Socially responsible investing now encompasses more than $3 trillion of the total U.S. investment marketplace. While institutional investors comprise the majority of the SRI world, individuals are becoming increasingly involved too. This approach to investing is evolving as it grows.

As more investors look to apply various SRI principles within their investment approach, there are several issues and considerations to bear in mind:

**Defining the parameters**

There is no universal definition for socially responsible investing, which goes by multiple names and approaches. It is important for investors to know the differences in order to be aware of their options and to align their portfolios with their values.

A brief overview: Also known as sustainable, socially conscious, green or ethical investing, SRI is the umbrella term for a philosophy of investing by both financial and social criteria. It incorporates environmental, social and corporate governance factors within the investment process – hence ESG as a relatively new catch-all term for these investing criteria.

Positive or negative screens, or a combination of both, can be applied to the investment process.

The use of positive screens, sometimes called impact investing, involves seeking out companies with, for example, the best human rights records or those emphasizing investments in environmentally sustainable practices or products. These screens also can help select companies that excel in community relations, minority employment, product safety, same-sex benefits, sustainability, women’s issues or workplace practices.

Applying negative screens to avoid perceived irresponsible companies or "sin stocks" still accounts for a majority of socially responsible investing. Excluding companies with involvement in tobacco, alcohol or gambling typifies this approach. Negative screening also is used to proscribe investments in companies in a myriad of other industries or activities, including abortion, animal testing, environmental destruction, fossil fuels, military weapons, nuclear power, pornography and many more.
Investment returns

As much as investors would like to have definitive data about how much better or worse SRI investments fare than their counterparts, no obvious conclusion can be drawn regarding their performance.

The findings from numerous studies on the subject are contradictory. Many of the studies are inherently biased in that the organizations conducting them have a vested interest in the outcome. Those that see a marketing or financial benefit from SRI tend to conclude that it is superior to traditional investing. Others have competitive reasons for opposing it. The ideological bents of SRI researchers also may predetermine their findings.

In fact, there may never be a definitive answer to the question of whether SRI reduces investment returns. Legitimate disputes about data quality and methodology are likely to continue. Investors can learn, however, from the compelling cases made by the two sides in this debate.

Advocates of SRI say socially desirable companies have attractive characteristics that can make them stronger and more stable and therefore likelier to outperform over the long term – more than offsetting any loss of portfolio performance from focusing on a smaller investment universe.

Skeptics contend that there must inevitably be a cost when excluding the stocks of otherwise financially attractive companies from a portfolio because they are judged to be socially irresponsible. (We take a longer look at the studies in a separate section at the end of this paper.)

Our take is that the more constrained the portfolio, the lower the expected return. This does not mean we are opposed to SRI. We just want investors to be aware of the probable cost.

Another difficulty in assessing the performance of SRI investing is that investors have very different objectives. Some are based on their religious beliefs (such as abortion), some are based on environmental concerns (for example, fossil fuels), some are based on undesirable behaviors (alcohol, gaming, and tobacco), some on equality (women in management, same-sex benefits). Others create their own unique combination of screens.

Therefore, comparing the returns of one strategy with those of another may truly be comparing apples to oranges.

Impact

Investors who wish to encourage social or corporate change with their money have options. Among the choices: They can pursue socially responsible investing, or they can donate a portion of their investment proceeds to a charity or organization supportive of their cause.

SRI investors, according to a 2009 study by Michael L. Barnett of the University of South Florida and Robert M. Salomon of the University of Southern California, “have caused firms to take certain actions that, without such pressure, they would have taken much later or not at all.”

However, high-net-worth individuals may potentially make more of a difference by investing without regard to social screening and contributing some of the higher expected returns to an advocacy group supportive of their cause.

