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SOCIALLY RESPONSIBLE INVESTING

Introduction to Socially Responsible Investing

"Socially responsible investing" (SRI) refers to financial contributions into investment vehicles designed to combine the traditional investment philosophy favoring profit-maximization with a values-based component seeking non-financial benefits. Such non-financial benefits are often referred to as social returns. These social returns vary in scope but can be broadly defined as company policies and actions that enhance a socially responsible investor's specific environmental, religious or social values. These enhancements may or may not have any impact on the profit-maximization component of the socially responsible investment and may actually cause a socially responsible investment to decrease in value. Socially responsible investing is the common term for this practice in the United States but the concept is also referred to as "ethical investing", primarily in the United Kingdom, or "values-based investing."

Today, major institutional investment groups such as corporations, hedge funds, insurance companies, mutual funds, pension funds, religious institutions and universities, along with the environmentally/religiously/socially-motivated individual investor, are entering the realm of socially responsible investing. According to the Social Investment Forum (SIF) – the most prominent SRI industry group – over $2.16 trillion was invested in 2003 in professionally managed portfolios that implemented at least one core aspect of socially responsible investing. The SIF claims that this figure, representing one out of every nine dollars invested professionally in the United States, grew from $1.19 trillion in 1997 and from $40 billion in 1984. On the other hand, it is important to note that many scholars and investment professionals remain skeptical of this investment philosophy. Many academic studies demonstrate that socially responsible

investors are not able to achieve either their desired social objectives or a competitive return, at least when compared to traditional investing practices focusing on profit-maximization alone.

Socially responsible investing is an umbrella term covering three core investing groups: (1) environmentally-motivated investors, (2) religiously-motivated investors and (3) socially-motivated investors. While all three groups seek social returns along with capital appreciation, the major difference between the groups stems from the motivations behind their investment practices. Environmentally-motivated investors seek corporate policies and actions that either benefit, or do no significant harm to, the environment – both in the United States and abroad. Religiously-motivated investors are guided by specific faith-based issues such ethical treatment of employees. Socially-motivated investors, on the other hand, desire company policies and practices that adequately address key social issues like diversity, HIV/AIDS as well as corporate governance. The history of SRI demonstrates that all three groups played a prominent role in the establishment of SRI as a major player in the twenty-first century investing landscape.

Socially responsible investing also encompasses three core subject areas: (1) social screening, (2) shareholder advocacy and (3) community investing. While social screening is by far the most popular of these categories – with $2.14 trillion invested in this manner in 2003 – each of the other areas comprises a growing component of the SRI community.

A Brief History of SRI

Socially responsible investing has religious roots. In fact, scholars trace the earliest form of social screening of investment opportunities back over two thousand years to the Hebrew Bible. More recently, socially-conscious investors played a major role in the religious communities of pre and post-revolutionary America. In pre-revolutionary America, the Methodists, followed by the Quakers, developed the habit of refusing to support companies involved with alcohol, gambling or tobacco. Investments in all three of these industries were considered "sin stocks" and were screened out – or ignored – by the commercial practices of early American religious communities. The institution of slavery was also an issue of concern to many early American socially responsible investors with specific groups avoiding companies dealing in the slave trade.

From the seventeenth century until the mid-twentieth century, the concept of socially-screened investment remained a small, religiously-centered, movement. However, in the 1960s, as movements against the Vietnam War emerged alongside the civil rights, women's rights and environmental movements, investors took a renewed interest in socially responsible investing. Socially responsible investors, in tandem with a multitude of other groups and institutions, wanted to be certain that their investment money was not being used to support the war or to keep minorities in a second-class status. The key issues for SRI advocates in the 1970s were the nuclear arms race and the environment. It was during the 1970s that the first socially responsible mutual funds were created allowing investors to pool their funds together to achieve greater social returns. In the 1980s world-wide attention focused on apartheid in South Africa and companies were lobbied by the SRI community – and eventually mandated by the Anti-Apartheid Act of 1986 – to stop doing business in South Africa.

