The Rewards of Socially Responsible Investing

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This article is a study of socially responsible investing (SRI) specifically examining the key challenges facing the discipline. SRI is a conscience choice by investors who wish to fulfill their duty to behave ethically and to create the most good for the greatest number. The article concludes that SRI achieves competitive returns versus its non-SRI peers.

Amy Domini, a pioneer in Socially Responsible Investing (SRI), believes that investors can individually make a difference in the way that business is conducted and thereby make the world a better place by choosing investments that abide by a certain set of values. She quotes Rosa Parks, "I can't think of anything more important to teach young people today than this: that ordinary people working together can change history. They can look for a new Martin Luther King or Rosa Parks or Malcom X to tell them how to make a difference—but they can also look in the mirror".[1] Domini defines SRI as "the desire to align investments with values and the desire to play a role in creating positive social change".[2] SRI "has been explosive sine the late 1990s in the United States".[3] According to the Social Investment Forum's 2010 report, "at the start of 2010, professionally managed assets following SRI strategies stood at $3.07 trillion, a rise of more than 380 percent from $639 billion in 1995".[4] This boom in SRI suggests that more and more investors are demanding that companies in which they invest behave ethically and in a socially responsible manner. Despite the

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1 Domini, Amy. *Socially Responsible Investing Making A Difference and Making Money.* Chicago, Illinois: Dearborne Trade, 2001, p. 1.

2 Domini (2001), p. 13

3 Louche, Celine and Lydenberg, Steven, "Responsible Investing," in Boatright, John R. (ed) *Finance Ethics Critical Issues in Theory and Practice*. Hoboken, NJ: John Wiley & Sons, Inc. 2010, p. 394.

4 United States Social Investment Forum (USSIF), *2010 Report of Socially Responsible Investment Trends in the United States*, p. 8. Obtained from the following URL http://www.ussif.org/resources/research/

boom in SRI, there are drawbacks to following an SRI strategy that also warrant consideration.

The difference between Ethical Investing (EI) and SRI lies in the roots of the movement. SRI has been known by several names throughout its evolution. Amy Domini describes the roots of SRI in great detail in her book *Socially Responsible Investing Making a Difference and Making Money.* She explains that the roots of modern SRI "evolved out of faith-based investment decisions made over the past two centuries".[5] She explains that various religious groups began to avoid investing in products that they considered harmful. This included weapons, alcohol, tobacco and usury. During this age, SRI was known as "Ethical Investing" because the process was focused on avoiding harmful products and services.[6] Whether they were aware or not, these investors were using a consequentialist approach in evaluating their investment decisions.

This trend took a new form in the late 1960s through the 1970s in the United States. During this period, the U.S. saw many social advances, including civil rights and women's rights. The U.S. was also involved in the highly controversial Vietnam War. These events lead groups of investors to react to the political environment of the day by avoiding specific companies that were involved in producing weapons, or known violators of civil and women's rights. In this time period, investors also began shunning companies that were not environmentally friendly. As a result, ethical investing became more than just avoiding harmful products or services. It evolved into avoiding and actively protesting companies that were both unethical and socially irresponsible, thus the term "Socially Responsible Investing" was derived and is now used to describe the strategy. Since the 1990s, SRI has transitioned to include a large green movement as well as a focus on sustainability. Since the 1970s, SRI has also spread across the major markets in the globe.[7]

The ultimate definition of SRI lies in how an investor sees an investment. Most investors today take the Warren Buffet approach, which was recently explained in an article by Elizabeth Ody in Kiplinger's Personal Finance. Ody explains that investors can "Do it the Buffett way".[8] According to Ody, "Warren Buffett doesn't give a hoot about any moral gray areas of the businesses he invests in-unless they affect the value of those investments. If your ultimate goal is to make a difference, take a page from Buffett's playbook: Evaluate potential investments solely on their merits as investments. Then when you're ready, donate

5 Domini (2001), p.29.
6 Louche and Lydenberg (2010), p. 400
7 *Ibid.*
8 Ody, Elizabeth. "What You Need O Know About Ethical Investing." *Kiplinger's Personal Finance* 64.4 (2010): 87.

a portion of your gains to charities that cater to the issues you care most about".[9] Buffet's approach is in line with Modern Finance Theory and removes the ethics component from the financial decision.

