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Socially Responsible Investing: The United Nations Principles

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ABSTRACT

Socially responsible investing (SRI) is ever-evolving and has been since its inception in the 1900s. The United Nations Principles of Responsible Investing (PRI) Initiative established in 2006 served as a catalyst to transform SRI from focusing solely on financial return and moral/ethical investment criteria to include investment criteria related to environmental, social, and governance (ESG) issues. These six PRI principles will be described and also evaluated based upon data from a survey of asset owners, investment managers, and professional service providers who are PRI signatories. The findings from this survey offer lessons for investment professionals and academics who study SRI, governance, and environmental management.

INTRODUCTION

It has been reported that Socially Responsible Investing (SRI) has reached the tipping point and is now regarded as mainstream (Wagner, 2007). SRI has received considerable attention among academics in recent years (Orlitzky et al., 2003; Hill et al., 2007). Not only has SRI increased its visibility in academic circles but also in trade publications like *The Economist* which featured a special section on Corporate Social Responsibility (CSR) and made references to the UN Global Compact and the "…the integration of environmental, social and governance issues…(Franklin, 2008, page 4)." Furthermore, *The Economist* also made specific references to the United Nations Principles for Responsible Investment along with the over $10 trillion under management (Franklin, 2008). Martin (2006) has previously described the global nature of socially responsible investing before the United Nation Principles of Responsible Investment (PRI) Initiative.

SRI dates back to the early 1900s when individuals and institutions made investment decisions based upon both financial return and moral/ethical reasons. Since that time, SRI has evolved to its present day form by focusing on financial return, moral/ethical factors and non-moral/ethical factors. These non-moral/ethical factors refer to environmental, social and governance (ESG) issues. These ESG issues took center stage in the investment community when The United Nations Principles of Responsible Investment (PRI) Initiative was launched in 2006 at the New York Stock Exchange. This heralded the new age of SRI focusing on investment decision making criteria beyond financial return and moral/ethical factors. The current drivers of SRI in general and PRI specifically include: economic, political, environmental, governmental, climatic, energy, environmental, security, food scarcity, water scarcity, population growth, urbanization, changing demographics, and genetic engineering.

Both SRI and PRI are not without their critics particularly among investment managers and asset owners who are concerned about breaching fiduciary duty (Entine, 2005). This concern is being called into question even among pension fund trustees who are viewed as an increasingly powerful asset owner (Gay and Klaasen, 2005; Fridson, 2006). Wise investment practices can in many cases allay these concerns. To this point, it has been noted that "[A] portfolio of just 20 stocks eliminates most unsystematic risk, so achieving nearly maximum diversification is feasible even if a fund avoids all the "socially bad stocks (Fridson, 2006, page 77)." Futhermore, it has been argued that SRI and fiduciary duty can co-exist as shown below:

> "The integration of prudent financial management practices with environmental stewardship, concern for community, labor and human rights, and corporate accountability to shareholders and stakeholders, will minimize short- and long-term financial risk and identify investment opportunities that will lead to increased shareholder value (Viederman, 2003, page 31)."

The aim of this article is to define SRI, briefly describe the nature of SRI, succinctly review the performance of SRI using a risk/return perspective, and review the United Nation's Principles of Responsible Investment. In conclusion, this article will focus upon the shift in SRI from emphasizing moral and ethical criteria only to criteria that also include environmental, social, and governance criteria (ESG) particularly among institutional investors like pension funds and endowment funds. Opportunities for research will also be highlighted toward the end of this article.

Definition of SRI

Consensus on a definition of SRI is lacking (Schlegelmilch, 1997). Despite this lack of an agreed upon definition, the UK Investment Forum defines SRI as "investments enabling investors to combine financial objectives with their social values (Munoz-Torres et al., 2004, page 200)." SRI is an investment approach, not a product category. There is a diversity of SRI products and services including but not limited to the following: stocks, bonds, mutual funds, separately managed accounts, ETFs, UITs, indexes, customized structured products as well as work in engagement, community investing, philanthropy, and research.