An example: Assume that a certain set of socially responsible screens will have an annual “cost” of 10
percent (a figure chosen for illustrative purposes only). In other words, the expected return will be 10 percent lower than that of a traditional portfolio. In such a case, an investor could choose either a traditional portfolio with an expected return of 8 percent or a portfolio adhering to a certain set of socially responsible screens with an expected return that is 10 percent lower, or 7.2 percent. An investor who achieves an 8 percent annual return on $1 million from the traditional portfolio could donate the extra 10 percent of the $80,000 earnings, or $8,000, to the appropriate charity or advocacy group.

Some conclude that this approach of “donating the difference” creates a more immediate impact on behavior and results.

**Key questions to address**

As is always the case with investing, there are key questions to ask yourself before proceeding. With SRI, there may be more than with a more typical investment. These include: What aspect(s) of socially responsible investing do I want to pursue? What are my specific goals?

Would I rather invest by singling out preferred companies or by screening out undesirable ones? Am I willing to accept the possibility of lower returns, if it works out that way, in exchange for owning investments that better align with my principles? There may be some complicated decisions to work through.

**We welcome the opportunity to speak with you about your preferences and the different options for ensuring that your portfolio reflects your values.** In some cases, our current investment approach can accommodate these preferences directly. In others, we may help you source dedicated experts in your particular area of interest. Regardless of the implementation method, the more critical aspect in our view is to have well-defined preferences and to be fully aware of how those preferences may affect your portfolio performance.
Appendix: SRI Studies

Research on the relative performance of socially responsible investments has produced a wide array of conclusions and little overall consensus. But continuing efforts in this field suggest progress is being made toward more definitive answers as awareness of SRI grows and more products are offered.

In their 2009 study “Throwing a Curve at Socially Responsible Investing Research,” Michael L. Barnett of the University of South Florida and Robert M. Salomon of the University of Southern California acknowledged that “SRI research is imperfect.” They noted that “self-interest exists, and it inevitably if not intentionally shades our interpretations of subjective data.” Findings of SRI research, according to the authors, have been “mixed, often incomparable, and as a result, not entirely compelling.” The state of the “art,” however, has continued to advance, they said.

A study published in The Journal of Investing in 2007 found that the menu of SRI offerings then available to investors had “many shortcomings,” including unintended style bets, high expenses, excessive tracking error and an incomplete set of social screens. “While the potential for SRI is great, the way it is currently practiced has serious limitations,” wrote authors William W. Jennings of the U.S. Air Force Academy and Gregory W. Martin of the University of Colorado (“Socially Enhanced Indexing: Applying Enhanced Indexing Techniques to Socially Responsible Investment”).

A 2008 study by McKinsey & Company consultants found agreement among a majority of U.S. chief financial officers and investment professionals surveyed that responsible ESG behavior typically creates value for shareholders. They cited these prospective benefits for companies: stronger corporate brands; more effective employee recruiting, motivation, and retention; greater operational efficiencies; and new business opportunities.

That belief got some backing from a report by the Boston College Center for Corporate Citizenship (“How Virtue Creates Value for Business and Society,” 2009), which said the majority of published academic studies found a positive empirical link between corporate social and financial performance. The catch: “Most studies are, however, undermined by inconsistent definitions and poor data quality, making it difficult to reach a definitive conclusion.”

Among the most-cited theses why SRI is detrimental to returns, according to skeptics, is that it imposes limitations on the investment process by reducing the universe of investment options. The greater the restriction, the greater the cost to the portfolio, concluded a 2008 study published in the Journal of Portfolio Management by quantitative analyst Mark Kritzman, chief executive officer of Windham Capital Management, and his colleague Timothy Adler. That cost is in lost returns, they wrote in “The Cost of Socially Responsible Investing.”

Economists Harrison Hong of Princeton and Martin Kacperczyk of New York University concluded in a 2009 study, “The Price of Sin: The Effects of Social Norms on Markets,” that avoiding investing in sin stocks entails a higher cost of capital. Sin stocks, they said, have less institutional ownership, less analyst coverage and higher expected returns than comparable stocks since their prices are comparatively depressed, consistent with them being neglected by norm-constrained investors. Thus, investing based on social norms carries a higher cost of capital, the researchers said, and consequences for investors who pay a price in the form of lower expected returns and less effective diversification.

