Socially Responsive Investing

"Investing can mean many different things, entrepreneurialism can mean many different things, philanthropy can mean different things. Never settle for one simple definition of a word or an approach, because trying different things means we can find more bottom lines, not just one...and in this way we can change the world."

–Sterling Speirn, Former President and CEO of the W.K. Kellogg Foundation[1]

The terminology around investments made with social as well as financial goals in mind remains fluid, and we have addressed some of the specific forms and terms in the following paper. In our discussion, we refer to SRI investments as "Socially Responsive Investments", to avoid the implication that any one set of social guidelines is more or less "responsible" than another. As we explore at length, there is a high degree of judgment and subjectivity involved in setting out an investment approach that is informed by social as well as financial principles, and many points of view can and should be aired as organizations seek out the best pathway to achieving their overall mission.

Socially Responsive Investing (SRI) has grown significantly since the turn of the century as investors and fiduciaries have expanded their definition of portfolio returns to include the externalities that can arise from their investment decisions. In response to this growth, the investment industry has developed approaches to support those investors and fiduciaries interested in implementing a social investment program. As SRI has continuously progressed, the traditional terminology has evolved as well to include labels such as *Responsible Investing* and *Sustainable Investing*. Nonetheless, despite the growth and high level of interest in SRI, there are a few fundamental questions that remain.

- Is the investment portfolio the appropriate vehicle to express the moral or social values of an organization?
- Should the investment portfolio be solely focused on achieving the highest economic value through traditional investing, thus maximizing the financial resources available to an organization that can be devoted to meeting its mission?
- Do socially responsive screens even matter when assessing portfolio performance?

The debate of moral value versus economic value has turned into a more complex issue as the concepts of "double bottom line" accounting have become widespread and the calculation of externalities arising from capital allocation choices has become more refined. Supporters of SRI believe that they can affect change at a company regarding environment, social, and governance issues through a variety of SRI investment strategies, such as seeking out (positive screen) or avoiding (negative screen) a company's stock based on certain measures of social impact. Supporters of economic value believe that portfolios should be structured to generate the highest expected financial return and, by utilizing SRI investment strategies, portfolio returns will be diminished. There is evidence to support both arguments and each argument is supported by passionate advocates. Boards and investment committees increasingly grapple with questions of mission and intertwined economic issues that arise from portfolio investment choices.

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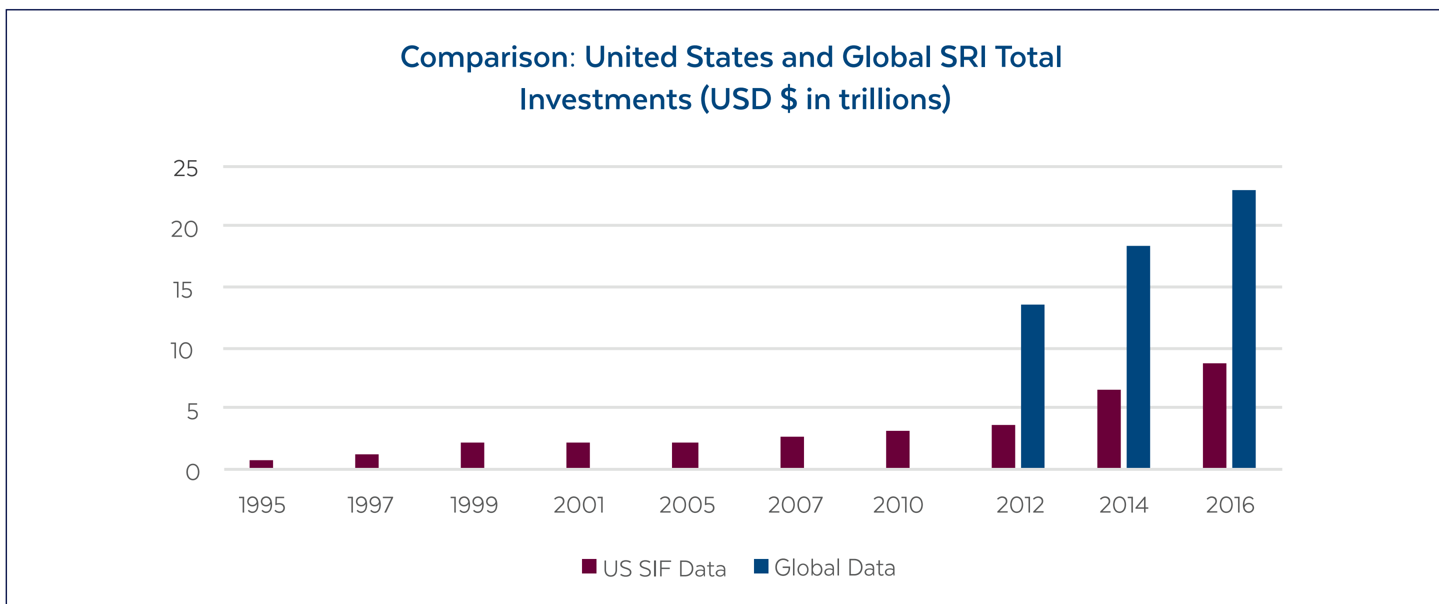
The Growth of Socially Responsive Investments (SRIs)

