WHY SOCIALLY RESPONSIBLE INVESTING OUTPERFORMS
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INTRODUCTION
by
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People talk a lot about "socially responsible investing" ("SRI"). We need to talk more about who determines what constitutes SRI. Who sets the standards? Or, put another way, what is SRI? Let's start with what it is not. SRI cannot be the best-intentioned, most elaborately researched conclusions of the "best people," be they corporate executives, university professors or philosophers. In a democratic society, only those whose authority derives from informed popular consensus can establish legitimate standards defining the balance between corporate and public interest. SRI, therefore, must focus on assuring that portfolio companies spaciously obey the law. However, it is not quite that simple.

For the democratic process to work in a meaningful way, laws must be based on full information. The situation today is often otherwise. Not only are legislators dealing with imperfect information, in many situations they are legislating in areas where the information is deliberately withheld or distorted by the party they are seeking to regulate. In the United States over the last twenty-five years, this has conspicuously been the situation with respect to the automobile and power generating industries. W.R. Grace deliberately withheld information that its products contained asbestos well after the time it was established that this would injure workers. Responsible shareholders must assure that the managements of portfolio companies disclose fully the impact of corporate functioning on to society.

Ownership responsibility goes further. It is necessary in a democratic capitalist society that business and government communicate. In order to pass responsible laws, government must have full information about business' operations and their impact on society. There is a further need that business be restrained in its impact on elections, the making of laws and their implementation. The perception that laws are being made and enforced not for the public good but for the interest of corporate money and power will surely destroy a free society. Where are we today?

Consider the example of Microsoft. When the Clinton Administration filed its first suit against Microsoft in the fall of 1997, the company had a one man lobbying shop with an office above a suburban Washington mall and company executives considered the Capitol as a largely irrelevant factor in corporate life. Its political contributions were minimal. By early 1998, the Justice Department and 20 states filed their broad anti trust suit against Microsoft. Many observers came to believe that persistent lobbying by its competitors and adversaries, and senators from the states where they were located contributed to the decision. As befits the premier enterprise of the time, Microsoft learned and reacted on a large scale. The company assembled the usual bank of lobbyists, spinmeisters, and political payoffs and, as they say, the rest is history.[1] There is no hero to this story. It is a story of SRI gone badly. It is a model of too much corporate power over government, both in its beginning and in its end.

The only element in the corporate universe that can effectively require that management be restrained in its dealings with government is the owners. What we are talking about is real SRI. It is what must be if the concept is to have legitimacy. It is not what it is today. Let's turn to that. Real SRI exists when owners change *their* company along lines of sensitivity to social concerns. Indeed, as we will note in concluding this introduction, shareholder involvement is necessary in order to mitigate the most brutal negation of shareholder values as dramatically evidenced in recent times by Enron.

SRI has largely existed as a passive concept. The guiding principle has been that skilled individuals are capable of selecting certain companies which do not (the emphasis has been on excluding certain categories) have acceptable impact on society. Using modern technology for diversification and risk, it has been possible to construct portfolios comprised of "good" (in the sense they are not bad) companies, which approximate the investment characteristics of the market as a whole – usually the S&P 5000 index. Peter Camejo devotes the first five chapters of this book to a careful analysis of the various modes of measuring stock performance over varying lengths of time. He usefully lays to rest any concern that SRI indexed funds perform at least as well as the general averages over any relevant length of time. This is very important, because of the persistent impression that social consciousness has an investment cost. So long as trustees, a species that incarnates risk aversion, have any basis to be inhibited by even a scintilla of potential liability they will decline to endorse a controversial investment mode.

This theme is picked up in Jon Hale's reference to the Department of Labor's Ruling 98-04A. The Pension and Welfare Benefits Agency (the "Agency") with authority over all U.S. private employee benefit systems under the Employees' Retirement Income Security Act of 1974 ("ERISA") is probably the most important explicator of fiduciary responsibility in the world today[2]. The Agency has consistently maintained that SRI is not in itself illegal. A trustee must manage prudently with an "eye sole" to enhancing the value of the beneficiaries' interest. However, this investment may at the same time serve a parallel social purpose. An example is the investment by Prudential, as trustee, in mortgages on projects that are constructed only with union labor. Prudential's loan committee reviews all loan applications on a union blind basis. Only after the committee has approved particular credits is the fact of union labor involvement in construction revealed. The Agency opined that there was no ERISA objection to a trustee selecting from the approved credits only those with union involvement. This is an essential legal foundation for the Community Based Investing referred to in Steven Schueth's article which "…allows investors to put money to work in local communities, where capital is not readily available, to create jobs, affordable housing and environmentally friendly products and services."

