

# Primer on Socially Responsible Investing

By Thomas Lau, CFA, FRM, CIM, CDipAF, MDE, [InvestWELLFinancial.com](http://InvestWELLFinancial.com)

April 2006

## Introduction

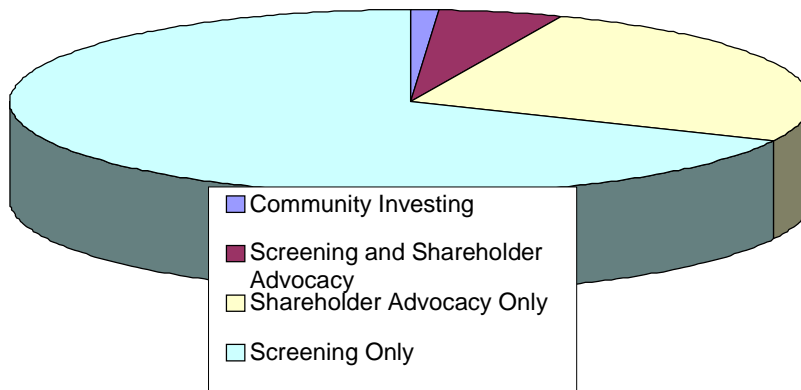
Socially responsible investing (SRI), or sometimes known as ethical investment, is an investment strategy combining financial with social, environmental or other ethical criteria that satisfy both the financial goals and personal values of the investor. Therefore, a socially responsible investment strategy is essentially one that strives to maximize the after-tax return of investments given the constraints of ethical factors.

## How Did SRI Come About?

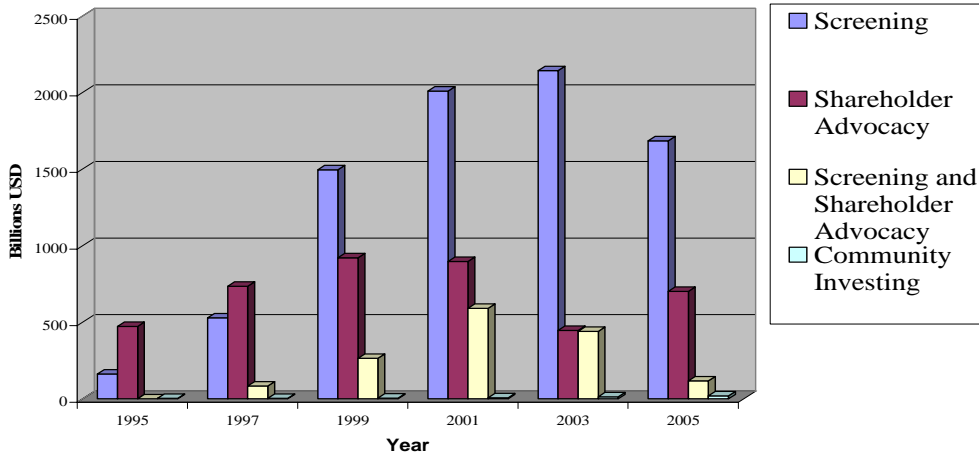
The historical beginnings of SRI were mostly religious: churches discouraged their members from investing in “immoral” businesses such as breweries, tobacco companies and gambling establishments (“the sin industries”). While these traditional forms of SRI still thrive, the whole notion of SRI has taken on a new meaning in the past 30 years to become an umbrella term for any investment strategy that takes into account the nature of the business being invested in, in addition to profitability. This can mean either the avoidance of certain types of industry that are deemed objectionable, or alternatively, the channeling of funds into companies that are perceived to be desirable.

The rise of the SRI is closely related to the increasing awareness of environmental and social issues around the world and the advent of modern communication technologies that have allowed new information and alternative views to be propagated widely and efficiently. Broadly speaking, SRI can be broadly grouped into four different categories: screening, shareholder advocacy, community investment, and investment integration (Graph 1). Screening, the original form of SRI, remains the most popular, but all forms of SRI has seen significant growth in the past decade (Graph 2).