Socially responsive investing consists of investments made under the belief that they can generate a desirable social, environmental, or governance impact while also producing a financial return. This approach to investing is growing in importance as developed societies and sophisticated investors try to address their financial goals, while also addressing the many global challenges now threatening a sustainable long-term global economy. It is the alignment of values with investment goals as a force for positive change.

Socially responsive investing has experienced huge growth over the past two decades. Since the US SIF Foundation began tracking SRI investments in 1995, there has been a 14-fold increase in the total investment amount. Between 2014 and 2016, there was an increase of 33% in SRI investments, which means that SRI-based investments now account for more than 20% of the total dollars under professional management in the United States.[2]

Global investment numbers mirror the trends experienced in the United States. The Global Impact Investing Network (GIIN) has reported very strong growth in impact investing in many areas of the world. Their report found that of the 62 repeat survey respondents, there was an 18% growth rate between 2013 and 2015 with total investment dollars going from USD $25.4 billion to $35.5 billion. The Global Sustainable Investment Alliance reports a total of USD $22.89 trillion at the start of 2016, which is a 25% increase from the 2014 figure.



Source: US SIF Foundation Biennial Reports on US Sustainable, Responsible and Impact Investing Trends and the Global Sustainable Investment Alliance, Biennial Global Sustainable Investment Reviews

This data supports the premise that SRI investments are growing at an extremely rapid rate, and this trend is likely to continue in the next decade and beyond.

The History of Socially Responsive Investing

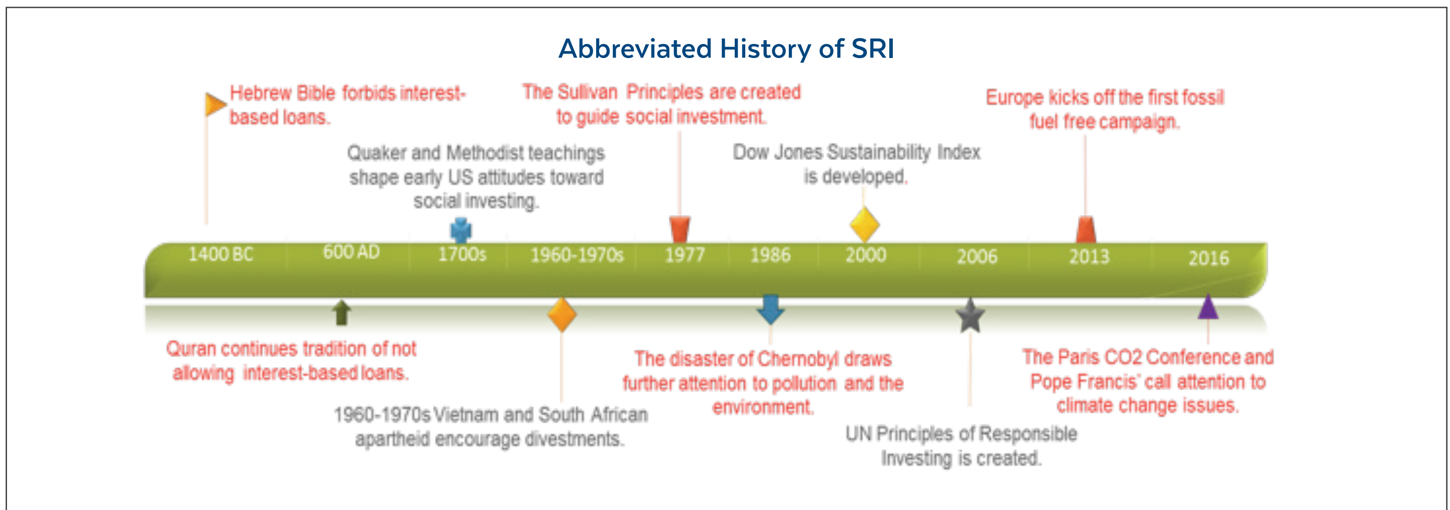
Socially motivated investments have a deep history with strong religious ties dating back to the Hebrew bible, which was first recorded ca. 1400 BC. Several passages in the scripture forbid accepting interest on any loan given to someone in need. Centuries later, around 600 AD, the Quran continued this same religious tradition of not permitting financial gain from loans, promising divine punishment to those who did.

