Socially Responsible Investing

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What is SRI?

- Investment in ethical firms.
- Investment in mutual funds that are screened for social responsibility.
- Investment in specifically designated SRI mutual funds.
- Shareholder activism.

Why do people do it?

- To avoid association with unethical firms.
- To influence firms to be more ethical.

Don't do it to make more money

- Some studies show that SRI brings higher returns.
- But if your goal is simply to make higher returns, you should choose investments that pay higher returns.
  - Forget about SRI.

Does SRI bring higher returns?

- It doesn't matter.
- If you are interested only in higher returns…
  - …choose investments that bring higher returns.
  - Forget about SRI.
- If you are interested in making higher returns by investing in ethical companies…
  - You don't care whether SRI brings higher returns on average.
  - You will do SRI anyway.

How is SR evaluated?

- There are many ways.
- Compliance with well-known codes of conduct.
  - For example, FTSE4good index uses codes.
- Specific criteria…

How is SR evaluated?

- Corporate governance
  - Board independence and diversity.
  - Transparency.
  - Reasonable executive salaries.
  - No insider loans, conflicts of interest.
  - No bribery, securities fraud.

How is SR evaluated?

- Environmental factors
  - Efficient use of resources.
  - Minimal impact through pollution, spills, waste.
  - Corporate environmental policy & training.
  - Sustainable development practices.
  - Transparency.

How is SR evaluated?

- Workplace
  - Compliance with labor laws.
  - Reasonable hours.
  - Equal opportunity.
  - No child labor.
  - Health and safety.
  - Violation of these standards through choice of subcontractors.

How is SR evaluated?

- Product safety
  - No alcoholic beverages, tobacco.
  - No gambling.
  - No weapons production.
    - Or no production of certain types of weapons (nuclear, chemical, biological, land mines).
  - No genetically modified foods.

How is SR evaluated?

- Human and animal rights.
  - No forced labor, child labor.
  - No collaboration with oppressive regimes.
  - No suppression of organized labor.
  - Respect for indigenous peoples.
    - Self-determination.
    - Informed consent when obtaining land, mining rights, intellectual property.

How is SR evaluated?

- Community relations
  - Corporate philanthropy.
  - Employee volunteerism.
  - No massive shutdowns that destroy communities.
  - Programs that target low-income populations.

Which companies are ethical?

- SRI investment firms provide assessments, often for a fee.
  - Calvert Group.
  - Trillium Asset Management
  - Domini Social Investments

Which companies are ethical?

- Social responsibility awards.
  - Business Ethics Magazine 100 Best Corporate Citizens.
  - Business Ethics Magazine Business Ethics Awards.
  - U. S. Chamber of Commerce Corporate Citizenship Awards.

Which companies are ethical?

- Business news media sources
  - CSR Newswire service.
  - Lexis-Nexis Academic
  - Bloomberg’s

SRI mutual funds

- SocialFunds.com
- Social Investment Forum
- Good Money

Why SRI?

- To avoid association with unethical firms.
- To influence firms to be more ethical.

Avoiding unethical firms

- Stockholders are owners and bear ultimate responsibility for the firm’s conduct.
  - Executives and board members are agents for the owners.
- What if company is partly good and partly bad?
  - Islamic concept of purification.

Influencing firms to be ethical

- SRI may raise the stock price.
  - This may give firm an incentive to be good and attract SRI.
- SR investors may take an active role in corporate governance.
  - They may influence the firm through proxy voting, attendance at shareholders’ meetings.

Raising the stock price?

- Classical financial theory predicts flat demand curve for financial instruments.
  - This means attracting SR investors won’t raise the stock price.
  - Modigliani-Miller theorems, capital asset pricing model.
- But classical theory assumes perfect markets.
  - In practice the theoretical assumptions may be violated.

Flat demand curve?

- Investors may have different opinions on the value of investments.
  - So demand curve has negative slope.
  - If SR investors already believe SR stocks are better buys, SRI investment won’t change the price.
  - But if they do SRI because it is *ethical*, they may raise the price.

Flat demand curve?

- Substitutes may be imperfect.
- Portfolios may not be diversified.
  - On the classical CAPM, price depends only on the risk in the entire market, not in the individual firm.
    - This assumes investors hold fully diversified portfolios that represent the entire market.
  - But SR investors are not fully diversified.

Flat demand curve?

- Under these conditions, the theory predicts that the stock price rises with a larger investor base.
  - Since more owners mean less risk.
- So SRI can influence stock price.

Raising the stock price?

- Conclusions of theoretical analysis: the price of a stock will be more sensitive to SRI if:
  - The stock is risky.
  - The stock is unique.
  - The stock trades in small, restrictive markets.

Shareholder activism

- Voting by proxy.
- Attendance at shareholder meetings.
  - Occasionally, demonstrations at meetings.
- Investment in activist SRI funds.
  - The fund votes according to a stated policy.
  - Fund managers lobby the board and executives.

SRI alone is not enough

- It is a blunt instrument.
- It may interfere with the rational allocation of capital.
  - Not a problem if SRI is intended to promote good *business* ethics.
    - It is rational to allocate capital to ethical firms.
  - But should not be applied to issues that go beyond business ethics (political controversies, etc.)

SRI alone is not enough

- Even in matters of business ethics, public discourse is necessary to arrive at good policy.
  - Financial markets and corporate governance provide no mechanism for public policy discussion.
- There is no substitute for public policy and regulation.

Basic goal of SRI

- Rational allocation of capital is essential to prosperity and even survival.
- Private capital formation relies on individual investors to make good decisions.
- Financial markets may not always provide the right incentives for rational investment.
  - E.g., dot-com boom/bust.

Basic goal of SRI

- Individual investors must keep social welfare in mind.
  - Investment in ethical firms.
  - Long-term investment as opposed to speculation.
    - Excessive churning destabilizes the market and rewards short-term corporate gains.
  - Investment in productive, sustainable enterprises.
    - Even when, and especially when, they do not maximize return.

Further Reading

- SocialFunds.com, *Socially Responsible Mutual Funds* (free)
- Pietra Rivoli, "Making a difference or making a statement? Finance research and socially responsible investment," *Business Ethics Quarterly* **13** (2003) 271-288.