

What is SRI?

(Socially Responsive Investment)



Editors Note: Many people think of social investing as simply **SCREENING** (avoiding tobacco, nuclear, etc.), but screening alone has minimal impact unless combined with the more powerful tools **SHAREHOLDER ACTIVISM** and **COMMUNITY INVESTMENT**.

This guide, written by a former Governing Boardmember of the Interfaith Center on Corporate Responsibility (ICCR) and co-founder and first Director of the NW Coalition for Responsible Investment, explores these two higher-impact strategies. Without a sacrifice to financial return, these strategies allow investors to more effectively integrate investment decisions with social concerns and personal or institutional values.

THREE LEVELS OF SRI

To best understand the three levels of SRI, an analogy can be drawn to the environmental axiom *Reduce-Reuse-Recycle*, that describes a progression in which recycling is the point of entry, or lowest-impact activity. While necessary, recycling alone is not sufficient to reach long-term goals. Every concerned citizen, therefore, is called upon to engage in the higher-impact activities of reducing and reusing.

In social investing a similar progression occurs with the three key SRI strategies: (1) Screening, (2) Community Investment, and (3) Shareholder Advocacy. Though most people think of SRI as simply applying screens to their portfolios (to exclude tobacco, for instance), as with *Reduce-Reuse-Recycle* there are clearly defined levels of benefit in which **screening is an entry-level, least-impact activity, while community investment and shareholder advocacy are the higher levels that can lead to much greater benefit** .

These are the three levels of SRI strategies (in order of increasing benefit):

SCREENING began with the churches, which in the 1920s decided to exclude



the so-called "sin stocks" from their portfolios. Today the term screening describes either the *inclusion* or *exclusion* of securities based on social or environmental criteria. While **all investors - social or otherwise - begin the investment process with vigorous financial analysis**, SRI investors also evaluate a company's social and environmental qualifications.

While this has little direct impact on a company's social performance (for reasons discussed later), it may boost financial performance by avoiding corporations whose sub-standard practices can become liabilities that lower shareholder value.

Social investors seek profitable companies that also evidence respectable employee relations, strong records of community involvement, excellent environmental policies and practices, respect for human rights, and safe and useful products. Conversely, they avoid (screen out) investments in firms that fall short.

COMMUNITY INVESTMENTS directly help those who have traditionally been denied access to capital and other meaningful bank services. These investments support development initiatives in low-income communities throughout the United States and overseas because they provide affordable housing, create jobs, and help responsible small businesses get started.

SHAREHOLDER ADVOCACY is the prime catalyst for the social investment movement . First used in 1972 when the Episcopal Church filed a social resolution on South African divestment, shareholder advocacy (or engagement) employs the proxy resolution process - dialogue with management and the filing of resolutions to be voted on by all shareholders - both to educate and to advocate for improved corporate practices.

The dialogue and resolution filing process generates pressure on corporate executives while directing public attention to important social, environmental, and workplace issues. This powerful tool **has energized many inspiring turnarounds in companies' social, environmental, and corporate governance practices** . Longer term, it can contribute to a company's bottom line as well by identifying trends - sustainable ones to embrace and looming liabilities to avoid.

ENGAGE OR AVOID?

Key to understanding shareholder advocacy is the concept of **engagement versus avoidance**. Many investors do not realize that selling a company's stock

on the exchange (screening, or avoidance) has very little actual effect on the company. Just as buying a used car benefits the lot dealer but not the original car manufacturer, **screening involves "secondary" transactions that the company is typically unaware of**. Owning shares, however, brings with it powerful shareholder rights and access to the proxy.

Using these rights, **leading-edge social investors look to solve problems by facing them, using access to the proxy to improve the policies or practices of the companies involved**. Over the decades shareholder engagement has led to an impressive array of win/win success stories involving a broad range of detrimental social and environmental issues that otherwise, unchallenged, would continue today.