Socially responsive investing in England and the United States finds its roots with the Quaker and Methodist teachings in the 18th century. One of the founders of Methodism, John Wesley, famously gave a sermon entitled, “The Use of Money” in 1760. In this sermon, he preached of the importance of using money for good, instructing others to “gain all you can,” “save all you can,” and “give all you can,” with a mindfulness to the physical and mental health of yourself and your neighbors.[3]

This idea of gaining all that you can without harming your neighbor plays an integral role in the modern era of socially responsive investing. We saw this principle being played out in the 1960’s when thousands of students across the country demanded university divestment from Dow Chemical for its involvement in weapons production (napalm) used in the

Vietnam War. In 1971, Luther Tyson, Jack Corbett and Tony Brown recognized the need for socially conscience investment tools and created the first socially responsive mutual fund, the Pax World Fund. Socially responsible investing continued to grow in prominence as tensions grew during South Africa's apartheid, which led to the development of the Sullivan Principles in 1977. The Sullivan Principles were created by civil rights activist and General Motors' board member Reverend Leon Sullivan. This list of principles acted as a guide for those investors who were looking to divest in the region until equal rights were granted. In both instances, the call for divestment impacted the social climate at the time.[4]

Throughout the 1980s and 1990s, socially responsive investing was not considered a primary investment strategy, but it slowly gained traction leading to the development of multiple indices. The first SRI index was the **MSCI KLD 400 Social Index (formerly known as the Domini 400 Social Index)**, which was established in 1990 to address U.S. investments. The **Jantzi Social Index** was established in 2000 to address investments in Canada. In 2001, two global indices, **Dow Jones Sustainability** and **FTSE4Good**, were developed to track global SRI investments.[5] Six years later, the UN started the Principles for Responsible Investing outlining policies to assist in the investment decision making process. Since that time, social investing has grown exponentially, enabling investors to now select from a myriad of issues that are important to them, which may be chosen in several different ways.



Source: CROSSMARK Global Investments, The Evolutions of Responsible Investing

Types of Social Investing Strategies

It is important to realize that all individuals make decisions based on the culmination of their unique experiences and preferences. During the 1970s, when socially responsive investing started to become more common, it was based on **negative/exclusionary screening**. This type of screening, which is the oldest method, removes investments that could be engaged in undesirable products, services or even actions. In the times of the South African apartheid, the socially responsive investment strategy was to encourage divestment from any American company that was operating in South Africa until the country employed greater civil rights. Other common targets of negative screens include firearms, gambling, tobacco, and pornography.

Doubts have arisen regarding the efficacy of negative screening strategies and whether they have a measurable impact on the companies targeted. In the case of South Africa and the anti-apartheid campaign, the economic toll of sanctions fell harshly upon the least advantaged in the society – the very individuals the sanctions were intended to help. Long term, the sanctions may have played a role in helping to end apartheid, but exacted a near-term cost in the process.

On the other end, there is **positive/affirmative/best-in-class screening**, which is a much more proactive approach. Rather than excluding companies based on their business practices, investors will support companies that uphold socially responsible philosophies and practices. These investments usually include a more in-depth analysis on the business's position and impact across a variety of different issues, including, but not limited to diversity, safety, environmental impact and hiring practices. Additionally, the reasoning behind positive screening is usually based on the investor wanting assurance that the company is engaging in actions that contribute to sustainability. This is different from negative screening, which sometimes seeks just a simple response, such as the end to a war or better working conditions.

A major approach to socially responsive investing is to include **environmental, social** and **governance (ESG) integration** into your overall analysis of an investment. There is a practical belief that a company's approach to these factors will be a strong determinant in the overall longevity of the company. Analysis along these lines can come with a focus on one or all three factors and there are many smaller issues in each category that may also be selected as a particular focus. According to a survey conducted by the CFA Institute, ESG Integration is the most widely used SRI strategy. Of the six available socially responsive investing strategies, 57% of the survey respondents incorporate ESG integration into their entire investment analysis and decision-making process.[6]

Examples of ESG Issues

Environmental Issues	Social Issues	Governance Issues
Climate change and carbon emissions	Customer satisfaction	Board composition
Air and water pollution	Data protection and privacy	Audit committe structure
Biodiversitty	Gender and diversity	Bribery and corruption
Deforestation	Employee engagement	Executive compensation
Energy efficiency	Community relations	Lobbying
Waste management	Human rights	Political contributions
Water scarcity	Labor standards	Whistleblower schemes

Source: CFA Institute

ESG analysis of investments can include an extremely sophisticated process to assist the investors with understanding the company's stance on complex issues, ranked in importance based on their mission.

