Global Socially Responsible Investing

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According to the Centre for European Economic Research, “Investments based on social, ethical and environmental criteria are still a small but growing segment of the international capital markets.”

The goal of this article is to define socially responsible investing (SRI), which is known in Australia and Europe as “ethical investing,” to describe regional sociopolitical climates; to review empirical evidence related to regional SRI performance; and to share a decision-making model that may guide investment consultants in making recommendations about global SRI.

Defining Socially Responsible Investing

In their investigation of Australian ethical mutual funds, Haigh and Hamilton cast doubt upon the distinction between SRI funds and conventional funds. This begs the question as to the definition of SRI; indeed, there is no single, accepted definition. Waddock, however, describes SRI as “an investment community encompassing a wide range of individuals and groups (including religious groups, universities, and some pension and mutual funds) interested in criteria other than simple return on investment.”

Sociopolitical Climate

The sociopolitical climate of major regions of the world must be considered when evaluating the acceptability and merits of SRI. Nobel Memorial Prize-winning economist Milton Friedman weighed in on the sociopolitical dimensions of socially responsible investing in 1962: “Few trends would so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of a social responsibility order other than to make as much money for their stakeholders as they possibly can. This is fundamentally a subversive doctrine.”

Friedman’s position, however, has become antiquated. It ignores the fact that for-profit corporations exist as part of a larger sociopolitical climate: They have both shareholders and stakeholders, and sustained financial performance and corporate responsibility are a weave of whole cloth. This realization is reflected in the rise of initiatives such as the International Chamber of Commerce’s Business Charter for Sustainable Development and academic publications such as the Journal of Corporate Citizenship. How would Friedman have looked upon the rise and fall of Enron and WorldCom?

In the discussion below, both the sociopolitical climate and financial performance of SRI will be presented by major regions of the globe: Americas, Asia, Europe, and emerging markets.

Risk and Financial Performance

Before exploring SRI regionally, it is critical to discuss briefly risk and financial performance measures.

Risk

According to neoclassical economic theory and modern portfolio theory, any SRI vehicle increases unsystematic risk due to social screening. Traditional portfolio management theory predicts that each time a portfolio is constrained, financial performance is compromised, thereby arguing against social screens. Other risks include higher expenses and greater betas. Recent evidence shows that SRI index returns have a higher risk compared with the benchmarks.

On the contrary, studies have found empirically that SRI decreases financial risk. This paradox is explained by frameworks supporting the inefficiency hypothesis, which directly contrasts with the capital asset pricing model. Behavioral finance and behavioral economics are among the schools of thought advancing these ideas.

Financial Performance

Do ethical funds differ from conventional funds in risk-adjusted return and investment style? There is no certain answer: the data analyses, which suffer due to time and end-point sensitivity, aren’t statistically significant. We can, however, review performance by region.

Americas

The United States and Canada are the focus of this region, and other countries in the western Hemisphere are included in the emerging markets region. By far, the United States is the single largest SRI market in the world, followed closely by Canada. According to the “2005 Report on Socially Responsible Investing Trends in the United States: 10 Year Review,” by the Social Investment Forum, “[O]ver the last ten years, assets involved in social investing have risen four percent faster than all professionally managed investment assets in the United States.”

During this time, the U. S. SRI market grew from $639 billion in 1995 to $2.29 trillion in 2005 (258 percent). Compare this figure with the broader universe of...
assets under professional management, which increased 249 percent, from $7 trillion to $24.4 trillion over the same period. In short, nearly one out of every 10 dollars under professional management in the United States today is invested in SRI.