**Graph 1. Socially Responsibility Investing in the US in 2005**



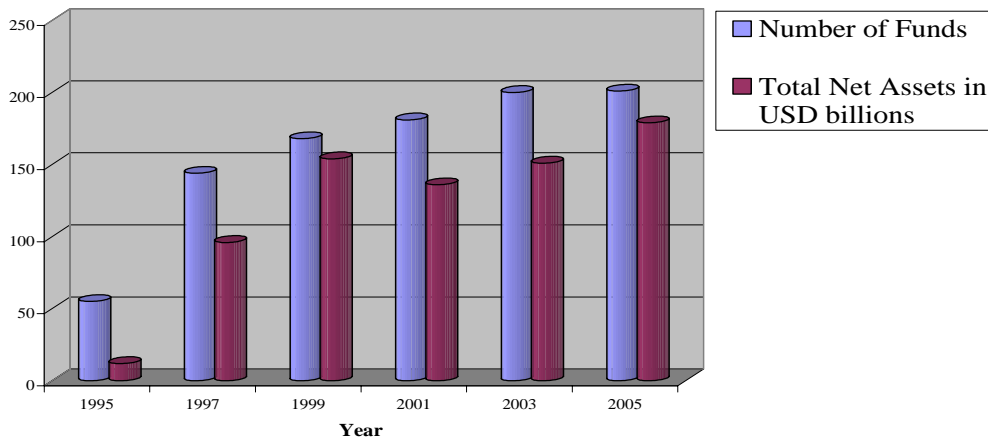
**Graph 2. Socially Responsible Investing in the US 1995 - 2005**



**a. The Screening Model**

This is the most traditional form of SRI where entities to be invested in are chosen by applying social, environment or ethical criteria. This process can either be “negative”, with entities deemed unsuitable or whose activities are considered undesirable being excluded, or “positive”, i.e. funds are directly towards specific, “desirable” businesses in the asset-selection process. Originally, negative screening is the norm, but positive screening has been gaining popularity. According to the Social Investment Forum (SIF) in the US (<http://www.socialinvest.org/>), the most popular used screens are tobacco, alcohol, gambling, defense/weapons and community relations. Socially-screened mutual funds catering for a variety of investment styles are also available: large-cap, international, Catholic, Protestant, Islamic, as well as single-issue funds dedicating to environment, labor, employment equality issues, etc. From 1995 to 2005, environmentally and socially screened mutual funds in the US alone experienced a 940% increase in total assets from US\$162 billion to US\$1,685 billion (Graph 3).

**Graph 3. Socially Screened Funds in the US 1995 - 2005**



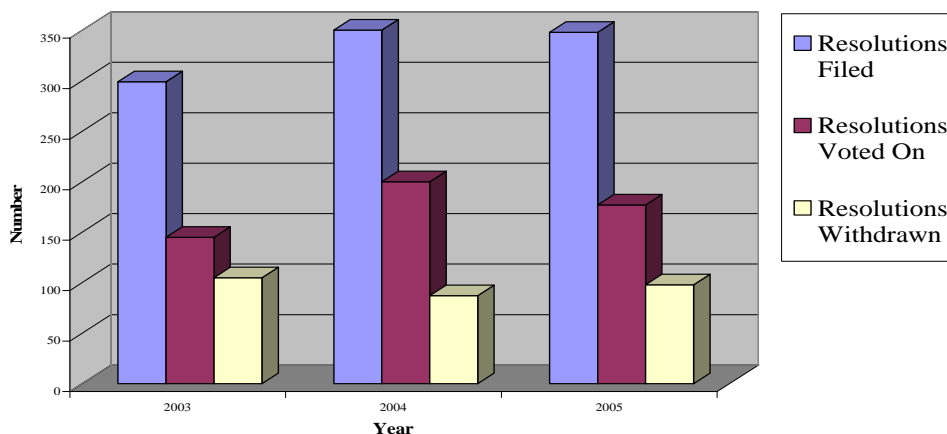
## **b. Shareholder Advocacy**

This is one of the non-traditional forms of SRI. By organizing themselves, retail shareholders can influence the management of a company so that its policies conform to their ideals and values. This usually happens when shareholders pass a resolution to force the management to improve its performance or to make changes to the company's governance to uphold corporate social responsibility. In 2000, for example, a shareholders' resolution prompted the management of General Electric to amend its non-discrimination policy to include sexual orientation, while McDonald's made a similar change to its policy to order to avoid a shareholders' resolution. The SIF listed the following leading social issues, among others, on which shareholder resolutions were proposed from 2003 to 2005.

- Political Contributions
- Equal Employment
- Climate Change
- Sustainability
- Tobacco
- Charitable Contributions
- Executive Pay and Social Link
- Animal Welfare
- Board Diversity

The potential list of issues is almost endless. Recognizing the growing power of individual shareholders, corporate management is becoming more engaging and proactive in communicating with shareholders about their needs and concerns. During the past decade, mutual funds and independent accounts involved in shareholder advocacy in the US increased by close to 49%. In recent years, however, shareholder advocacy is increasingly taking the form of direct contact and dialogue with management instead of filing resolutions. In 2005, shareholder resolution activity in the US has actually decreased due to this new trend (Graph 4).