Another social investing strategy is **Active Ownership**. This strategy is employed by exercising rights as a shareholder to create dialogue with a company's senior management team regarding ESG issues. Active owners do not believe that shareholders should sell securities when ESG issues arise; however, their philosophy is to work with management and influence outcomes and practices regarding ESG issues.

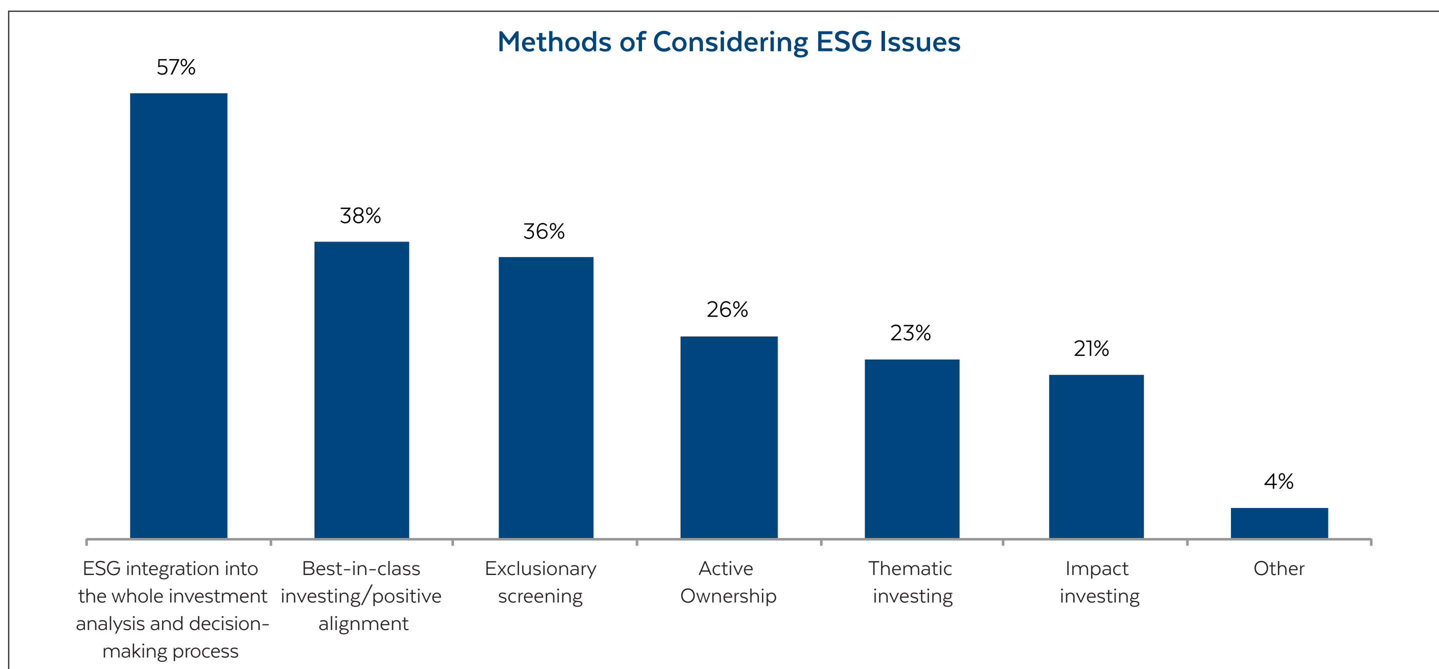
The following actions are part of active ownership:[6]

- Vote in shareholder general meetings
- Write a letter to the company
- Meet with company representatives
- Raise a question at a general meeting of the shareholders
- File a shareholder resolution
- Attempt to gain a seat on the board
- Call for an extraordinary/special meeting of the shareholders
- File a complaint with the regulator/authority
- Issue a statement to the news media

Sustainability Themed Investing is associated with the investment of assets based on trends such as social, industrial, and demographics. This type of investing specifically focuses its efforts on thematic issues such as clean tech, sustainable forestry and education.