I would argue, and I believe that Domini would agree, that the charitable organizations to which Buffet refers are typically only treating the symptoms of a faulty system. The unethical and socially irresponsible actions taken by firms fueled by investor demands for returns create the very problems being treated. So why would an investor not want to attack the cause of those problems by only investing in firms behaving ethically or in a socially responsible manner? According to Domini, "The investor stands at the juncture between the engine of the world's economy and the fuel, money. This is the reason that the way we invest today will shape the world we live in tomorrow. Investments are both the link and the engine upon which both commerce and finance rely. By not accepting responsibility for this, investors have built the world we inhabit today, the shrinking world with so little time remaining".[10]

While socially responsible investors identify themselves with their investments and choose to invest their money with values in mind, there are some known drawbacks to this strategy. The largest question surrounds the performance of funds that screen investments. Critics sight Modern Financial Theory noting that the lack of diversification and the added expense of screening companies will yield a lower return.

Elizabeth Ody explains in a recent Kiplinger's Finance article (2010), "But for all the diversity of choice, the one thing these funds have in common is their propensity to underperform: Over the past ten years (as of February 15), 56% of socially screened funds trailed their peer group's average (that is, they returned less than the average of funds that invest in similar styles). Over the past year, 63% lagged".[11] In this article, Ody demonstrates that the funds do lag their peers but she does not explain how significant the differences are.

Craig Israelsen, an associate professor at Brigham Young University, conducted a study looking at the returns of SRI funds compared to non-SRI funds in 12 Morningstar categories over a five-year period to June 30, 2010. Israelsen used screens to get a population of funds that "created a high degree of homogeneity among the SRI funds and non-SRI funds in terms of portfolio composition".[12] Israelsen concluded that "a comparison of five-year performance

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9 *Ibid*.
10 Ody (2010).
11 *Ibid.*
12 Israelsen, Craig. "Conscientious Investing." *Financial Planning*, November 2010, 127-130.

reveals that SRI funds—in the aggregate—compete favorably against non-SRI funds. Among the 12 fund categories, non-SRI funds had statistically higher performance in only three buckets".[13] The results of his study are shown in Appendix A.

While on average SRI funds may lag against their peers, it doesn't appear, in recent periods at least, to be all that significant. Thomas Anderson explains in a recent article, "investors don't buy averages, they buy specific funds. Just like anything else in the fund business, choices matter".[14] Anderson believes investors should consider each fund separately when making a decision. Yes, the numbers show that an SRI strategy will tend to yield lower results than its non-SRI peers, but not by a significant amount. An investor must make a personal choice on whether their values should play a role in their investment decisions and to what extent it should play. It is the investor's responsibility to research and select funds that match their values (if they so choose) but also review the funds to determine if the additional costs associated with screening and potential lack of diversification are a concern.

