

Social Investing: Mainstream or Backwater?

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ABSTRACT. Social investing, though not yet fully mainstream, has the potential to obtain such status. Questions relating to the future of social investing include the following. (1) What properly falls within the ambit of social investing? Assuming that no single definition of social responsibility is feasible, what then are the limits? (2) What do we need to know about investor psychology concerning social investing? What motivates people to buy socially screened investments and why do they sometimes act inconsistently? (3) How can we improve the measures of social performance? Is it possible to develop GAAP and GAAS equivalents for social reporting? (4) Should social reports by firms be audited? If so, how? (5) What sorts of public policies are necessary to support the social screening of investments?

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Charles Jaffe, who writes on mutual funds for the *Philadelphia Inquirer*, predicted in 2000 that social investing, where individuals choose or avoid stocks on the basis of social criteria, would go mainstream. As a mainstream phenomenon, one would expect social investing to be part of the investment strategy of the typical individual and institutional investor. On the supply side one would expect the establishment of a sizable industry of financial services firms providing screening. Ultimately, there would be a clearly established professional subgroup of analysts specializing in social analysis of investments.

Social investing has made great strides over the past decade. Domini, a leading social investment firm, grew from \$9.5 million under management in 1992 to \$1.7 billion in 2001 (*Financial Times*, 2001). Although we have no way of knowing the sum total of investments screened on the basis of some sort of social criteria, some estimate at least a trillion dollars. On the basis of these successes one might conclude that, although social investing is not yet fully mainstream, it surely has the potential to obtain such status. Even so, severe obstacles still remain and must ultimately be overcome. The function of this short essay is to identify and elaborate on some of the essential questions about the future of social investing. We begin with the most fundamental question of them all.

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1. What properly falls within the ambit of social investing?

The broadest definition of social investing would be any investment strategy based upon identifiable non-financial criteria incorporating a social or religious dimension. Such a definition is open to the criticism of being overbroad because it conceivably includes criteria many would consider antithetical to genuine or appropriate social screening. Critics might also argue the definition is incoherent in that it includes contradictory or mutually exclusive strategies. Consider the wide variety of screens currently applied. Some funds screen on the basis of religious principles. Examples include the Islamic-based Amana Growth Fund, the Methodist Pax World Balanced Fund, the Mennonite Mutual Aid's Praxis Growth Fund and the Ave Maria Catholic Values Fund (Beard, 2001). Other funds have a narrow emphasis on the environment, or on diversity. The well known Domini Social Equity Fund excludes certain "sin" equities such as those issued by military contractors, tobacco and liquor companies.

Highly socially conscious individual investors and tightly focused religious funds such as the Noah Fund, which applies Old Testament based criteria, may employ very fine screens. In this environment it is not surprising to discover groups of funds with mutually exclusive screening strategies. Wal-Mart may be considered exemplary by one and verboten by another. The same goes for Shell, which caused a controversy when it was included in FTSE4Good, the new ethical share index launched as a joint venture by the *Financial Times* and the London Stock Exchange in July 2001. One study found that of the 50 largest U.S. stocks ranked by market cap, 40% triggered a split, in with one and out the with other, among three major screening funds, Vanguard Calvert, Domini Social Equity and Citizens Index (Damato, 2000).

If this critical question is rephrased to be: Is there or should there be a single definition of "social responsibility" for the purposes of social screening of investments, the answer appears clear. There is no Holy Grail definition capable of serving as a definitive and appropriate standard

for all those engaged in social screening. First, it is clear from the controversies surrounding the selection of firms to include or exclude from various indexes that there is no general consensus among investors, or even business ethicists, as to appropriate standards. This is particularly the case when one considers religious investors. The focus of the Islamic Amana Fund and the Ave Maria Catholics Values Fund would be expected to diverge substantially. This leads to the second compelling reason why a single standard is not appropriate. Respect for diversity in values among investors requires that fund developers and managers be free to respond to groups who have distinct moral preferences. Thus, one fund might eschew Merck because it conducts health related research on animals (e.g. the Humane Fund), while another fund would include Merck because of its humanitarian programs and positive workplace environment.

Viewed in this way, the claim that the field is incoherent because it allows for mutually exclusive investment strategies is seen to be inappropriate and misfocused. A charge of incoherence can only hold if there is in fact a single universal standard that all should follow. We have just shown that uniformity is neither possible nor desirable. One caveat is necessary however. Not every non-financially focused fund should be considered to be a social responsibility fund. Consider the case of a fund that invests solely to finance terrorist activity that will foreseeably result in the death of innocent humans. Such a fund violates manifest, universal principles of ethics. Donaldson and I (2000) have called them hypernorms because they are principles so fundamental that they constitute norms by which all others are to be judged. Hypernorms are discernible in a convergence of religious, political and philosophical thought. In this case they would operate to exclude a fund such as the one hypothesized. In reality, there are few, if any, socially screened funds whose selection criteria would be found to be in violation of the stringent test required to violate hypernorms.

Thus, in summary, many differing approaches to social screening are valid. There is no single universal, superior, mandatory standard that must be followed by a firm to be considered an ethical

socially screened fund. The only constraint is that a fund cannot violate hypernorms in its selection and implementation of screening criteria.