Impact Investing equally balances the social and environmental impact of an investment and the financial return, which can range from below market to market rate. This type of SRI strategy allows investors to direct capital to specific companies, organizations and funds that address challenging issues in sectors such as sustainable agriculture, renewable energy, conservation, micro-finance, and affordable and accessible basic services including housing, healthcare, and education.

Below is a graphical illustration based on a survey conducted by the CFA Institute showing the types of socially responsive investing strategies employed when dealing with ESG issues and the usage by percent based on survey respondents.



Source: CFA Institute

Is there a balance between social obligation and maximizing portfolio returns?

The overarching goal of SRI investments is to generate returns while also affecting social change. The key toward a successful investment is considering the relationship between these two elements. The innovation arises in the challenge to the traditional notion that social and environmental issues be handled via philanthropy, while market investments solely focus on achieving maximum returns. Supporters of social change through investments believe it is a moral obligation of the investor to hold companies accountable for their actions and the manner in which they conduct business. Increasingly, individuals and institutional investors feel it is a fiduciary responsibility to ensure the companies they invest in are in line with their core beliefs or their organization's mission statement as they understand it. At the same time, there is a greater comfort level when investing in companies that adhere to ESG screens, driven in part by a belief that ESG screened portfolios do not result in concessionary levels of return relative to non-screened portfolios. According to a survey of investment professionals conducted by the CFA Institute, 63% of the respondents take ESG issues into consideration during investment analysis/decisions to help manage investment risks. Not surprisingly, 44% of the respondents noted that their clients/investors are demanding ESG screens.[6]

Despite the survey results noted above, the data regarding the impact on returns and volatility arising from ESG screens is incomplete. There is a persuasive rational argument being made that supports the possibility that an ESG portfolio, which reduces the investable universe of stocks using screens, may produce lower returns and higher volatility over time than non-screened portfolios. The macroeconomic environment plays an important role in the impact of screens over time, especially during times of depressed growth and heightened levels of uncertainty. In these types of environments, investors tend to pursue sectors that have higher yields and greater liquidity. Examples of these sectors include tobacco and oil and gas, which are excluded from ESG portfolios.[7]

Furthermore, according to Cliff Asness from AQR Capital Management, a portfolio constructed utilizing ESG screens will generate a lower expected return because the portfolio is investing in "non-sinful" stocks. These "non-sinful" stocks have a lower cost of capital to pursue projects and a lower break-even return on investments; therefore, the shareholders of these stocks accept a lower expected return to meet their social obligation.[8]

In reviewing a number of socially responsive strategies, it's possible to consider that the performance of SRI funds relative to a non-screened benchmark could be linked primarily to sector tilts and time-dependency. For example, the MSCI KLD 400 Social Index tends to have a heavier weighting to technology companies, which are more likely to pass ESG metrics versus companies in the industrial and utility sectors because of concerns regarding pollution or defense contracting.[9] As a result, SRI funds that track the MSCI KLD 400 Social Index may have an overweight in technology; therefore, these SRI funds may have the tendency to perform better during time periods when bull/ growth-dominated markets are persistent.

The question facing mission-driven investors is simple. Can they create the societal change they desire more efficiently through ways in which they invest their assets or by using the returns earned by investing their assets with the sole goal of return optimization?