Approaches to SRI

There are three general approaches to SRI: (1) screening; (2) advocacy; and (3) community development. First, there are two types of screens used in SRI-positive and negative. Positive screening occurs when investment professionals include a particular company or asset because of desirable characteristics, like having women or minorities on the Board of Directors. In contrast, negative screening occurs when investment professionals exclude a particular company or asset because of less than desirable characteristics, like manufacturing alcohol, tobacco, or weapons. A relatively new type of screening is "best-in-class" which occurs when investment professional select the relatively best company within a particular industry for specific characteristics. Positive and negative screenings are absolute criteria. "Best-in-class" screening is a relative criterion. All of these screens may be constructed upon moral/ethical and/or ESG criteria. These three general approaches to SRI are not mutually exclusive. In fact, Williams and Sharamitaro (2001) describe the relationship between social screens and shareholder advocacy. Social Investment Forum (SIF) also describes the evolutionary process of the gradual integration between screens and advocacy as::

> "…new issues of social and environmental concern, such as international labor standards, emerge first through the shareholder advocacy process and then, over time, quantitative criteria are developed to apply them as portfolio screens (2001, page 15)."

The convergence of these three approaches is giving rise to the development of sustainability ratings.

Finch (2005) defines sustainability ratings as "…rank organizations' effectiveness at meeting the expectations of stakeholders while maintaining sustainable financial, environmental, and social performance (page 3)." Two prominent sustainability ratings are The Dow Jones Sustainability World Index (DSJI) and the FTSE4Good Index. According to Fowler and Hope (2007), the DSJI corporate sustainability weighted criteria are as follows in descending order: industry criteria (39.8%); economic (30.6%); social (20.4%); and environment (9.2%). Similar to any rating, rating seeks to serve as a measure, a grade or standing (Simpson and Weiner, 1989). As such, ratings allow for comparisons.

Nature of SRI

Neoclassical economic theory (Michelson et al., 2004) and modern portfolio theory (Markowitz, 1952) posit that SRI constrains the investment universe by reducing the number of options. However, within the SRI community, the counter argument is that investors seek investments which align with their values (Domini, 2001). Also, stakeholder theory argues that "…some firms may be consistently better financial performers than others because of their socially oriented characteristics (Barnett and Salomon, 2006). Branco and Rodrigues (2006) assert that a resource-based perspective (RBP) is essential in explaining why firms engage in corporate social responsibility. The theoretical foundation of SRI and PRI is currently being developed in the literature.

Given the definition and nature of SRI, an issue that arises for investment professionals is how to serve as a fiduciary while at the same time pursuing a socially responsible investing agenda. Contrary to conventional wisdom, the two are not mutually exclusive. As will be discussed in greater detail later, The United Nations Principles for Responsible Investment enable investment managers and asset owners to meet their fiduciary duties while at the same time "…increasing the relevance of environmental, social and corporate governance issues to investment practices (PRI, 2006, page 5)."

A hallmark of serving as a fiduciary is to draft an Investment Policy Statement (IPS) which serves as a guideline for decision making. As an illustrative example, the Jessie Smith Noyes Foundation Investment Policy Statement includes the following sections: statement of fiduciary responsibility; investment philosophy; spending and investment goals; investment guidelines; asset allocation; screening; proxy voting guidelines; monitoring; performance standards; manager review and termination; and conclusion (Jessie Smith Noyes Foundation Investment Policy Statement, 2006). This IPS differs from a more traditional IPS in two specific areas: screening and proxy voting guidelines. The underlying concern of both SRI and PRI revolves around the issue of taking on too much risk for the expected return.

Risk/Return Relationship of SRI

The research is equivocal regarding SRI performance. This line of inquiry dates back to Moskowitz (1972). However, a growing body of research suggests that SRI is at a minimum neutral with regard to investment returns (Schroder, 2007; Schroder, 2005; Guerard, 1997) and in some cases even desirable. For example, it was discovered that "…a stock portfolio consisting of large-cap companies labeled 'most eco-efficient' sizably outperformed a less eco-efficient portfolio over the 1995-2003 period (Derwall, Guenster, Bauer, & Koedijk, 2005, page 61). Furthermore, these "…findings suggest that the benefits of considering environmental criteria in the investment process can be substantial (Derwall, Guenster, Bauer, & Koedijk, 2005, page 61)."