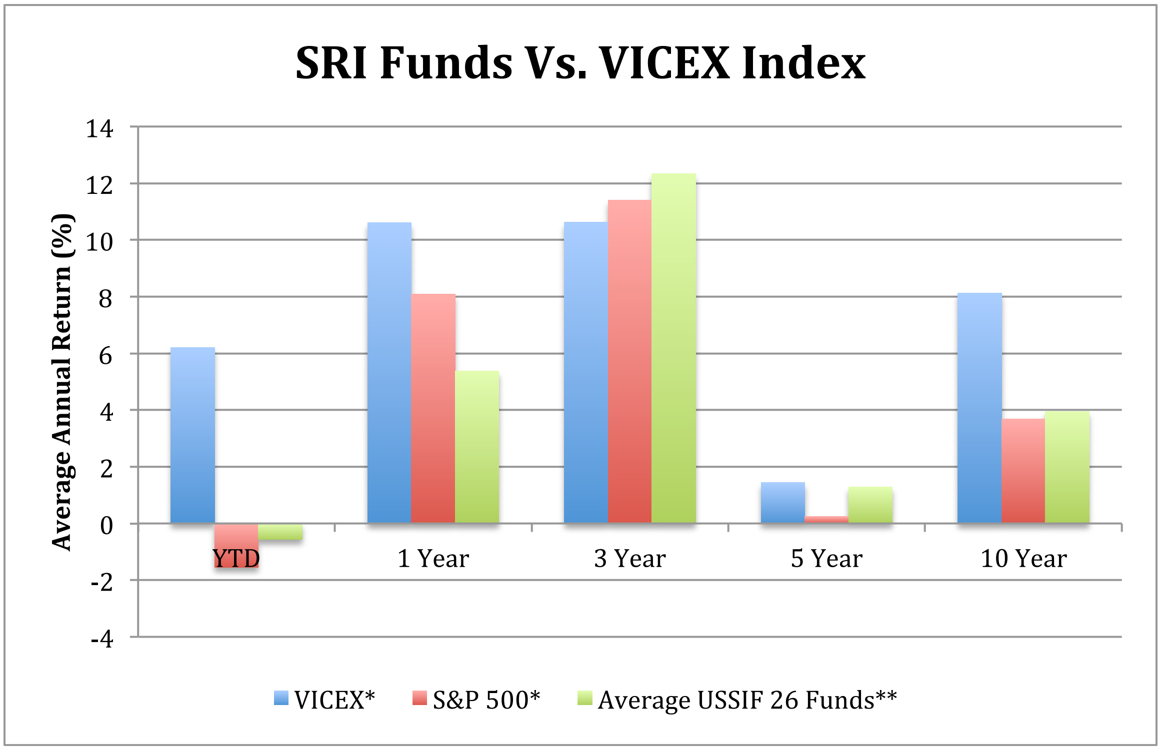
Most studies on the performance of SRI investments rightfully compare SRI investments to their non-screening peers that are trying to achieve the same financial objective. What about comparing the funds to their opposites? The VICEX index tracks a portfolio of investments that are typically deemed unethical by some SRI strategies. According to the Yahoo Finance fund summary, the index " normally invests at least 80% of net assets in equity securities of companies that derive a significant portion of their revenues from alcohol, tobacco, gaming and defense/aerospace industries." The following are the average annual returns of 26 SRI funds listed on the USSIF website as having the S&P500 as a benchmark. The USSIF (United States Social Investment Forum) is an organization that researches, educates investors and supports the SRI movement. These funds were selected for comparison because the VICEX Index also lists the S&P500 as its benchmark.

[13] Israelson (2010).
[14] Anderson, Thomas M. "The 7 Top Funds For Ethical Investing." *Kiplinger's Personal Finance* 64.7, 2010, 32-34.

Average Annual Returns (%)

	YTD	1 Year	3 Year	5 Year	10 Year
VICEX*	6.21	10.62	10.63	1.44	8.13
S&P 500*	-1.55	8.09	11.41	0.25	3.69
Average USSIF 26 Funds**	-0.57	5.38	12.33	1.28	3.95

*As of 10/31/2011 Taken from Fidelity.com. The VICEX Index 10 Year figure is average annual return for life. It was founded on 8/30/2002.
**As of 10/31/2011 Taken from http://ussif.org/resources/mfpc/



Over a ten-year period it is clear to see that the VICEX has outperformed both the S&P 500 as well as the selected SRI funds. One cause of this difference may lie in the fact that the VICEX is not a diversified portfolio where the USSIF funds selected attempt to diversify. The U.S. has been in war over the past decade along with several other countries driving up the demand for weapons and war related products and services. In addition, tobacco and alcohol related companies tend to be well-established, high earners that are not as sensitive to economic events like the recent crisis.