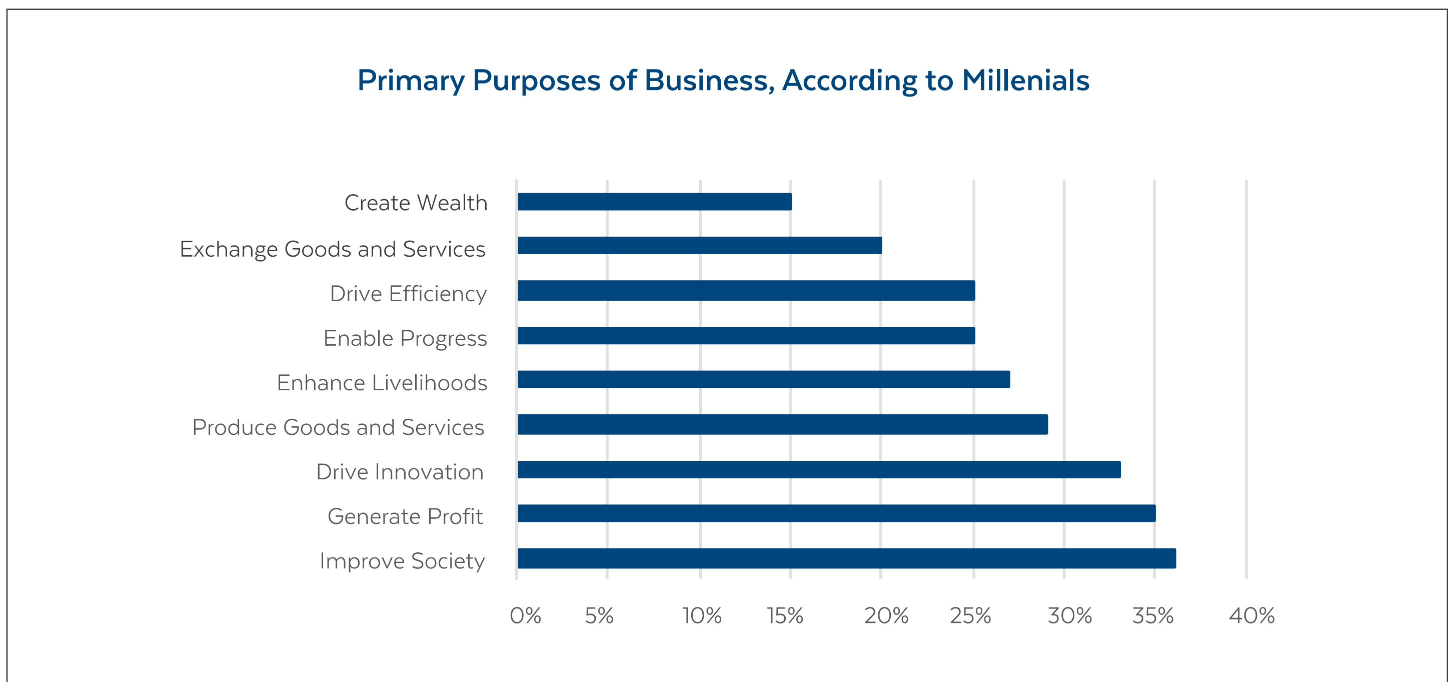
With rising client demand and the perception that sustainable companies are acceptable investments, the investment industry has taken notice and responded by creating products to meet this mandate. The number of investment funds incorporating ESG factors has grown 12% over the last two years.[2]

Investment Funds Incorporating ESG Factors 1995-2016											
	1995	1997	1999	2001	2003	2005	2007	2010	2012	2014	2016
Number of Funds	55	144	168	181	200	201	260	493	720	894	1002
Total Net Assets (in Billions)	$12	$96	$154	$136	$151	$179	$202	$569	$1,013	$2,457	$2,597

Source: US SIF Foundation
Note: ESG Funds include mutual funds, variable annuity funds, closed-end funds, exchange traded funds, alternative investment funds and other pooled products, but exclude separate accounts, Other/Not Listed, and community investing institutions.
From 1995-2012, separate account assets were included in this data series, but have been excluded since 2014, in order to focus exclusively on commingled investment products.

The Impact of Millennials

Several trends will likely have an impact on overall SRI activity over the coming years. On a global scale, the millennial generation is soon entering their peak economic and investment age, and they are perceived as being more willing to pay extra and invest more when an issue matters to them. Almost three quarters of the members in this demographic group responded in 2015 to a hypothetical question of cost and benefit that they would pay more if it had a positive impact on sustainability – a response that was much higher than that of previous generations. Perhaps more importantly, the generation after the millennials (Generation Z) also reports an equally strong commitment toward socially responsive investing. This shift in priorities may have economic consequences. Those brands that articulate as a component of their brand identity a commitment to sustainability are growing at a much more rapid rate (>4%) than those who do not have the same commitment (<1%).[10] In fact, when asked directly, millennials reported that the "primary purpose of business" is to Improve Society (36%), while the last item listed on the survey was *Create Wealth*, which only 15% of the respondents considered to be a primary purpose.



Source: World Economic Forum, From the Margins to the Mainstream, Assessment of the Impact Investment Sector and Opportunities to Engage Mainstream Investors, September 2013

In response to this potential cultural shift toward value-based investing, the United Nations' Principles for Responsible Investment was formed in 2006 by a group of institutional investors to further the scope of socially responsive investments. As a result, The Six Principles for Responsible Investments was created to encourage support for ESG investing and provide possible actions regarding ESG issues. While the Principles are voluntary and aspirational, in the past few years over 1,700 investors have committed to the Principles. The total amount of capital committed through these investors is $62 trillion, coming from 50 different countries. This represents another indication that the trend of increased social investment will continue in the coming years.[11]

The Six Principles for Responsible Investments

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

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

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

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

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

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

Source: Principles for Responsible Investments, United Nations 2016

The World Economic Forum reports that those businesses that incorporate positive social and environmental policies have huge potential, especially in developing markets, in which the investor can achieve the desired social and environmental impact while still resulting in strong financial returns. This is contrary to the widespread belief that socially responsive investing typically has a negative consequence on financial performance. Most investors list the greatest challenge of SRI investing as changing the financial perception of socially responsive investing.