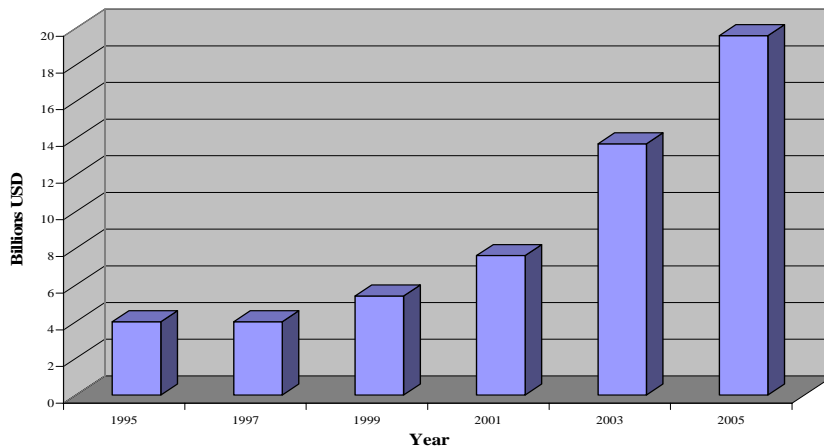
**Graph 4. Social Shareholder Resolution Activity 2003 - 2005**



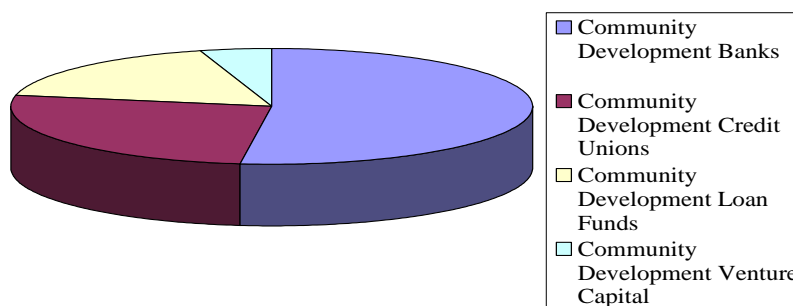
### c. Community Investment

This newer, proactive form of SRI has seen a large increase in activities around the world. Compared to other SRI strategies, community investment requires greater active participation by investors, who direct their funds to entities that are committed to the development of disadvantaged social groups, neighborhoods, regions or countries. A prime example of community investment is the selling of certificates of deposit (CDs) by credit unions in southern US to fund investments in the areas devastated by Hurricane Katrina. A model of community investment in developing countries is the Grameen Bank (<http://www.grameen-info.org/>) in Bangladesh, a community-owned bank that provides microfinance and banking services (very small loans) to small rural enterprises. Very often governments also encourage community investment by giving tax credits and other benefits to investors who are willing to channel their investments to new industries or disadvantaged regions (e.g. government-sponsored venture capital funds). According to the SIF, assets under community investment have grown more than 388% in the past 10 years, making it one of the fastest-growing segments of SRI (Graph 5 - 6).

**Graph 5. Community Investing Growth 1995 - 2005**



**Graph 6. Assets of Community Development Institutions 2005**



#### **d. Investment Integration**

Rather than focusing on “negative screening”, this new strategy seeks positive performance criteria by directly integrating social, environmental and ethical factors in the conventional financial analysis in order to maximize returns of an investment portfolio. This more “holistic” approach is gaining popularity in Europe but is still relatively rare in North America.

#### **The Future**

According to its *2005 Report on Socially Responsible Investing Trend in the United States*, the SIF asserted that SRI is getting more popular than ever. SRI assets have grown faster than the entire universe of managed assets in the US in the past 10 years. From 1995 to 2005, SRI assets have increased more than 258% from US\$639 billion in 1995 to US\$2.29 trillion in 2005. As SRI is gaining ground around the world, the concept of SRI keeps evolving. In the near future, we can look forward to a continued growth in SRI assets, with an increasing diversity of screened issues, as well as higher involvement in the emerging markets, particularly through community investment.

Data source: Social Investment Forum (SIF)

By *Thomas Lau, CFA, FRM, CIM, CDipAF, MDE*, [InvestWELLFinancial.com](http://InvestWELLFinancial.com)

*Thomas Lau holds a master's degree in development economics from Dalhousie University in Halifax and comes from a family who has been involved in the financial industry for three generations. Thomas has worked in various financial institutions in the private and public sectors. His diverse interests include foreign exchange, economic psychology and political economy. Thomas is also an avid florist during spare time.*

*Thomas can be contacted at [tlau@accamail.com](mailto:tlau@accamail.com)*