The decade of the 1990s saw a renewed interest in the environment and the somewhat tenuous relationship between the corporate mission of profit maximization and corporate policies and practices designed to protect the environment. These issues coincided with the commencement of the major tobacco litigation cases and calls for avoidance of one of the top three "sin stocks" – tobacco. The most relevant SRI topic from the dawn of the new millennium to the present is corporate governance. Originating with the recession of 2001 and peaking with the major corporate scandals that plagued the economy thereafter, corporate governance and business ethics have become major issues in the SRI community as well as in the traditional investing world. Interestingly, a few key issues retained prominence over this half-century period of modern SRI. Issues like abortion, contraception, HIV/AIDS, "sin stocks" and unfair labor practices in third world countries remain compelling and are always on the radar screen of SRI.

Three Categories of Socially Responsible Investing

Socially responsible investing is traditionally divided into three core categories: (1) social screening, (2) shareholder advocacy and (3) community investing. These three categories are not mutually exclusive – for example, a socially responsible investor may practice social screening while also investing in community development projects. The majority of socially responsible investors, however, focus on social screening and shareholder advocacy although community investing is growing in prominence as the SRI movement itself expands.

Social Screening

Social screening is a means by which investors either divest a financial holding or invest in a particular company based on the company's social record – or lack thereof. The basic premise underlying social screening is the idea that companies that meet the social standards required by SRI screens will be the most profitable and successful companies in the long-term. Social screening can be divided into two types: (1) negative screening and (2) positive screening.

Negative screening occurs when an investor divests a specific stock or industry group holding from a portfolio based on a company's practices diverging from some criteria of social investment. Once an investor screens a stock out of a portfolio the ownership relationship between the company and the shareholder ends and often so does the investor's ability or desire to institute social change at the organization. It is for this reason that many shareholders refuse to sell shares of a company with a poor social record and instead choose the path of shareholder activism, as described below.

Positive screening occurs when an investor seeks out a specific stock or industry group and invests because of positive social policies and actions of the company. Many SRI organizations have created sophisticated software intended to search for just this type of investment opportunity. Companies that produce certain products – such as the "sin stocks" mentioned previously – have a hard time meeting the criteria required to be included in a positive screen. Interestingly, even a company producing a more socially-accepted product will also miss the cut if such a company has poor corporate governance standards or employment practices.

Depending upon the volume of shares subject to both negative and positive screening, such screening practices may alter stock prices due to the decreased demand caused by negative screening and the increased demand for a company's stock caused by positive screening. As socially responsible investing continues to grow in volume of dollars invested, SRI proponents hope such supply/demand attributes cause companies to become more responsive to the voice of socially responsible investors.

Shareholder Advocacy

While social screening is intended to serve the dual purpose of altering the supply/demand equation for a specific company stock and to satisfy the ethical desires of the socially responsible investor, this category is not the only means at the disposal of socially responsible investors to satisfy their goals. Investors desiring to change corporate practices often turn to the shareholder advocacy category. Shareholder advocacy proponents attempt to take advantage of share ownership and the potential of such ownership to obtain access to management and to other shareholders. This access can be a bit misleading however because the purchase of a small amount of stock will create a relationship with the company but a more significant stake may be necessary to truly obtain access to and attention from company management. A significant ownership position allows shareholders to engage in three primary shareholder advocacy tactics: (1) Discussions with Management, (2) Shareholder Resolutions and (3) Boycotts.

Discussions with Management

The socially responsible investing community currently rallies around the idea that discussions with management should be the first step taken in efforts to create desired social returns. In fact,

certain SRI institutional investor groups state that they will attempt discussions only and exclude other, more confrontational, shareholder activism tactics.

Discussions with management occur when shareholders group together and arrange meetings with high-level executives who run the company on such shareholders' behalf. Often, the issue discussed is a corporate policy or activity that the SRI proponents allege is endangering the environment (such as deforestation) or an issue shedding a negative light on the company's public image (such as excessive executive compensation). Often, if company management feels a change is warranted, these face-to-face encounters result in an amended corporate policy and no further action is necessary. Management is often more willing to engage in these informal discussions because a mutual understanding and compromise often limits the shareholder resolutions that occur under the second category of shareholder activism.

