants are more environmentally-friendly than a coal-burning power plant. It is clear that ethics is not a binary subject and will always be debatable. For this reason, many sophisticated investors prefer to do their SRI independently of a mutual fund investment. Independent SRI is also expected to experience fast growth rates but will be nearly impossible to track.

The Internet has allowed investors to rapidly share information leaving companies exhibiting poor corporate citizenship no where to hide. Combine that with whistleblower legislation and the overall anti-corporate sentiment and companies are scrambling to promote themselves as corporate citizens of the highest regard. Investors, both independent and professional, will need to exercise uncommon judgment to correctly identify which firms truly are worthy of their investment.

In the past, human resource professionals have maintained that the best method of aligning the manager’s goals with shareholders is to pay-for-performance. This usually took the form of millions of stock options and bonuses when earnings per share targets were met or exceeded. The problem is that these compensation contracts focus the manager on short-term results rather than the long-term viability of the firm. Shareholder activists and human resource professionals must find a method to make the executive compensation package focus more on long-term goals and not the next quarter’s earnings figures. In addition, the executive compensation has been dramatically increasing at the expense of loss of high-paying jobs in America. These social issues will become more important as it becomes clear that the generation in college today will be the first generation that will not be better off than their parents due to pressures of globalization.

SRI has always been focused on equity investments simply because the universe of investment-grade bonds is much smaller than that of equities. However, preliminary research indicates that the screens can successfully be used on bonds with no loss of return; a result similar to the traditional SRI equity investing.

For more information on how to incorporate SRI into your portfolio:

www.socialinvest.org - lists funds and the screens used on each fund
www.domini.com - website of one of the largest SRI family of funds
www.coopamerica.org - general description of social investing, different screens and sites for more information
www.socialfunds.com - has a search engine for SRI funds by category and a bulletin board for investors
www.greenmoney.com – another website listing SRI funds and related data
References


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