Mathew Kiernan's piece and the article by Hawley and Williams raise the interesting question whether SRI is correctly seen as an entirely passive activity. One can ask what useful purpose is served by declining to invest in "bad" companies. The theory is that if enough potential buyers decline to purchase a security that its price in the market will drop, leading, one hopes,, to appropriate remediation. The "creation myth" here is the long program of forced disinvestments in apartheid South Africa. It is occasionally cited that Nelson Mandela applauded those who demonstrated concern in this way; it is also widely cited that the great man applauded those companies who continued operations in South Africa with the effort to improve racial working conditions. There has never been any demonstration of adverse stock price on companies who continued to do business in South Africa. Horribly enough, the only financial consequences from this well intended effort that can clearly be adduced are the huge losses of the companies who, in

response to SRI clamor, divested their operations under “fire sale” conditions. It is also certain that divesting institutions suffered losses. Roland Machold, formerly the much respected Investment Manager (later, Treasurer of the State) for the New Jersey pension funds, estimated his funds’ losses at half a billion dollars. Philosophers have long taught that one cannot prove a negative. By analogy it is difficult to imagine being able to prove that moving pieces of paper (this is the action required under traditional SRI) representing minor ownership percentages among classes of owners will have material effect on the conduct of a publicly owned corporation.

We need pause to reflect on the appalling economic consequences involved in the creation myth of the SRI movement. What do we learn? Unless the “social rules” requiring divestiture are *universally agreed and universally enforced*, passive non-investment can be predicted to have little positive effect and, indeed, serious value destroying consequences. Global enforcement of a universal norm that not everyone will necessarily agree to seems unlikely in the extreme. This same energy directed at changing companies from within offers a more promising route.

The idea that there is such a category as SRI certainly raises consciousness. Thus, in Aiyer and Helm’s article we learn that Novartis was retained in the favored index notwithstanding “a well documented, troubling legacy of product liability and environmental problems”, [12-7]. The basis for this was the willingness of the company to change its internal environmental management systems and to have a dialogue with its critics. The concept of informed and persistent involvement by the shareholder begins to appear a critical element for an effective SRI.

Williams and Hawley bring us tantalizingly close to a world in which the global investors, whom they identify and quantify, can have useful impact, but they content themselves with “... a universal owner has a fiduciary obligation to use a variety of means (including public policy advocacy and the corporate governance processes) to encourage firms to produce positive externalities, and to minimize or eliminate negative ones…’Care’ involves active and forceful engagement with the firms they own…Thus, they must engage.” [12-19,21] We are left to wonder, how? But, we can hope that fascinating subject will be the subject of their next book.

Stephen Viederman concludes this useful collection of papers with a most insightful listing of the reasons why the finance committees and board of directors and trustees of our leading institutions largely continue to refrain from considering social investing. The facts are discouraging – Harvard University teaches ethics, Harvard Management Company eschews active shareholding; the Ford Foundation grants hundreds of millions of dollars annually for well-conceived programs; Ford’s investment committee declines to be involved in shareholder activism. This raises a most serious question – is SRI a fringe activity, to be limited to the “true believers” who have always had a bit of trouble with the ugly face of capitalism?

Where are the “great and the good”? This question is slowly and patiently being addressed in the United Kingdom where institutional investors are now required explicitly to adopt social and environmental policies with respect to their investments. The burden has been placed on institutions to become activist with respect to the companies whose equity securities are held in their portfolios if such is necessary to enhance value (the “Myners Report”). This has come about as a result of ten years of public dialogue, starting with the so-called Cadbury Commission, involving managements, accountants, money managers, bankers and government figures. No

such high level discussion has yet taken place in the United States, either in the public or private sector.

Who is opposed to SRI? There is, to be sure, legitimate concern by the pension and investment communities that fiduciary disciplines not be diluted. Are those who hold back genuinely moved by the imagined plight of the pensioners, or is something else at stake? Do companies worry that social consideration will decrease their competitiveness domestically and abroad? If all companies operate under the same rules, there should be no change in competitiveness. Is it a question of power? Is there something fundamentally unacceptable about accepting corporate wisdom from a group outside of the management? The overarching reality is vast inertia from a community that is riddled with conflicting interests and which finds the present resolution of power and wealth satisfactory.

Over the next decade, I predict that sensitivity to societal and environmental concerns will be *explicitly* recognized as adding value to companies. I have patented a simulation *BRIGHTLINE* that is available at **http://www.ragm.com** for those who would like to probe this area further. We need to ingrain into the public consciousness the reality that only attention to sustainable values will allow corporations to achieve optimum value.

The debacle of Enron causing the destruction of values for hundreds of thousands of pensioners and investors has turned attention at the Presidential level to the need for corporate accountability. "Through stricter accounting standards and tougher disclosure requirements, corporate America must be made more accountable to employees and shareholders and hold to the highest standards of conduct."[3] The pervasiveness of public outrage gives the opportunity to assure that 'accounting standards' are defined spaciously so as to include fully the impact of corporate functioning on society. The possibility of fully legitimate legal standards raises the hope for a robust conceptual basis for socially responsible corporations. The certainty of loss in the absence of informed and effective activity persuades owners to be responsible themselves and to require it from their managers. This is the only formulation that there can and that there should be global sustainability of a corporate system.

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[1] The foregoing is based on and paraphrases a brilliant article by Joel Brinkley, "A Huge 4-Year Crusade Gets Credit for a Coup," *New York Times*, September 7, 2001, at p C5.

[2] Because it directly regulates a larger volume of assets than any other single authority.

[3] The State of the Union Speech, President George W. Bush, 1/31/02