Shareholder Resolutions

Assuming the shareholder and management discussion session proves unfruitful, socially responsible investors often turn to a more structured and persuasive option – the shareholder resolution. A shareholder resolution is a proposal by a shareholder or a group of shareholders recommending a change in company actions or policies regarding a particular social issue. The proposal process and content requirements are governed by the Securities and Exchange Commission (SEC). The SEC mandates that proposals must be submitted to management at least four months before the company mails its proxy materials and can be no longer than 500 words. Such resolutions must meet other procedural hurdles as well; the proposals may only be advisory and non-binding upon management and the proposing shareholder(s) must own at least

$2,000 worth of company stock (or one percent of the company's total stock outstanding) and must have owned such stock for least one year. If these procedural hurdles are met, then the proposal may be included in the company's annual proxy statement unless the company propounds one of a few specific regulatory reasons for exclusion. Once in the proxy statement, the proposal must be formally presented at the company annual meeting and then such recommendation is subject to a vote of shareholders present or voting via proxy.

Most shareholder resolutions concerning environmental, religious or social issues do not garner a majority of shareholder votes. However, a mere five to seven percent of the total votes cast in favor of a proposal at a company annual meeting may represent millions of shareholders – a large voice against the company practice at issue. Therefore, companies often take even the slightest approval rates as an impetus to enter into discussions previously avoided or to amend current company policy to comply with the desires of the proposing shareholders. Management likes to avoid shareholder resolutions because of the potential for negative publicity and because executives and the board of directors are charged with creating company policy and do not like policy dictated from shareholders who might not have a clear understanding of the complete operational picture. Investors, on the other hand, view this type of advocacy as an acceptable exercise of their power as owners of the company.

Another interesting development in this part of the shareholder advocacy process is that since August 2004, mutual fund managers have been required to publicly disclose their votes on issues that could materially affect their portfolios. Therefore, socially responsible investors holding shares through mutual funds – and therefore not allowed to vote their shares at the annual

meeting – are now able to discern whether their particular SRI fund manager is helping them achieve their desired social returns.

Boycotts

Socially responsible investors also use various forms of protest – such as economic or physical boycotts – in an attempt to vie for corporate social responsibility. Although this form of shareholder activism can occur at any stage in the process, usually boycotts are attempted only after the discussion and resolution processes have failed. Many boycotts are purely economic protests whereby consumers refuse to purchase, sell or handle a company's product or service on a local or a national level while also attempting to enlist more consumers to follow suit. Another form of boycott – the physical protest – is employed less often and resembles a social protest rally at which socially responsible investors might be joined by various other company stakeholders and physically protest outside a company establishment or headquarters. Both forms of boycotts use the publicity from the boycott to garner attention and support from other investors and from the general public for the social cause and against the company policy.

Community Investment

Community investment is the process by which socially responsible investors direct investment funds into lower-income and less economically successful communities which have been historically underserved by traditional financial services. The goal of community investing is to provide access to basic banking services, capital, credit, equity and healthcare previously unavailable inside the community. These programs are designed to stimulate the economic growth such areas desperately need. Community development capital is most often used in

micro-lending initiatives to lower-income entrepreneurs, building affordable housing and assisting in employment efforts within the immediate area. Community Development Financial Institutions (CDFIs) – such as specialized banks and credit unions, venture capital community development accounts and micro-enterprise loan funds– receive the majority of these funds and serve as the distribution center for the community investment area.

Community investment is the most recent addition to the SRI core categories. The concept, however, is demonstrating its potential based on a plethora of community success-stories and a steadily growing resource base. From 2001 to 2003, assets held by community development institutions increased 84 percent from $7.6 billion to $14 billion. As SRI moves into the future, community investment appears as if it will compete for attention from socially responsible investors with the predominant tactics of social screening and shareholder activism.

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See also:

Divestment; Domini Social Investments; Religiously-Motivated Investing; Shareholder Activism; Shareholder Resolutions; Social Investment; Social Investment Forum

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