In “Misadventures of an Irrepressible Investor,” a paper published in the fall of 2012 in the Rotman International Journal of Pension Management, finance professor Jack Gray of the University of Technology in Sydney, Australia, argued that ESG/SRI detracts from risk-adjusted returns and defeats its purpose because of higher expenses. He also said that calling the practice socially responsible investing implies that those who disagree are irresponsible, but social responsibility is a matter of subjectivity. For example, he noted, one investor may oppose nuclear energy as irresponsible while another sees it as a viable solution to climate change.

A paper published by the CFA Institute in 2009 rendered a split decision. Denys Glushkov of Wharton Research Data Services at the University of Pennsylvania and Meir Statman of Santa Clara University analyzed returns during 1992-2007 of stocks ranked highly
for social responsibility and found that this tilt gave socially responsible portfolios a return advantage relative to conventional portfolios. However, they wrote in “The Wages of Social Responsibility,” shunning stocks of companies associated with tobacco, alcohol, gambling, firearms, military and nuclear operations brings to socially responsible portfolios a return disadvantage relative to conventional portfolios.

“The return advantage that comes to socially responsible portfolios from the tilt toward stocks of companies with high scores on social responsibility characteristics is largely offset by the return disadvantage that comes to them by the exclusion of stocks of ‘shunned’ companies,” Glushkov and Statman concluded. They said socially responsible investors should thus construct portfolios tilting toward stocks of companies with high scores on social responsibility characteristics, such as community, employee relations and the environment but refrain from negative screening.

A joint report by the Asset Management Working Group of the United Nations Environment Programme Finance Initiative (UNEPFI) and Mercer reviewed 20 academic studies on ESG and investment performance. The report, “Demystifying Responsible Investment Performance” (2007), found that 10 showed evidence of a positive relationship between ESG factors and portfolio performance, seven reported a neutral effect and three a negative association. Results varied depending on research methods used.

A similar study by Sweden’s Seventh National Pension Fund (AP7) looked at an additional 21 academic studies published after the UNEPFI report, focusing only on environment and social and omitting governance studies. Two-thirds of the studies stated that there was no obvious connection. In the remaining third, five studies suggested a positive correlation while three pointed to a negative correlation. The review, “The Performance of Socially Responsible,” indicated that nothing was found to suggest that responsibility for environmental and ethical issues in asset management in general either raises or lowers returns.

Aperio Group, which does socially responsible indexing and uses ESG screens in investor portfolios, says the studies on SRI are not conclusive regarding a return penalty. It says its portfolio analysis using tracking error – the deviation from a target benchmark over time – “does support the skeptics’ view that screening negatively affects a portfolio’s risk and return, but it also shows that the impact may be far less significant than presumed.”

In “Do the Investment Math: Building a Carbon-Free Portfolio” (2013), Aperio analyzed the extra investment risk of excluding a small sample of U.S. companies from a portfolio – the so-called “Filthy Fifteen,” which climate change advocates have deemed particularly harmful to the environment based on the amount of coal mined and coal burned as well as other metrics. It found that a portfolio consisting of the broad-market Russell 3000 benchmark minus the Filthy Fifteen resulted in an additional annual cost (tracking error) to the investor of just 0.14 percent. Excluding the entire oil, gas and consumable fuels industry from the portfolio would increase the annual cost to 0.6 percent.

In another Aperio analysis, a client wanted to invest in companies in which women were well-represented among senior executives. But only 172 Russell 3000 companies, or 6 percent, had filed disclosures showing women in management. Eliminating the 94 percent of companies that had not done so would have resulted in a large, virtually immeasurable cost to the portfolio.

The extra risk cost of screening thus varies widely by screen.
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