The next question pertains to investor psychology in reference to socially screened funds.

2. What do we need to know about investor psychology concerning social investing?

What motivates an individual investor to choose a socially screened investment? A natural assumption is that the investor has certain personal beliefs and wishes to invest consistently with those beliefs. Thus, a Muslim may choose the Amana Fund to be sure that his investments are not used in a manner inconsistent with his personal religious beliefs. Other investors may believe that investing in socially responsible funds may produce superior returns over time. Still others may hold an attitude of social activism. An environmental activist may believe that when she invests in funds which screen for firms committed to a sustainable environment her actions, combined with those of other like-minded individuals, will strengthen those firms and help to bring about a more desirable physical environment.

One of the few published empirical studies of ethical investors found a “fog of confusion” concerning the ethical standards being applied (Mackenzie and Lewis, 1999). One group of Christian investors offered generalities such as “economic injustice, fair play, conscience salving, keeping up appearances, the value of free markets, and self-respect” (p. 441). All of those studied had difficulty articulating their principles. Broader and more comprehensive studies of investor motives are needed. Quality studies would enable funds to target likely investors by designing screens that appeal to their moral preferences.

In the current environment it may be that investors essentially trust socially screening funds to be making appropriate choices. Based on that trust, such investors derive general satisfaction from investing in a fund supporting good business

behavior – whatever that happens to mean in practice.

A very interesting finding of the MacKenzie study was that many investors simultaneously held investments at odds with their screening strategy. For example, one might eschew tobacco stocks or invest in a socially screened fund that does so, while at the same time owing a broad-based growth or index fund, which includes the forbidden companies’ securities. Even more interesting, the screened investments tended to be a minority of the total portfolio, typically around 5%. On first impression, this appears to be hypocritical and inconsistent. How can one reject a stock for part of one’s portfolio on moral grounds and then turn around and hold the stock in a different portion of the portfolio? A likely answer given by the many who engage in this seemingly odd behavior is that they are constrained by their overall investment strategy. For example, broad based index funds may be considered a key part of a particular investor’s portfolio. The investor is willing to hold the shares of some prohibited companies, although only on an indirect and rather diluted basis. The investor might further reason that any investment decision, even that involving only 5% of one’s portfolio, may have an impact if large numbers of other investors engage in the same practice. Such a view may be inconsistent with the manner in which the market actually works, but nonetheless may serve as a rationalization for some.

Why investors invest in socially screened funds remains too much of a mystery. Much more needs to be known about investor psychology in this area. Are most “social” investors only interested in putting a half-tithe portion of their investments into any fund that claims to socially screen? Or do they care more specifically about the screens and seek to implement their moral desires through their investment decisions? Answering these questions will make it far easier for funds to market their products.

The questions which follow, are directed at operational issues pertaining to the creation, implementation and operation of socially screened mutual funds.

3. How can we improve the measures of social performance?

A major challenge for those who operationalize screens is how to judge a firm's performance. In the late 1970s and early 1980s some firms, including the notable example of General Motors, published annual reports emphasizing select social practices of the firm. Some of these reports had the appearance of self-serving public relations pieces, while others contained claims that were questionable or hard to compare. Firms were free to pick issues and data that stood them in good light.

Because there is no independent body establishing generally accepted accounting principles for social reports, it has fallen to the social screeners themselves to develop criteria that help to sort among firms. *Business Ethics Magazine* has its Business Ethics 100. They rank companies on specific criteria that give a 4 digit ranking in categories of community, minorities & women, employees, environment, non-U.S. stakeholders and customers. The Domini Social Equity fund excludes major military contractors, international oil companies, and tobacco and liquor companies while focusing on human rights, environmental good practice and similar factors. Dow Jones and FTSE have developed indexes reflecting commitment to a sustainable environment or, in the latter case, a more general orientation toward socially responsible practices. The result is still a mishmash of standards with considerable academic debate concerning the validity of alternative measures. The Global Reporting Initiative (GRI) is a major effort to bring about some standardization. The GRI involves a number of firms from a variety of industries and nations experimenting with social reports. All of these efforts are the product of the revival of the idea of social reports in the late 1990s. This "second wave" of reports does appear to be less self-serving than their predecessors of two decades. Even so, it is very difficult to compare one report to another. One reason for this is the wide range of social issues confronting a company and the practices that can be reported upon. Further, the form of the reporting can make a cross comparison virtually impossible.

Until something akin to Generally Accepted Accounting Principles for social reporting becomes widely recognized, comparison of reports will be impractical, even meaningless and social reporting is likely to be *sui generis* to the reporting firm. The experience of those developing social screens is likely to help provide direction toward the possibility of a GAAP for social reporting. The presence of such principles would provide authentication for those firms issuing social reports. The principles would serve as benchmarks for appropriate reporting.

Ultimately, it is my belief that the development of a GAAP equivalent for social reporting will require the establishment of a respected profession of social auditing. In turn, the profession of social auditing will require vigilant self-regulation supported by oversight by a global equivalent of the United States Securities Exchange Commission. Firms would not be required to issue such reports, but if they do so, the reports must meet the standards established by the profession.