Other studies offer a different perspective, with one study from the U.K. suggesting a 30 to 50 basis points annual reduction in performance as a result of a negative-screened portfolio.[7] Different analyses offer different outcomes, particularly as some studies focus on pro-activelypositive investments, i.e., contributing to infrastructure investments in developing countries to create sustainable economic growth, versus portfolio screens on secondary market investments designed to include or exclude certain factors.

The influence of millennials will continue to grow as they begin to serve as board/investment committee members and trustees for not-for-profit organizations. As the composition of boards and investment committees evolve, the discussions of the complex relationship between the duties of the fiduciary and the implications of investment decisions will become more nuanced. Additional complexities may arise if, as SunTrust expects, future investment return levels are modest; institutions will then face challenges in earning investment returns that both sustain their cash flow needs and provide for real growth in asset value after the effects of inflation. This issue raises the stakes for any discussion that influences investment returns over long periods of time.

The Impact of Socially Responsive Investments on the Organization

Investment committee and board members must consider how investment decisions ultimately align with the mission statement of the organization. Do educational institutions have a responsibility to include environmental guidelines in their investment policies? Activists of today argue that they do – students of the future, who may bear the costs of reduced endowment returns, may have a different view. Issues of inter-generational equity arise, as the concerns of today may drive decisions in a direction that creates disadvantages for future constituencies, and the complex cost/benefit analysis of a social investment may suffer from substantial mismatch in the timing of the cost and the impact of the benefit.

On a national scale, individuals are growing increasingly aware of the connection between money and making social progress, and a greater number of individuals are willing to spend more for the same product if they know the company is affecting

positive change. In the same vein, as more data becomes available to support the fact that SRI can lead to tangible and positive social outcomes, institutions and not-for-profit organizations that fail to incorporate an SRI strategy may actually face a reduction in their donor base. Donors may be likely to increasingly incorporate an analysis of an institution's SRI strategy in their decision-making process. Crucial to such an outcome is an accounting mindset that looks beyond pure economic profit as captured in public accounting standards, and instead incorporates a "double bottom line" standard that includes the impact of externalities that are not reflected in traditional accounting measures. The development and acceptance of a widespread, objective standard for measuring such externalities has yet to be determined.

As a result, investment committee members may struggle in efforts to balance the mission of the organization they are serving with their fiduciary responsibilities through the lens of SRI investments.

Questions to Ask Prior to Investment

MISSION
- Is the investment aligned with our mission?
- Are we meeting the funders' guidelines and requirements?

FIDUCIARY
- Is the rate of return satisfactory?
- What is the long-term sustainability of the company?
- Are there sufficient checks and balances to prevent fraud and abuse?

Educational Institutions, as a whole, lack consistency with SRI mandates

University of California

There is perhaps no better example for the model of institutional-level socially responsive investing than what is found with the University of California (UC). Across ten campuses, five medical centers, three national laboratories, as wells as agricultural and natural resources centers, the entire university system is committed to launching sustainable initiatives, which guides their investment decision-making process. They approved a Framework for Sustainable Investing in September 2015. The UC system actively considers their role to be that of "sustainable investors," which accounts for long-term investment markets, as opposed to that which may be more profitable in the short-term, although the returns that are being actualized by their sustainable investments remain very competitive.

Their investments are guided by the principles they have identified as crucial to their mission. The biggest one currently is combatting climate change. Towards this end, they have allocated over $1 billion in their UC Ventures program that promotes entrepreneurship and innovation in achieving effective, climate-change solutions. They participate as a signatory of the UN-supported Principles for Responsible Investment. In almost every dimension, their guiding principles are incorporated into the investment decision-making process. The institution has received widespread accolades for becoming a global leader in socially responsive investing and they have also received widespread support from their educators, researchers, and students.

Stanford

Stanford has had a Statement on Investment Responsibility in place for its institution since 1971. This statement outlines conditions of divestment from certain companies when conditions cause social injury. While this statement is extremely relevant when discussing human rights violations, it does not address other, more contemporary concerns, including climate change. Since this is such a pressing social concern, students on the campus have been protesting in support of divestment activities similar to what the UC system implemented.

