Doing the right thing

One of the strongest drivers to increased corporate responsibility has been the emergence of an increasingly activist and socially conscious investor. What began as a few niche religious investment groups and concerned individual investors has snowballed into a much broader trend, attracting money from investors of all stripes – including those who are motivated purely by returns. **Solomon Teague** reports.

There is no accepted definition of what constitutes socially responsible investment (SRI). "There are as many definitions for SRI as there are managers of SRI funds," said Silvio Mattanza, managing director at Zurich-based Zegora Investment Management. At one end of the spectrum are funds that have identified certain companies that are seen to fall short of a given definition of "responsibility", in which the fund will not invest. At the other end of the spectrum are funds with complicated quantitative models to assess management structures, business plans and operational execution.

The investment universe of funds at the different ends of the spectrum is therefore potentially very different. For example, Nokia tends to score very high on many CSR ranking studies and has numerous certificates, including the ISO 1401, acknowledging its efforts in this area. For funds investing in sustainable or responsible companies it is a popular investment. But Zegora invests predominantly in environmental technology companies, whose purpose is to develop, for example, alternative energy. As such it does not consider telecoms companies, no matter how responsible they are.

Another branch of SRI includes activist funds that actively seek out "sin stocks" in order to bring about improvements in their practises, in the belief this will be reflected in better performance over the medium-to-longer-term. Other funds operate a screening process of some kind as an overlay on their investment process, eliminating stocks that do not adhere to certain principles. The Norwegian Government Pension Fund has an investment universe of approximately 7,000 stocks, and has a relatively modest SRI overlay that eliminates a small number of stocks – around 25 – which are judged to be extremely irresponsible.

Even funds that do similar things, for example screening out companies they believe have bad business practices, might have very different ideas about what constitutes acceptable or responsible behaviour. There are no universally accepted answers to questions about how important employment conditions are relative to involvement in questionable industries like arms trading – or where the boundaries should be set in such matters. So it is down to the manager to decide.

There is a school of thought that limiting your investment universe in any way is only likely to have a detrimental affect on returns, by placing restrictions on the manager. Another counters that consumers and investors now place more importance on corporate social responsibility than ever before, making it a valid investment indicator and one that will lead to improved performance over time. In fact, it cannot be taken for granted that there is a correlation between fund performance and SRI. The appeal of such funds is as likely to rest with the religious or moral beliefs of the investor as it is with a conviction about the relationship between CSR and returns.

The investors are likely to vary in different types of SRI fund. In an environmental fund like the Zegora Environmental Fund, there may be a mix of investors with strong concerns about the environment alongside others who are less concerned personally, but harbour a macro-economic view that this is a growth sector. Other funds that screen out sin stocks are likely to have a higher

SRI strategies applied in Europe

Source: Eurosif European SRI Survey, 2008

proportion of investors wishing to factor religious or moral principles into their investments.

Investors in Rathbones Greenbank have bespoke portfolios created for them matching their own ethical criteria and investment expectations. It manages around £300m for a broad range of investors, some interested in environmental matters and some of a more religious bent. "We engage clients so we have a good idea of what they want," explained Mark Mansley, investment director at Rathbones Greenbank. "Consider companies like BP or Glaxo. They do some responsible things, but they also do some things people might consider problematic. We let our investors decide."

Faith investing

There is significant overlap between Sharia investing and broader SRI, which in Europe has its roots in Christian traditions – particularly in Methodism and various non-conformist denominations. Sharia rules have proved popular, even with non-Muslims, because its rules are applicable to a broader spectrum of ethical palates, for example in its rejection of investment in the arms industry.

Sharia funds have also proved quite successful this year through their avoidance of financial institutions. Yet some non-Muslim investors might find the preoccupation with usury irrelevant, placing an unnecessary restriction on a manager to invest in a sector which, at other points in the economic cycle, might make compelling investments. And while some financial institutions could be rejected by SRI funds for other reasons besides their association with interest payment – perhaps by financing questionable businesses – others sit much more comfortably in an ethical portfolio: the UK's Cooperative Bank, for example, is itself governed by strict CSR/SRI principles.