FOUR MEASURES OF SRI'S SUCCESS

1. Dollars Under Management. The positive effect of social investing has grown dramatically in recent years even as many financial markets have declined. Assets in socially screened portfolios now total more than \$2.2 trillion, an increase of more than \$200 billion since 2001. This represents 11% of all dollars under professional management, per the most recent *Report on Socially Responsible Investing Trends in the United States* (by the Social Investment Forum). This growth trend gives rise to an ever more powerful call for corporate transparency and accountability, a trend that benefits all investors.

2. Growth in Shareholder Engagement. In social terms, the 2003-2005 proxy seasons will come to be viewed as watershed years.

As never before, the heretofore distinct worlds of traditional institutional investors and socially-concerned shareholders found common cause in efforts to bring control, transparency and accountability to executive suites and boardrooms around the world.

The explosion of corporate scandals starting in 2002 sparked a record number of proxy votes in 2004 - 40% more than in 2002, with the greatest increase focused on corporate governance. The number of these types of resolutions soared by 200% and, significantly, the *majority* of corporate governance proposals in 2003 received votes greater than 50% (compared with only one in 2002). 2005 saw similar resolution totals as well as a number of significant vote tallies.

3. Rule Changes at the SEC. In August 2004 the Securities and Exchange Commission (SEC) began enforcement of a groundbreaking new rule that requires mutual funds and large money managers to disclose how they vote



proxies, which until then were voted *in secret* . A significant victory for corporate accountability, this creates a far greater obligation for the largest institutional shareholders to be accountable to the investing public that they serve.

Still open in early 2005, a public comment period is available for an equally critical SEC rule to improve how corporate directors are elected. The goal is to create broader stakeholder representation on the boards of corporate America , and to introduce more sustainable longer-term business perspectives.

4. Competitive Performance. Despite persistent attempts to discredit SRI, it has now been demonstrated that social screens and shareholder engagement do *not* harm financial return, and in some cases have improved performance. A sampling drawn from dozens of longitudinal academic studies that demonstrate the benefits of social investment activity includes the following examples:

- Orlitzky, Schmidt, and Rynes (2003) perform a meta-analysis of past studies and find a statistically significant positive association between corporate social performance and corporate financial performance .
- Bauer, Kees, and Otten (2002) measure the risk-adjusted performance of 103 German, U.S. , and U.K. mutual funds for the 1990-2001 time period, and find **no significant differences between SRI returns and those of unscreened funds**.
- Stone, Guerard, Gultekin, and Adams (2001) show that for the 1984-1997 time period, the implementation of social screens did not harm the returns of a stock selection model.
- Gompers, Ishii, and Metrick (2001) demonstrate that firms with corporate governance practices that favor management over other stakeholders tend to have lower price/book ratios, and that **firms in the bottom quartile of their corporate governance ratings had significantly below-average risk-adjusted returns** over the 1990-1999 time period.
- Dowell, Hart, Yeung (2000) show that between 1994 and 1997, U.S. multinational **corporations with high global environmental standards tended to have higher price/book ratios** than companies adopting local environmental standards, even after adjusting for factors such as industry membership, R&D intensity, and advertising intensity.

- Repetto and Austin (2000) use discounted cash flow models and scenario analysis to show that the financial impact of future environmental regulation may be quite material (up to 11% of market value) for U.S. pulp and paper companies.
- Russo and Fouts (1998) find that **companies with better environmental records appear to have better-than-average returns on assets.**
- Hamilton, Jo, and Statman (1993) analyze risk-adjusted returns and find that **socially screened mutual funds are statistically indistinguishable from unscreened funds.**



In conclusion, individual and institutional investors have the opportunity (and in some instances a fiduciary duty) to link their values with their investments.

Addressing financial goals while also encouraging corporations to improve their social and environmental actions is fiscally prudent, strategically advantageous, and contributes to a healthy, more just world for all.



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- ◇ **Financial coaching** and **Life Planning** that creates peace of mind, a sense of integrity and financial security.
- ◇ **Community investment** for strong local benefits.
- ◇ **Shareholder advocacy** for transparency and accountability.

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