Socially responsible investment (SRI) is an umbrella term that comprises a broad array of asset classes and investment strategies. The one thing that all SRI has in common is the incorporation of environmental, social, and governance (ESG) factors or ethical criteria into some part of the asset management process, including shareholder advocacy.

SRI has grown rapidly in the past two decades, as has investors’ knowledge of it. According to the Social Investment Forum in the United States, SRI at its broadest definition has grown from approximately $639 billion in assets in 1995 to almost $2.3 trillion in 2005, an annual growth rate of 13.7 percent. Of the 2005 total, about 8 percent is in SRI mutual funds, which account for $179 billion. The growth of SRI mutual funds’ assets has been impressive, rising from $12 billion to nearly $180 billion between 1995 and 2005, a compound growth rate of more than 31 percent.

Outside the United States, Europe is the world’s other hot spot for SRI. The European Social Investment Forum, or Eurosif, reported in its 2006 study on European SRI that broadly defined total SRI assets amounted to €1.03 trillion, with what Eurosif defines as “core” SRI making up €105 billion of that total.

The Social Investment Forum classifies SRI in the United States in four categories:

- Social screening, including both mutual funds and separately managed accounts
- Shareholder advocacy, or funds that implement their SRI principles through advocacy rather than screening
- Screening and shareholder advocacy, which counts strategies that employ both screening (positive or negative) as well as advocacy to implement SRI principles
- Community investing.

Eurosif uses a different classification that describes two main forms of SRI, each with subcategories:

- Core SRI
  - Ethical exclusions, where a variety of exclusionary criteria apply (as opposed to simple criteria such as only tobacco or only weapons)
  - Best-in-class screening, or selection of the companies judged to have the best ESG performance

- Pioneer screening, or thematic funds based on ESG themes
- Other positive screens.

In the broader classification of SRI beyond core, Eurosif lists tobacco screening, human rights/norm-based screening, other/unspecified simple screens, weapons screening, integration of social, environmental, and ethical (SEE) issues, and engagement on SEE issues.

Beyond these first-order classifications and statistics lies a fascinating and varied landscape of strategies, criteria, and performance. Just as it would be misleading to go much beyond elementary principles in a discussion of any other investment style such as “large capitalization domestic fund,” simple descriptions of SRI almost always conceal more than they illuminate. Among SRI mutual funds, for example, there are funds that employ solely negative screens, or avoidance criteria, as well as funds that employ no screens and do only advocacy, and funds that use analytical screens with or without simple negative screens. This is, in fact, what many investors think all SRI is: avoidance of so-called sin stocks such as tobacco, alcohol, gambling, weapons, and the like. For the remainder of this paper, I shall concentrate on mutual fund or separately managed account approaches.

Distinctions with a Difference: Screening Approaches

As the short description of the different ways to classify SRI funds above hints, there are ways to classify species within the “screening” genus.
Positive screens or negative screens? At first blush, the distinction between positive and negative screening seems simple: Positive screens identify what should be in the portfolio and negative screens exclude securities from companies that do not meet the identified criteria. In practice, however, many investors use both: Positive screens may be used to identify an investment universe (the group of stocks from which the portfolio is built) as well as a specific portfolio, or to create ratings on ESG performance within portfolios that are defined by negative criteria. It also is easy to leap to the conclusion that positive screening would create a larger investment universe than negative screening, but in practice the opposite frequently is true: Companies that use solely positive screens may invest only in, e.g., the top 25 percent of rated firms, meaning that 75 percent of the ideas on a sector-by-sector basis are excluded from the portfolio.

Best of class or exclusionary? Another distinction that SRI taxonomists often make is between best-of-class screening and exclusionary screening. Best-of-class often is equated with positive screening, and indeed it is a form of positive screening (but not the only approach). A best-of-class approach usually defines a set universe (such as a standard market index like the MSCI World Index or Russell 1000 Index), rates each company according to a set of ESG criteria, and selects for the portfolio some defined percentage of companies based on those ratings. Exclusionary screening (itself a very diverse classification) usually starts with a defined investment universe as well, excludes the stocks (or securities) that do not meet the ESG criteria, and then may or may not add additional stocks from outside the initial benchmark universe to construct a well-diversified portfolio.

Simple or analytical? Many SRI approaches use simple screens that often have a binary or “yes/no” quality to them. This would include funds that screen for so-called sin stocks only, as well as criteria such as “this fund will not invest in any company that tests its products on animals” and the like. Analytical approaches to screening usually start with a philosophical premise such as “we avoid investing in companies that cause great harm to the environment and have no programs aimed at mitigation or pollution prevention.” The premise leaves open to interpretation which companies meet the criteria and which do not, and the implementation of such screens is done through fundamental ESG analysis, much like financial fundamental analysis, rather than the creation of exclusionary lists of “do not buy” stocks. Some investors use a combination of simple and analytical screens.

Integration or two-pronged selection? One of the most fundamental steps in the construction of any investment portfolio is the definition of portfolio construction. Throughout most of the history of SRI, portfolio construction was done through a process of agreement, or a two-pronged approach in which one group analyzes the financial fitness of each company in the investment universe and comes up with a potential buy list and another group (often separated from the financial analysis by a Chinese wall) assesses the ESG performance. Both groups must agree that a stock or other security meets their minimum criteria before the security can be bought for the SRI portfolio.