Recognizing that choice does play a part in any investment strategy, the top 5 performers on the USSIF's list of SRI funds were also compared to the VICEX and S&P 500. These funds were selected from the 26 funds listing the S&P 500 as its benchmark based on 10 year average annual returns. Below is the comparison:

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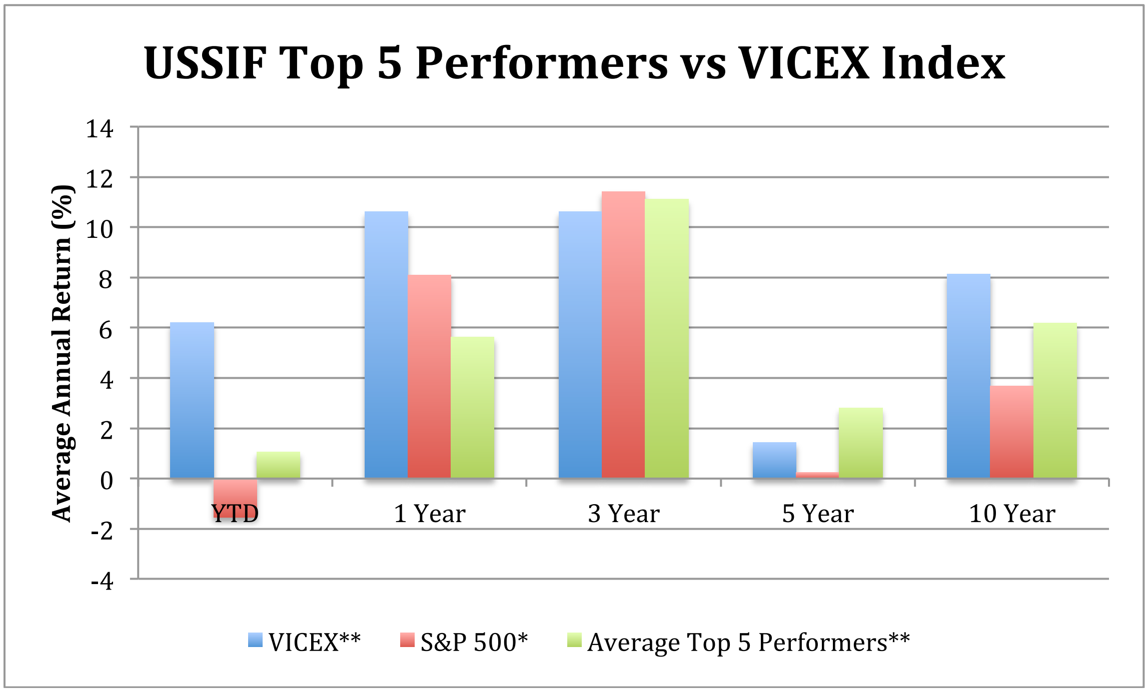
S&P 500*	**-1.55**	**8.09**	**11.41**	**0.25**	**3.69**
Parnassus Equity Income Fund	0.38	5.49	10.38	4.54	6.55
Neuberger Berman Socially Resp Inv	-3.53	3.59	11.95	1.1	5.98
Neuberger Berman Socially Resp Tr	-3.67	3.35	11.74	0.9	5.77
Parnassus Fixed-Income Fund	5.77	3.05	8.61	5.82	5.41
Calvert Equity Portfolio I	1.18	7.73	13.39	3.08	5.22
Average Top 5 Performers**	**1.06**	**5.64**	**11.12**	**2.81**	**6.18**

*As of 10/31/2011 Taken from Fidelity.com. The VICEX Index 10 Year figure is average annual return for life. It was founded on 8/30/2002.
**As of 10/31/2011. Taken from http://ussif.org/resources/mfpc/. The top five performers were determined by average annual return over 10 years.



The data support the idea that by carefully selecting top performing SRI funds an investor can achieve better results than the average SRI fund. The average 10 year annual return of the SRI funds selected outperformed the S&P 500 but still underperformed the VICEX stocks. The improvement in the top five performers over the average of all 26 is most likely attributable to better fund management. It is more consistent with Israelsen's study comparing SRIs to their peers. Understanding that this comparison is somewhat limited, it is fair to say that the VICEX overall has outperformed both the S&P 500 as well as the selected SRI funds during the past 10 years. In my opinion, this shows that there is some cost in avoiding these investments that SRI strategies must accept.

