Responsible Investing – An Evolved Definition for the 21st Century

By Herb Blank

There seems to be a lot of confusion in the market as to what constitutes Responsible Investing (RI) and Socially Responsible Investing (SRI). There shouldn't be, however, especially about the latter. The principles of SRI have over time become more clearly defined and now fit into a consistent framework. It may be worth taking a step back to look at the evolution of SRI through the years and try to define what SRI means within the modern context.

In western culture, many trace the SRI movement back to the famed John Wesley Methodist sermon, “The Use of Money”, encouraging business practices that do no harm to neighbors. One of the early investment funds quoted Edmund Burke, “The only thing necessary for the triumph of evil is for good men to do nothing” in implementing strategies that avoided ownership of the shares of companies in sinful industries as defined in the fund’s charter. The popularity of this fund led to the development of others, some of which defined sinful industries differently and some that also excluded companies with poor corporate citizenship practices. The latter was generally defined by public controversies. For example, in the 1980’s and early 1990’s, I served on the Investment Committee of a Social Principles Fund where the Board members determined the criteria for what business practices were undesirable. Excluded companies included: Sherwin Williams that produced lead-based paints linked to children’s deaths; Union Carbide over its resistance to taking full responsibility for the cleanup and restitution to victims following the Bhopal disaster; Schlumberger for its repudiation of the Sullivan principles; and Exxon for its Alaskan oil spill and subsequent unsatisfactory response.

Around the same time, there were a number of student protests attempting to pressure university endowments to employ socially responsible investment screens to influence the behaviors of corporations. In turn, this provoked papers by respected academics, one of which was by Yale University’s Dr. Stephen Ross arguing that removing stocks from the selection universe resulted in a reduction in the expected-return-per-unit-risk ratio for the overall portfolio. He turned the socially responsible proposition on its head, proclaiming that it was downright irresponsible for a fiduciary in charge of an investment portfolio to consider social factors because the fiduciary’s most important obligation was to generate the highest possible return for a selected level of risk. Other accomplished professors praised this paper. Several opined publicly that social constraints had no place in the science of investing. The concept that attention to social factors causes inferior returns is still held as gospel by some to this day.

The next shift occurred in the 1990’s when some advocates of good corporate citizenship applied the ecological term sustainability to finance and economics. Sustainability is defined as the potential for long-term maintenance of well-being which has ecological, economic, political and social dimensions. On March 20, 1987, the Brundtland Commission of the United Nations declared that “sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs “Applied to the investment in stocks of corporations, sustainability looks beyond whether a company is engaged in “good” or “bad” businesses and to the actual practices of the company.” However, as Louise Fallon, Editor of Worldwise Investor observed, “The problem with it, is that its interpretation depends on the perspective of the user.”

This harkens back to the “arbitrary” criticism attributed to SRI because what is socially irresponsible to the Southern Baptist Convention is not necessarily socially irresponsible to the Sierra Club and vice versa. In fact, one observed trend has been to drop the word social from responsible investing practices. A lot of companies have renamed their CSR (Corporate Social Responsibility) departments and officers to Corporate Responsibility. Similarly, many investment publications and an increasing number of investors have evolved these concepts from SRI to the phrase Responsible Investing. In this context, the word responsible means to divert resources away from the least sustainable activities in order to increase allocations to the more sustainable areas of the firm while the word social is firmly ensconced as one of the pillars of ESG (Economic, Social, and Governance) by referring to measurable firm behaviors with social impact. This is consistent with and leads into the current United Nations Principles declaration.

The United Nations Principles for Responsible Investing (UNPRI) defines “responsible investment” as an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and the long-term health and stability of the market as a whole. It is driven by a growing recognition in the financial community that effective research, analysis and evaluation of ESG issues is a fundamental part of assessing the value and performance of an investment over the medium and longer term, and that this analysis should inform asset allocation, stock selection, portfolio construction, shareholder engagement and voting. Responsible investment requires investors and companies to take a wider view, acknowledging the full spectrum of risks and opportunities facing them, in order to allocate capital in a manner that is aligned with the short and long-term interests of their clients and beneficiaries. This definition has led many to refer to responsible investing as ESG Investing.

Identification of ESG factors as the three main building blocks brings form and shape to Responsible or ESG Investing (RI or ESGI). Rather than judging a line of business to be “bad”, RI takes a best-practices approach within the ESG framework As the global trends of corporations stepping up reporting these data items continue to increase, the There are two major global organizations: the Global Reporting Initiative (GRI) and the Sustainable Accounting Standards Boards (SASB) dedicated to global acceptance of ESG reporting standards. The GRI is in its fourth global iteration and is based on the underlying principles of sustainability. The US-based SASB follows a more rules-based approach. Both initiatives focus on identifying material Key Performance Indicators (KPIs) within each of the three ESG pillars, then creating a reality where corporate reporting of these KPIs becomes as automatic as reporting on the firm’s key balance sheet and income statement items.

As increasing amounts of measurable corporate ESG data have become available globally, so have efforts to integrate these data into investment portfolios - even those portfolios without ESG mandates. This makes sense because they contain the same types of insights into the future directions of companies and potential major risks (e.g., environmental events, litigation) as inventory turnover ratios and projected revenue growth rates. One such approach that has gained popularity is called Triple Bottom-Line Investing. This is a holistic approach to measuring a company’s performance on environmental, social, and economic issues. The triple bottom line approach to management focuses companies not just on the economic value they add, but also on their exposures to potential positive and negative environmental and social effects and controversies.

Certainly, we will continue to see investors who wish to put their money to work in accordance with their beliefs. This includes the traditional no-sin and socially principled investors referenced earlier along with a more recent movement known as impact investing. One early forms of impact investing by institutional investors was the voting of proxies against management initiative to institute “poison pills” and other

practices they considered representative of poor corporate governance. These efforts continue today but some have adopted even more activist approaches. According to the Global Impact Investing Network, impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside an investment return.

