Socially Responsible Investing

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What is SRI?

- Investment in ethical firms.
- Investment in mutual funds that are screened for social responsibility.
- Investment in specifically designated SRI mutual funds.
- Shareholder activism.
Why do people do it?

- To avoid association with unethical firms.
- To influence firms to be more ethical.
Don’t do it to make more money

- Some studies show that SRI brings higher returns.
- But if your goal is simply to make higher returns, you should choose investments that pay higher returns.

  - Forget about SRI.
Does SRI bring higher returns?

- It doesn’t matter.
- If you are interested only in higher returns…
  - …choose investments that bring higher returns.
  - Forget about SRI.
- If you are interested in making higher returns by investing in ethical companies…
  - You don’t care whether SRI brings higher returns on average.
  - You will do SRI anyway.
How is SR evaluated?

- There are many ways.
- Compliance with well-known codes of conduct.
  - For example, FTSE4good index uses codes.
- Specific criteria…
How is SR evaluated?

- Corporate governance
  - Board independence and diversity.
  - Transparency.
  - Reasonable executive salaries.
  - No insider loans, conflicts of interest.
  - No bribery, securities fraud.
How is SR evaluated?

- Environmental factors
  - Efficient use of resources.
  - Minimal impact through pollution, spills, waste.
  - Corporate environmental policy & training.
  - Sustainable development practices.
  - Transparency.
How is SR evaluated?

- Workplace
  - Compliance with labor laws.
  - Reasonable hours.
  - Equal opportunity.
  - No child labor.
  - Health and safety.
  - Violation of these standards through choice of subcontractors.
How is SR evaluated?

- **Product safety**
  - No alcoholic beverages, tobacco.
  - No gambling.
  - No weapons production.
    - Or no production of certain types of weapons (nuclear, chemical, biological, land mines).
  - No genetically modified foods.
How is SR evaluated?

- Human and animal rights.
  - No forced labor, child labor.
  - No collaboration with oppressive regimes.
  - No suppression of organized labor.
  - Respect for indigenous peoples.
    - Self-determination.
    - Informed consent when obtaining land, mining rights, intellectual property.
How is SR evaluated?

- Community relations
  - Corporate philanthropy.
  - Employee volunteerism.
  - No massive shutdowns that destroy communities.
  - Programs that target low-income populations.
Which companies are ethical?

- SRI investment firms provide assessments, often for a fee.
  - Calvert Group.
  - Trillium Asset Management
  - Domini Social Investments
Which companies are ethical?

- Social responsibility awards.
  - Business Ethics Magazine [100 Best Corporate Citizens].
  - Business Ethics Magazine [Business Ethics Awards].
  - U. S. Chamber of Commerce [Corporate Citizenship Awards].
Which companies are ethical?

- Business news media sources
  - CSR Newswire service.
  - Lexis-Nexis Academic
  - Bloomberg’s
SRI mutual funds

- SocialFunds.com
- Social Investment Forum
- Good Money
Why SRI?

- To avoid association with unethical firms.
- To influence firms to be more ethical.
Avoiding unethical firms

- Stockholders are owners and bear ultimate responsibility for the firm’s conduct.
  - Executives and board members are agents for the owners.

- What if company is partly good and partly bad?
  - Islamic concept of purification.
Influencing firms to be ethical

- SRI may raise the stock price.
  - This may give firm an incentive to be good and attract SRI.

- SR investors may take an active role in corporate governance.
  - They may influence the firm through proxy voting, attendance at shareholders’ meetings.
Raising the stock price?

- Classical financial theory predicts flat demand curve for financial instruments.
  - This means attracting SR investors won’t raise the stock price.
  - Modigliani-Miller theorems, capital asset pricing model.

- But classical theory assumes perfect markets.
  - In practice the theoretical assumptions may be violated.
Investors may have different opinions on the value of investments. So demand curve has negative slope. If SR investors already believe SR stocks are better buys, SRI investment won’t change the price. But if they do SRI because it is ethical, they may raise the price.
Flat demand curve?

- Substitutes may be imperfect.
- Portfolios may not be diversified.
  - On the classical CAPM, price depends only on the risk in the entire market, not in the individual firm.
    - This assumes investors hold fully diversified portfolios that represent the entire market.
  - But SR investors are not fully diversified.
Flat demand curve?

- Under these conditions, the theory predicts that the stock price rises with a larger investor base.
  - Since more owners mean less risk.
- So SRI can influence stock price.
Raising the stock price?

- Conclusions of theoretical analysis: the price of a stock will be more sensitive to SRI if:
  - The stock is risky.
  - The stock is unique.
  - The stock trades in small, restrictive markets.
Shareholder activism

- Voting by proxy.
- Attendance at shareholder meetings.
  - Occasionally, demonstrations at meetings.
- Investment in activist SRI funds.
  - The fund votes according to a stated policy.
  - Fund managers lobby the board and executives.
SRI alone is not enough

- It is a blunt instrument.
- It may interfere with the rational allocation of capital.
  - Not a problem if SRI is intended to promote good business ethics.
    - It is rational to allocate capital to ethical firms.
  - But should not be applied to issues that go beyond business ethics (political controversies, etc.)
SRI alone is not enough

- Even in matters of business ethics, public discourse is necessary to arrive at good policy.
  - Financial markets and corporate governance provide no mechanism for public policy discussion.
- There is no substitute for public policy and regulation.
Basic goal of SRI

- Rational allocation of capital is essential to prosperity and even survival.
- Private capital formation relies on individual investors to make good decisions.
- Financial markets may not always provide the right incentives for rational investment.
  - E.g., dot-com boom/bust.
Basic goal of SRI

- Individual investors must keep social welfare in mind.
  - Investment in ethical firms.
  - Long-term investment as opposed to speculation.
    - Excessive churning destabilizes the market and rewards short-term corporate gains.
  - Investment in productive, sustainable enterprises.
    - Even when, and especially when, they do not maximize return.
Further Reading

SocialFunds.com, Socially Responsible Mutual Funds (free)