Barnett and Salomon (2006) found a curvilinear relationship between the number of social screens used and financial returns and those financial returns vary depending upon the types of screens. Specifically, it was discovered that labor relations and environmental screens resulted in a decrease in financial returns but community screens increased financial returns (Barnett and Salomon, 2006). As the investment sciences have empirically investigated the performance of SRI and as institutional and retail consumers have increasingly demanded SRI products, the SRI industry has begun to evolve over time.

Changing Landscape of SRI

SRI is maturing as an industry. It is a relatively new industry (Schueth, 2003). It is has evolved beyond negative screens, positive screens, and even, "best-in-class screens to include criteria that go beyond purely moral/ethical considerations but also environmental, social and governance (ESG) criteria. These industry changes will be briefly traced below to provide a topographical view of the maturing of the SRI industry. All of these changes represent the building blocks to the United Nation's Principles of Responsible Investment (PRI) Initiative.

The Equator Principles
The Global Compact
Recommendations by the Institutional Investors Group on Climate Change, the Carbon Disclosure Project.

Each one of these aforementioned building blocks will be briefly described to set the stage for the development of the United Nation's Principles of Responsible Investment (PRI) Initiative. First, the Equator Principles were adopted in 2003 and revised in 2006 by the Equator Principles Financial Institution (EPFIs) "…to ensure that the projects we finance are developed in a manner that is socially responsible and reflect sound environmental management practices (Equator Principles, page 1). Second, the Global Compact was launched in 2000 by the United Nations "…to contribute to more sustainable and inclusive global markets by embedding them in shared values (Kell, 2003, page 36)." Third, the Carbon Disclosure Group (CDP) is "…an independent not-for-profit organization aiming to create a lasting relationship between shareholders and corporations regarding the implications for shareholder value and commercial operations presented by climate change (Carbons Disclosure Project, 2007)."

UNITED NATION'S PRINCIPLES OF RESPONSIBLE INVESTMENT

The former United Nations Secretary-General Kofi Annan launched the Principles of Responsible Investment in 2006 with more than $2 trillion in assets. The Principles were a culmination of work conducted by the UN Environment Programme Finance Institute (UNEP FI) and the UN Global Compact. This clearly links governance with environmental and social responsibility. In a 2007 McKinsey survey of 391 UN Global Compact CEOs, nearly six in ten (59%) reported incorporating ESG issues into their core strategy which was more than in the previous five years (McKinsey, 2007).

The Principles for Responsible Investment (PRI) were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance (ESG) issues to investment practices. The overall goal of PRI is "…to help investors integrate consideration of environmental, social and governance (ESG) issues into investment decision-making and ownership practices, and thereby improve long-term returns to beneficiaries (PRI, 2006, page 6)." The preamble to the six Principles of Responsible Investment highlights the fiduciary role:

> "As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social,

> and corporate governance (ESG) issues can affect the performance of investment portfolios. We also recognize that applying these Principles may better align investors with broader objectives of society (PRI, 2006, page 4)."

The six Principles of Responsible Investment include the following: (1) We will incorporate ESG issues into investment analysis and decision-making processes; (2) We will be active owners and incorporate ESG issues into our ownership policies and practices; (3) We will seek appropriate disclosure on ESG issues by the entities in which we invest; (4) We will promote acceptance and implementation of the Principles within the investment industry; (5) We will work together to enhance our effectiveness in implementing the Principles; and (6) We will each report on our activities and progress towards implementing the Principles. These principles emphasize corporate engagement rather than screening as the dominant approach to SRI.

The governance and organizational structure of the PRI Initiative consists of a 13-member board of 11 elected asset owner signatories and 2 United Nations representatives. The Initiative is composed of three types of signatories: asset owner (e.g. pension funs, endowments, etc.); investment manager (e.g. institutional/retail, etc.) ; and professional service partner (i.e. offer products and services to asset owners and/or investment managers). All signatories may volunteer to contribute $10,000 when signing the Principles.

The practical implications of The Principles have sparked innovation in the investment community. For instance, Northern Trust announced a new fund, the Global Sustainability Index, which is based upon the ESG framework (Cui, 2007). At the macro level, it appears that green investing has blossomed as investment firms have incorporated environmental considerations into their investment products (Cui, 2007). The other pragmatic aspect of the PRI Initiative has been described as providing "…investors with a high-level framework for integrating ESG issues into investment decisions (PRI, 2006, page 6)."