Integrated approaches are beginning to appear, and arguably, this may be more prominent on the SRI landscape in the future. In integrated approaches, financial and ESG analysis are integrated, treating all variables—financial, environmental, social, and governance—as possibly material to the target price or valuation of the company. Integration really is in its infancy, or possibly early childhood, but its growth is aided greatly by increasing interest in ESG issues among sell-side financial analysts. A recently launched new program called the Enhanced Analytics Initiative (EAI) provides a mechanism to encourage more sell-side analysts to integrate ESG and financial analysis. EAI has begun to provide a stream of thoughtful research that makes integration a much more straightforward proposition than it was even just a year or two ago.

Advocacy and Engagement

Not all SRI strategies use advocacy and engagement, and some rely on it exclusively as the mechanism to implement ESG criteria. Advocacy proceeds from a simple proposition: Equity owners are owners of the corporation, and as such they have some rights to direct the management of the corporation, which serves at the pleasure of the owners (as represented by the board of directors). There are many ways to pursue advocacy, but nearly all start with dialogue, or active engagement, with management and sometimes board members. In SRI, advocacy usually means bringing to the attention of management proposals that the shareowner believes will improve the company’s performance on ESG issues. For example, one of the most active areas of shareowner advocacy at the moment is climate change, and dozens of shareholder proposals and engagements are requesting that companies report to shareholders on greenhouse gas emissions or strategies for managing climate change-related risks and opportunities. Some of the most high-profile shareholder advocacy is carried out by investors that do not see themselves as SRI firms, including some of the larger institutional plan sponsors such as state and city pension funds in the United States or corporate pension fund managers such as Hermes in the United Kingdom. SRI mutual funds in the United States frequently engage in advocacy, as do many religious investors.
The Complexity of Screening: Biotechnology

Social and environmental analysis is similar to financial fundamental analysis: nuanced and complex. While some SRI strategies employ simple exclusions such as tobacco and weapons, many use judgmental screens that cannot be reduced to a cookbook approach. That judgment often is used when new issues emerge.

The tech boom of the late 1990s together with rapid advances in DNA sequencing and genetic engineering make a good case study. Biotechnology offers a cornucopia of new opportunities, but it raises many thorny issues as well. Genetic engineering of agricultural crops is a case in point. Many will remember the outcry, particularly in Europe, about the use of genetically engineered ingredients in food, citing many risks: the risk of environmental release of genetically engineered organisms, consumption risks (e.g., the possibility of allergic reactions to introduced genes), and the threat of natural interbreeding and mutations creating generations of superweeds and superpests. On the flip side, however, genetic engineering may offer the potential to expand the arable range of many crops, improved nutritional value of staples (fortified golden rice is an example), and possibly reduced reliance on chemical pesticides.

Treating the use of genetically modified organisms as a simple portfolio exclusion might sacrifice the potential of the technology, still in its commercial infancy. Investing without regard to the possible hazards and risks, however, is equally shortsighted. Developing a nuanced approach that distinguishes appropriately among the many different corporate strategies in pursuing genetic modification requires an understanding of the basic scientific and technological issues as well as frequent monitoring as the technology advances.

SRI Performance

One of the most common misconceptions about social investment is that it places ESG criteria ahead of financial performance, or that SRI funds are likely to yield lower financial returns, or underperform, mainstream strategies. There have been scores of academic studies showing that SRI strategies are no more or no less likely to perform well than other funds . . .

That said, no investment strategy can be expected to outperform in all market conditions. SRI strategies in the United States, especially in the index (passive) and mutual fund areas, tend to tilt toward growth (rather than value), and may have a modest bias toward smaller- rather than larger-cap stocks, so several outperformed their market benchmarks in the late 1990s when growth was in favor and some have underperformed in the more value-oriented period since 2000. But that is true of growth funds generally and not a particular attribute of SRI strategies. There are some value-oriented SRI strategies on the market, and some of these have done well in the current value market.

There have been scores of academic studies showing that SRI strategies are no more or no less likely to perform well than other funds . . .

Conclusion

Socially responsible investment has matured considerably in the three-plus decades of its history. It has evolved from approaches primarily based on simple exclusionary screening to analytical screening, advocacy and engagement, and integration with financial analysis, and that evolution continues. SRI spans many asset classes—from equity funds to fixed income, commodity, and hedge strategies, from domestic to international and global (including emerging markets), and from growth to core to value. It still is thinly represented in a few asset classes, but every indication is that there will be SRI strategies available to investors across the spectrum of asset management. As integrated strategies grow and proliferate, it is quite possible to imagine a day in the not-too-distant future when the term “SRI” disappears from the investment landscape, and all investors will consider ESG factors in making investment decisions.

Asset management is a business that has never stood still, even for a minute. Today's SRI may be tomorrow's mainstream. Even if it remains a niche, it is likely to be an increasingly important one, if the recent past is any indication.

Julie Fox Gorte, Ph.D., is vice president and chief social investment strategist at the Calvert Group, which offers socially responsible mutual funds in the United States. She earned a B.S. magna cum laude in forest management from Northern Arizona University and M.S. and Ph.D. degrees in resource economics from Michigan State University. Contact her at fox@calvert.com.

Endnotes
2. Eurosif, European SRI Study 2006.