Sharia rules are narrow compared to the broader SRI universe, and have nothing to say, for example, on environmental concerns or corporate supply chains and working conditions. According to Mansley, Christian SRI funds tend to be more flexible than Sharia ones, and often correlate more closely with the moral priorities of European investors.

Principle versus profit

The billion dollar question is what impact a global slowdown, recession or depression will have on SRI. Investors with only a fleeting commitment to the sector are likely to pull back from ethical investments.

Yet those who do believe in the relationship between responsibility and performance are unlikely to abandon SRI. And the case can be made that more people will be attracted to the sector in the event of a global recession or depression, as investors look for transparency – or the cost saving associated with efficiently run businesses. Conceivably, certain subsets within SRI could gain as the markets fall, while other could decline.

"The credit crunch is driving a growing emphasis on greater responsibility and accountability," said Mansley, with questions about "moral hazard" – the idea that bankers make money when their bets pay off, but taxpayers lose it when they don't – becoming mainstream talking points. These themes tie in well with the SRI agenda, which is keen on promoting accountability and transparency. The current financial problems could, therefore, help bring SRI – or at least the values it promotes – further into the mainstream, and help to reverse the culture of short-termism which, on the financial side has led to the credit crunch, and on the social side has created the need for the CSR movement.

"Sustainability investing is about long term and – among many other topics – governance," said Christoph Muller of Inrate, stressing a correlation between the recent performance of financial stocks and their CSR problems. "In both fields the failing financial institutions and banks had very poor performance, which the public and the investment community are aware of."

The hope is that the aftermath of the current situation will see financial institutions, and others, reassess how they approach such issues. "Sustainable investors have more in mind than just riding the next wave and closing their eyes in the face of unsound incentive structures," Muller said. "This makes SRI currently popular – or less unpopular than other investments."

Yet while some investors conduct significant due diligence on SRI funds to ascertain exactly what their investment criteria are, it seems many more are content to believe a product that is labelled SRI is just that, especially if returns are good: the act of investing in an SRI fund is enough to assuage the conscience of many mainstream investors.

At the same time, the growing interest of CSR for investors and consumers alike is alerting corporate PR departments to its potential as a marketing tool, making life increasingly difficult for fund managers trying to cut through the spin. "Northern Rock won plaudits for its community involvement and for the Northern Rock Foundation, but this only ended up diverting attention away from its flawed business," said one fund manager.

Many multinational companies have been busily creating the illusion that they are dedicating significant resources to charitable causes or addressing the impact of their businesses. SRI managers have to make an assessment regarding how meaningful their efforts are as a proportion of the revenues generated by such companies. Again, managers – like consumers – will vary in their assessment of what a meaningful proportion is.

Part of the problem for manager arises from a lack of consistency in the way companies report on their businesses – for example, giving data in different date ranges or being selective in the information they release. It makes it hard to interpret information from one company, as well as comparing between companies. A business has sprung up from the opaque nature of CSR reporting: Asset4 is a provider of ESG (environmental, social and governance) information, allowing its clients to see independent and standardised information regarding corporate CSR. Many of its clients are from the buyside, with some dedicated SRI funds but many more mainstream asset managers that believe in a positive correlation between good CSR and financial performance.

In some instances it scores companies in certain areas, while in others a yes/no answer is more appropriate, for example, regarding whether a company employs child labour. It has 800 data points – such as, CO2 emissions – and 278 indicators – for example, CO2 emissions per unit of revenue generated.

Interestingly, Asset4 data on global investment banks throws some light on performance since the credit crunch took hold, said Henrik Steffensen, responsible for marketing and business development at Asset4: the banks that have done worst have tended to be those that scored poorly in the ESG data, with Lehman among the worst.