The opportunities for the academic community with the PRI Initiative include but are not limited to training to research. With regard to training, the first principle [We will incorporate ESG issues into investment analysis and decision-making processes] offers academics the opportunity to design curricula and deliver education and training for investment professionals. With regard to research, the first principle includes a possible action which states, "[E]ncourage academic and other research on this theme (PRI, 2006, page 4)." Other possible areas for action that support the research agenda for academics includes two such action items under Principle 4 [We will promote acceptance and implementation of the Principles within the investment industry]: "support the development of tools for benchmarking ESG integration (PRI, 2006, page 5)" and "Support regulatory or policy developments that enable the implementation of the Principles (PRI, 2006, page 5)."

A YEAR IN THE MAKING: PRI PROGRESS REPORT

The UNEP Finance Institutions issued a PRI Report on Progress 2007 and noted that the key accomplishments below.

> "One year on, the PRI has gained the support of more than 180 signatories, developed a reporting and assessment framework, provided implementation tools and created the first global investor network dedicated to addressing the broader ESG agenda (UNEP Finance Institute, 2007, page 4)."

This report was developed based upon the findings drawn from a written questionnaire designed for PRI by Mercer Investment Consulting. In this section of the article, each of the six principles will be reviewed and key accomplishments will be highlighted.

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Slightly more than eight out of ten (83%) investment managers and nearly seven out of ten (67%) of asset owners responding to the questionnaire have a formal investment policy statement that incorporates ESG decision making criteria. Furthermore, more than one in two (54%) of the investment managers and four out of ten (40%) of the asset owners actually make investment decisions based upon the ESG criteria in their respective investment policy statements.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

All of the responding investment managers are engaged in voting and 93% have a policy on proxy voting. Additionally, 85% of investment managers conduct proxy voting on behalf of their clients. The top issues addressed are as follows: governance, environment, and social considerations. With respect to filing shareholder resolutions, there is more activity reported among the investment managers (24%) than the asset owners (17%).

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Half (50%) of the investment managers require that investee firms report to them on ESG issues like the Carbon Disclosure Project compared to only 26% of asset owners. In addition, half (50%) of the investment managers require that investee firms comply with standards like The Global Compact in contrast to only 27% of asset owners.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Both investment managers and asset owners pay for services of other financial firms. Accordingly, nearly four-tenths (38%) of the investment managers and nearly one quarter (23%) of the asset owners require PRI related information in the proposals that they receive in response to their RFPs to a large extent. The next step will be for investment managers and asset owners to request that their suppliers and vendors sign the PRI. To date, nearly six out of ten (58%) of the investment managers and nearly half (45%) of asset owners have not made this request.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

According to the 2007 PRI Report findings, the vast majority of investment managers and asset owners have yet to use and post to the PRI Engagement Clearinghouse. Specifically, less than one in ten (9%) of both investment managers and asset owners have used and posted to the PRI Engagement Clearinghouse. However, both investment managers and asset owners are engaged in other collaborative initiatives like the Carbon Disclosure Project (67% investment managers; 50% asset owners) and the United Nations Environment Programmes Finance Initiative (53% investment managers; 23% asset owners).

Principle 6: We will each report on our activities and progress toward implementing the Principles.

More than half (52%) of the investment managers and slightly more than four out of ten (42%) asset owners reported that they make disclosures related to RI/ESG issues to a large extent. Disclosure is one of the cornerstones of accountability and transparency.

CONCLUSION

The UN Principles of Responsible Investment (PRI) represent the realization of the triple bottom line approach to corporate sustainability. The triple bottom line includes financial performance, social performance, and environmental performance (Branco and Rodrigues, 2006). PRI represents an innovation in the evolution of SRI in that "[T]he Principles apply across the whole investment business and are not designed to be relevant only to SRI products (PRI, 2006, page 6)."

Future research in PRI should focus upon examining how investment managers and asset owners are using ESG issues to make investment decisions and then to empirically document the risk/return relationship from incorporating these ESG issues. Governance researchers can investigate to what degree shareholder resolutions and proxy voting is having an impact on the environment, society, and the governance of firms as PRI signatories begin to adopt the six Principles of Responsible Investment.

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