The Board of Trustees issued a statement in April, 2016 indicating they would not divest from companies in the fossil fuel industry. Their position is explained by two points they illustrate. First, they believe that the endowment must invest broadly in order to meet its financial needs so it may adequately fund its educational offerings. They also cite that their Advisory Panel did not recommend divestment, because it could not adequately evaluate whether the social injury caused by the fossil fuel industry outweighs the social benefit it provides. The university points to its strategies for reducing carbon emissions

through other activities, such as a new energy system across campus and their adoption of sustainability initiatives. These efforts, however, fall short of socially responsive investing and there is no indication that they are generating greater returns by continuing their investments in the fossil fuel industry. Students continue to protest these investments on Stanford's campus.

Harvard

The endowment for Harvard is one of the largest academic endowments in the world and their management company cites a strong commitment to sustainable investing. They reference a three-pronged approach to guide their sustainable investment work and priorities, consisting of ESG Integration, Listed Equity Active Ownership in order to exercise the client's voting rights, and Collaboration with global investors and other endowments. They are also a signatory on the Carbon Disclosure Project, which works with governments, companies, institutions and other investors to advance environmental and performance disclosures of publicly listed companies.

Despite these activities, the Harvard endowment also emphasizes that it believes that the best way in which the university can serve society is through its educational offerings, which they believe will benefit from not divesting in the fossil fuel industry. The student and public demand for divestment has been especially vocal for Harvard. There has been a movement called Divest Harvard, which has been calling for divestment from fossil fuels and reinvestment into more socially directed funds. They have been active in their mission for over five years and due to the pressure from this coalition, the institution stopped investing in fossil fuel interests in April 2017. At the same time, the Harvard Management Company (HMC) has restructured its entire investment office and is pursuing a wholly new model of investing due to a long history of sub-par endowment returns. Given the demands of the student body and changes at HMC, we anticipate the tension between the need to improve investment returns and the demands for divestment to likely increase in the coming years.

Each of these universities, willingly or due to public demand, has approached sustainable investing in its own way given their current student body, faculty and staff, and donor base. Despite efforts to satisfy their current constituents, it is uncertain as to how these decisions to implement SRI will impact the portfolio and affect their future obligations. Nonetheless, these universities rely heavily on their respective endowments to perform and generate the highest return available. In fiscal year 2016, Stanford's endowment disbursed $1.1 billion to support financial aid, academic programs, and current operations. Of the disbursed amount, 23% was used to support the University's operating budget. In addition, Harvard's endowment, in fiscal year 2016, disbursed $1.7 billion, of which 36% was used to support operating costs of the University. Moreover, in June 2017, the University of California agreed to certain conditions in order to receive increased state funding to help meet pension liabilities after a negative audit report. One of the conditions required the University to keep tuition steady for two years, effectively shifting the responsibility of offsetting higher cost to the endowment.

Conclusion

While the discussion of SRI and ESG investing has exploded in recent years, actual adoption lags due to a number of very real challenges. The interpretation of intangible sentiments surrounding mission into actionable portfolio guidelines is a process that can lead to fracture and division if world views differ among board and investment committee members. Short-term political or cultural fads can have long-term portfolio implications, the effects of which can long outlast the "cause du jour."

At the same time, mission-centric organizations hunger for the ability to live out their missions in real time and to "walk the talk" in terms of the ways in which they manage their resources. As with so many other topics, there is no one-size-fits-all solution, and purists from either side of the conversation may find that a middle ground exists in which social guidelines can be a part of the investment discussion alongside return expectations and the duty of fiduciaries to preserve the value of perpetual pools of capital for future generations.

In this complex and evolving dialogue between mission and fiduciary duty, between economic realities and the pressing social concerns that garner our attention, investment committees and boards should seek information, analysis and perspective on the array of choices available to them. In this area as in so many others, *where your treasure is, there will your heart be also* (Mt 6:21 [KJV]). We stand ready to assist in the conversations that can help define the outlines of an evolving financial ethos for your organization.

[1] W.K. Kellogg Foundation President and CEO Sterling Speirn at TEDxUofM talk. Available at https://www.tedxuofm.com/2013/ (accessed June 2017)

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[1] As of March 31, 2017

For more information about the SunTrust Foundations and Endowments Specialty Practice, please visit us at www.suntrust.com/foundationsandendowments or www.suntrust.com/nonprofitinsights

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