In the United States, some researchers have concluded that there were no statistically significant differences between returns of ethically screened and unscreened universes.11 For the Canadian market, researchers have found no statistically significant differences between risk-adjusted returns of Canadian ethical mutual funds and the performance of the TSE 300 Index (a broad Canadian equity benchmark), but they have found some weak evidence suggesting that ethical investing is less risky.12

Asia
The Association for Sustainable and Responsible Investment in Asia (ASRIA) is a nonprofit with more than 100 members managing more than $2 trillion in assets.13 ASRIA reports that a growing number of Asian nations, including but not limited to Australia, Japan, Hong Kong, Singapore, Korea, Malaysia, Taiwan, and New Zealand, are adopting SRI. Other Asian SRI funds are managed globally by U.K.-based Henderson, Canada-based Ethical Funds, and Australia-based Glebe. One force driving the growth of SRI in Asia is a change in regulatory environment that requires pension funds to disclose social, environmental, and/or ethical holdings and/or activities.14 This trend began in the United Kingdom and Europe and has spread to Japan.

Europe
The European Commission has committed to SRI by pledging in its mission statement “to promote the development and convergence of SRI across Europe and act as a platform for all actors interested in sustainable and responsible investment” in France, Germany, Italy, Holland, and

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the United Kingdom. According to a report of European fund managers, financial analysts, and investor-relations officers released in 2003, the European SRI retail market was about 12.2 billion euros and the European SRI institutional market was about 336 billion euros.15

Even when using multifactor models that control for size, book-to-market, and momentum bias in equity portfolios, analyses show that the performance of ethical mutual funds in the United Kingdom, Germany, and the United States is similar to conventional mutual funds.16 Another study found that, regardless of the small-cap bias among ethical trusts, there is no significant difference between the financial performance of ethical and nonethical unit trusts.17

Emerging Markets
The International Finance Corporation (IFC), which is part of the World Bank Group, estimates that potential demand among U.S. SRI investors alone in emerging-market investment vehicles could be as high as $4.5 billion.18 According to the Social Investment Forum’s 2005 Report, “investor involvement in promoting corporate social responsibility and providing economic opportunities for underserved populations has clearly become an emerging trend all around the world.”19

The IFC states that “the limited available data indicate mixed emerging market SRI fund performance” when analyzing funds from South Africa, Brazil, China, and Hong Kong.20 On the other hand, the IFC found that Brazil’s Bovespa New Market (SRI) Index beat the main index by 1 percent.21

Investment Consultant: The Role of Decision Making in an Era of Complexity
In the final analysis, the performance of any investment is based upon the rigor of the investment consultant’s decision-making process. An exploration of this decision-making process follows. Note that as the number of variables increases so does the process complexity.

Decision Making
Real-world decision-making problems usually are too complex and ill-structured to be examined through a single criterion, attribute, or point of view and reach an optimal decision. This holds true for SRI, which is one reason that SRI also is referred to as triple-bottom-line investing—investing that seeks to optimize financial performance, environmental quality, and social justice.

Given this complexity, investment consultants should rely upon frameworks to guide decision making. Klaassen and Gay specify one such framework designed specifically for SRI as the following five-part model of prudent investment management decision making:
• analysis of client needs and risk tolerance
• design of an optimally diverse portfolio
• formalization of the investment policy to be followed
• implementation of that plan
• ongoing monitoring of the resulting portfolio

Klaassen and Gay conclude that if “SRI strategies do not create diversification worries, then nothing about SRI would make these steps impossible.”22

Moreover, it can be argued that SRI’s additional layer of research asks questions that traditional investments do not, potentially exposing hidden risk.”23 Investment consultants can enhance the quality of decision
The Future of Global SRI
SRI, like other types of investing, is undergoing transformation and innovation. One such innovation occurred in 2005 with the first socially screened exchange traded funds (ETFs), and socially screened indexes and international funds also have proliferated. Other innovations include SRI hedge funds and a growing number of SRI index funds such as the Dow Jones Sustainability Index and FTSE4GOOD.

Conclusion
SRI is moving from the periphery to the core. As one observer has stated, “Fund managers who do not want to offer any ethical investment selection and monitoring services to trustees risk losing competitive edge, both in winning and retaining funds’ and charities’ investment business in the future.” Will investment consultants face a similar fate as fund managers? Only time will tell, but retail antic face a similar fate as fund managers? Only time will tell, but retail.

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Endnotes
7. Schroder, op. cit.: 19.

Additional References