Another sited drawback to an SRI strategy is the choice of which funds to invest in and whether an investor agrees with the screens used by the fund. The numerous funds available range from religious based strategies to environmentally based strategies, with some funds specializing in very specific concerns and others being more general. Jason Zweig advises: “There's still one area, however, where I believe SRI funds come up short. The funds don't advertise the fact, but the truth is that they take a one-size-fits-all investing approach that's straight out of the 1960s, when ideologies were rigid and technology was primitive. If you're a Prius-driving, pro-choice Obama supporter, it's not hard to find an SRI fund: TIAA-CREF Social Choice Equity (ticker symbol: TICRX) or Vanguard FTSE Social Index (VFTSX) should work for you. Conversely, if you're an Evangelical Christian, one of the Timothy funds (timothyplan.com) could make sense. But if you're a devout Catholic environmentalist, a hard-core lefty who smokes and plays poker, or a gay Republican, you're most likely out of luck. You won't easily find an SRI fund that favors "green" companies but opposes abortion, or one that fights global warming but sees nothing wrong with "sin stocks"”.[15]

In my opinion, the supporters and critics of SRI are divided on the question of whether ethics should be a factor in financial decisions. Ultimately, financial decisions are decisions made by individual investors, who in their daily lives generally follow some moral code. So why should this not be true in their investment decisions?

In any investment strategy an investor is faced with a multitude of options for investing their money. Modern Finance Theory says that an investor will choose a portfolio that yields the greatest return for the lowest amount of risk without regard to what the underlying companies do to earn that reward. Socially Responsible Investing is a conscience choice of an investor to direct their investment towards companies that sell goods or services that are considered morally sound and practice business in a socially responsible way. I believe that most investors practicing an SRI strategy believe that they are fulfilling their individual duty to behave ethically and in a socially responsible manner. They recognize that the returns may be slightly lower but receive an intangible return in the fact that they have chosen to invest using their values. Although, there are most likely some investors who are simply following a fad and are not as

[15] Zweig, Jason, and Asa Fitch. "The Good And Bad Of Ethical Investing." *Money*, 37.1, 2008, 62-63.

connected to the intangible reward that comes with knowing they have adhered to their values.

Amy Domini by quoting Rosa Parks has the right idea. She believes that we can change the world and improve the situation for all if we demand change in the way we use our money. Given the growth of SRI funds available and participation in those funds, this movement is going to stay around. The movement is one way that investors can more actively be involved in their investments. We make up the market and we created the assumptions of Modern Financial Theory so we have the power to change our demands and those assumptions. SRI strategies accomplish this by demanding with investment that more attention be paid to ethical and social concerns.

At the end of the day, we the investors, though we may not be directly choosing to act unethically or behave irresponsibly with regards to social issues, have some level of responsibility because we drive the demand for higher returns. Investors should pay attention to where their money is invested. In this way, perhaps we can achieve what Rosa Parks and Amy Domini so passionately envision.

Appendix A

Morningstar Fund category	5-Year Annual Return (%) (as of June 30, 2010)		Statistically Different Performance? (80% or higher confidence)
	SRI Funds	Non-SRI Funds	
U.S. Equity Large Blend	-0.35	-1.13	No
U.S. equity Large Growth	-0.06	-0.44	No
U.S. Equity Large Value	-2.29	-1.57	No
U.S. Equity Midcap Blend	-0.77	0.53	Yes
U.S. Equity Midcap Growth	0.87	1.14	No
U.S. Equity Small Blend	1.53	0.07	No
U.S. Equity Small Growth	-2.01	0.42	Yes
Non-U.S. Equity Large Blend	-0.13	1.21	No
World Stock	1.23	1.16	No
Intermediate U.S. Bonds	4.68	4.98	No
Conservative Allocation	2.55	2.76	No
Moderate Allocation	0.83	1.37	Yes

This table contains the results of Craig Israelsen's study on SRI vs Non-SRI performance.