In accordance with active awareness, leading SRI and impact investing practitioners have embraced the promotion of ESG reporting and made active use of increasingly available ESG data. The traditional SRI investors score ESG data alongside traditional fundamental factors for their entire universe, then screen out companies in objectionable businesses or on a list of companies with bad practices. The impact investors use a similar universe screening practice to focus on companies where their investment dollars can promote positive impact.

The best fiduciary practices issue has now come full circle. Increasingly, companies are publicly disclosing data relating to Key Performance Indicators regarding their environmental, social and corporate governance practices. Published studies have documented relationships during different periods between such data and returns, some of which correlate periods of outperformance with positive ESG data. Whether these relationships will persist throughout the majority of market cycles is still open to question. Nevertheless, it is clear that investors who exclude or ignore ESG data as part of their fundamental research process do so at their own risk. The tenets of Modern Portfolio Theory state that alpha can only exist when one or more participants have access to and apply information that others do not. If investors have access to publicly available data but ignore them, this may create the same market advantages that investors can achieve with nonpublic information. The only difference is that in this case, that informational advantage is perfectly legal.

At this point, I turn the question back to Dr. Ross and his colleagues. As an increasing number of portfolio managers continue to integrate ESG data into the investment process, can investment policies that preclude the consideration of such data truly be responsible? I posit that such a position is internally inconsistent. ESG-aware investing that accounts for these factors along with other fundamental factors is destined to become the standard for responsible investing.

Glossary

Active ownership - Voting company shares and/or engaging corporate managers and boards of directors in dialogue on environmental, social, and corporate governance issues

Best-in-class – An approach that focuses on investments in companies that have historically performed better than their peers within a particular industry or sector based on analysis of environmental, social, and corporate governance issues. Typically involves positive or negative screening, or portfolio tilting

Corporate Governance - Procedures and processes according to which an organization (in this context, mainly a company) is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization—such as the board, managers, shareholders and other stakeholders—and lays down the rules and procedures for decision making

CR (Corporate Responsibility) also known as CSR (Corporate Social Responsibility) - An approach to business which takes into account economic, social, environmental, and ethical impacts for a variety of reasons, including mitigating risk, decreasing costs, and improving brand image and competitiveness.

Divestment - Selling or disposing of shares or other assets. Gained prominence during the boycott of companies doing business in South Africa

Environmental Investing – Sometimes referred to as green investing, this is an investment philosophy that includes criteria relating to the environmental performance and areas of business of companies considered for investment; the three principal areas of focus are: emissions reductions; natural resource usage; and innovative technological improvements

ESG (Environmental, Social, Governance) Investing – This is an investment approach which incorporates environmental, social, and governance factors into the investment process. ESG terminology was developed and promulgated by the United Nations Principles for Responsible Investing (UNPRI)

Ethical Investing - Investment policies and strategies guided by moral values, ethical codes, or religious beliefs. These practices have traditionally been associated with negative screening.

Global Reporting Initiative - The Global Reporting Initiative (GRI) is a network-based organization whose goals include universal disclosure on environmental, social, and governance performance.

Impact Investing – Investing in companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside an investment return

Negative Screening – This term can be used to categorize any investment strategy of avoiding companies whose products and business practices are harmful to individuals, communities, or the environment. Formerly used exclusively to screen out companies in “bad” or sinful industries, this now also applies to investment strategies incorporating a best-of-breed approach.

Proxy Activism – Actively voting on shareholder resolutions affecting environmental, social, and governance issues of a corporation.

Positive Screening - Screening may involve including strong corporate social responsibility (CSR) performers, or otherwise incorporating CSR factors into the process of investment analysis and management. This starts with a best-of-breed approach and then may overlay more traditional fundamental and price-based factors to create and maintain investment portfolios

Principles for Responsible Investment (PRI) -The United Nations-backed Principles for Responsible Investment Initiative (PRI) is a network of international investors working together to put the six Principles for Responsible Investment into practice. The Principles were devised with input from the global community of responsible investors. They reflect the view that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios and therefore must be given appropriate consideration by investors if they are to fulfill their fiduciary (or equivalent) duty. The Principles provide a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices and so better align their objectives with those of society at large.

Responsible Investing (RI) -This is the process of integrating data on environmental, social, and corporate governance performance and risk exposures into investment decision-making

Shareholder Activism - Actively voting on shareholder resolutions affecting environmental, social, and governance issues of a corporation

Social Performance – The social performance of a company involves its corporate citizenship and how it benefits or impacts negatively on the areas in which it operates. Issues include: product responsibility; health and safety; training and development; employment quality; diversity issues; and human rights issues

Socially Responsible Investing (SRI) - This is the process of coordinating investment policies and strategies with shared viewpoints as to what constitutes socially responsible corporate behaviors. Today's SRI investor frequently combines an RI approach with additional screens to eliminate companies in objectionable industries or with "anti-societal" practices.

Sustainability - Responsible, Impact investing (SRI) is the process of integrating personal values, societal concerns, and/or institutional mission into investment decision-making. SRI is an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis. SRI portfolios seek to invest in companies with the strongest demonstrated performance in the areas of environmental, social, and corporate governance issues (commonly referred to as "ESG")—in both the public and private markets. SRI is also known as "green" or "values-based" or "impact" investing, or simply as "responsible" investing.

Triple Bottom Line - A holistic approach to measuring a company's performance on environmental, social, and economic issues. The triple bottom line approach to management focuses companies not just on the economic value they add, but also on their exposures to potential positive and negative environmental and social effects and controversies

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