4. Should social reports by firms be audited? If so, how?

Social reports generated by the firms themselves would be more reliable and thus of greater use to social screeners if they were audited by professional, independent auditors. The highly developed profession of financial auditors is critical to the functioning of capital markets. An initial question is whether financial auditors would be capable of effectively auditing social reports. If so, the need for social auditors is essentially solved because the established profession of financial auditors could step forward to provide this service.

Many of the skills developed by financial auditors would be relevant in conducting social audits. Some social reporting involves assessing costs and using monetary measures of performance. Environmental reporting is a good example. Other common categories, such as female and minority representation on boards and upper levels of management, involve generation and assessment of data similar to financial

auditing. Skepticism regarding assertions by management and knowing how to probe and double check data are surely as critical for social as for financial auditing.

On the other hand, some components of social reporting may require novel skills. Assessment of the appropriateness of a privacy policy may require knowledge not only of the law, but also of relevant customs and norms. Assessment of whether a workplace environment harbors hostile or discriminatory elements necessitates types of judgments not ordinarily required in financial auditing. Unlike financial auditing, management may need assistance in identifying categories to include in the audit and may rely, at least in the early stages, on the auditing firm to provide guidance. All of these skills and foundational knowledge require training beyond that received by ordinary financial auditors. Thus, it is not surprising that sources of accreditation for social auditors are starting to appear and that there is a nascent movement toward the development of social auditing standards which may someday emerge as the equivalent of Generally Accepted Auditing Standards. The Institute of Social and Ethical Accountability, based in the U.K., launched a set of standards, Accountability 1000, in 1999, which constitute a strong first step.

However, it will not be until social auditing standards are widely recognized and followed that a satisfactory regime will exist that can sustain a social screening mutual fund industry without a substantial burden existing on the part of the funds to double check the information they receive from firm sources. Widespread acceptance is not likely to occur unless and until certain difficult issues are resolved. Certain issues are similar to financial auditing. Can an auditor be considered sufficiently independent if the auditor also performs substantial consulting services for the client? Consider the following scenario. A Big Five auditing firm serves as a social auditor for a large sportswear manufacturer. The auditing firm happens to provide a service in which it reviews Asian suppliers of the manufacturer to insure that the suppliers are not employing child labor and are providing decent working conditions. The report on supplier compliance is then one of many categories provided in the annual

social report of the manufacturer, which in turn is audited by the same Big Five firm. This scenario raises two issues of independence commonly found in financial accounting. First, the auditor is auditing its own work when it certifies that the information pertaining to the Asian suppliers is fully and fairly presented. That is, they are the source of the report that they are then “auditing” in preparing the annual report. Second, the auditing firm has a financial conflict of interest, particularly if, as might well be the case, the consulting fees for reviewing the Asian suppliers are much larger than the basic auditing fees.

In such an environment, the auditing firm may be less likely to challenge questionable assertions that management wants included in the annual social report.

As is true with accounting principles, the development of effective generally accepted social auditing standards would require the establishment and acceptance of a profession of social auditors.

5. What sorts of public policies are necessary to support the social screening of investments?

Up to this point the questions have focused on individual firms, investors and socially screened funds. This final question pertains to the issue of what types of public policies are necessary in order to support and sustain an environment in which social screening is a viable option for those so inclined. Because this is a financial market phenomenon, only policies essential to the operation of open, competitive markets are relevant.

As a starting point, policies supporting the availability of accurate information concerning the holdings, costs and policies of screened funds are essential. Fraud and deception are particularly problematic in the context of social investing because they are at direct odds with the essential values of the phenomenon. This is an area in which investors may be particularly likely to have an interest in knowing how the screens are constructed and applied.

One major source for socially screened investments is retirement funds of states and municipalities, corporations, unions and professions. Those whose pensions are affected need to know the policies followed by the trustees of their plans. Individual employees or retirees may object to a mandatory retirement fund employing a "social" screen that is completely incompatible with their own social preferences.

Shareholder resolutions are often focused on social issues and often contain proposals requiring that a firm report to the public on its actions in a certain area. Opening up the shareholder resolution process to permit a wider range of social resolutions raises questions of cost and of distracting management from its basic responsibility to generate profits. Coercion may result in an occasional gain in terms of disclosure of information, but peer pressure and the development of a widely accepted, and expected, process of social disclosure is a better approach.

The availability of accurate, relevant information is a key factor in encouraging people to invest in a manner consistent with their own social priorities.

Conclusion

Social Screening of Investments has the potential to become a mainstream phenomenon practiced by ordinary investors and reflected in the investment policies of retirement plans and mutual funds. The availability of accurate,

relevant information is key. The development of generally accepted social accounting principles and generally accepted social auditing principles is necessary in order to insure that useful, comparable information is available to investors and investment managers. This in turn is dependent upon the development of a respected profession of independent social auditors. Operationally, there should also be financial analysts specializing in social screening. Disclosure must be strongly supported by industry norms and by public policy.

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