

## **The Case for Socially Responsible Investing by Non-Profits and Congregations**

*The following represents the opinions of the Investors Against Genocide and should not be construed as financial advice or a recommendation for any particular investment. We are not legal or financial experts and, as with all investment decisions, before you make any decisions you should work with your financial and other advisors and do your own analysis of the issues covered here.*

Since large mutual funds have refused to sell their investments in companies that are funding the genocide in Sudan, many non-profits and religious organizations are realizing that their endowments and pension / 401(k) / 403(b) plans are invested in ways that conflict with their overall mission. These groups feel a moral imperative to sell investments funding the genocide but face a confusing range of options from avoiding specific direct investments and the mutual funds that hold them, to a more comprehensive change embracing Socially Responsible Investing (SRI).

SRI funds contain stock only in companies whose activities are considered ethical. Socially Responsible Investing accounts for a small portion of total investments but it is not a fringe approach. According to a 2007 report by the Social Investment Forum Foundation, institutional investors have now committed more than \$3.6 trillion to social investing strategies globally and more than \$2.25 trillion in the US alone.

Proving the logic of divestment is beyond the scope of this paper. The case is summarized on the Investors Against Genocide web page (<http://investorsagainstgenocide.org/page1005>) and in many linked documents.

The simplest response an organization can make to the Darfur genocide is to sell targeted direct and mutual fund investments and place the proceeds into other stocks / funds. This is beneficial since it puts pressure on the individual companies that can impact the situation. The weakness of this approach is that it imposes no financial penalty on investment companies that refuse to divest and, lacking clear statements by the funds, leaves investors open to the risk that they will inadvertently become investors in genocide by virtue of future fund purchases.

Organizations that wish to avoid relationships with financial institutions that ignore the fundamental ethical issues raised by Darfur may want to find other business partners. Unfortunately, since few large mainstream mutual funds have taken a pledge to be "Sudan-free," this currently leaves only the SRI funds as alternatives. While this limitation may initially seem like a disadvantage, moving to SRI funds not only addresses Darfur but also ensures that the organization's investments are aligned on a broad range of issues with their core values, now and in the future.

Three concerns are typically raised by those that oppose taking this step into SRI mutual funds: 1) returns are suspected to be lower and more risky than with traditional investments, 2) SRI funds may take social positions not favored by the organization, and 3) a fiduciary responsibility makes SRI funds unacceptable.

The benefits of SRI funds and detailed responses to each of these three concerns are explored in more detail in the following sections. The summary message is positive for each of these concerns. First, the returns on investments are a function of many factors; the specific stock selections made by the SRI funds are one of the least significant factors in the overall return. SRI funds have a wide range of performance histories, just as do non-SRI funds. Given the large universe of stocks to choose from, SRI funds have many good opportunities despite slightly limiting their choices. Second, SRI funds make their social positions clear and transparent, unlike traditional funds. As a result, fiduciaries can confirm their alignment with an SRI investment manager. In contrast, recent experience with traditional mutual funds

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demonstrates the inability of confirming alignment and the real risk of serious ethical entanglement with inadvertent investments in companies helping to fund genocide. Lastly, there are clear precedents supporting the legitimacy of fiduciaries considering SRIs. Further, a legal opinion, if sought, should confirm that there is no statute that prevents an organization from investing in SRI funds.

SRI funds can be sound investment decision for organizations and congregations who, not only want good returns and appropriate management of financial risk, but also seek to ensure that their investments are working to support their missions rather than against them.

### **SRI Fund Benefits**

Many organizations are disturbed that their financial investments and their missions aren't working in harmony. In the worst case, a group's investments may be inadvertently undermining the specific mission that the group works to foster. This is an issue facing small religious congregations and large private foundations. See, for example, the lengthy analysis done by the LA Times on the Gates Foundation (at <http://www.latimes.com/news/nationworld/la-na-berkshire4may04,1,7545044.story>).

Socially Responsible mutual funds were created to address this concern. Their obvious advantage is that they actively work to invest in companies that treat the environment, their employees, their communities, and consumers ethically. This is a matter, for example, of excluding companies that produce harmful products such as tobacco and actively supporting women- and minority-owned businesses. The goal is to "do well by doing good."

Given the crisis in Darfur and the mutual funds investments that continue to make large investments in companies that fund the genocide, many organizations are now examining their portfolios to make them Sudan-free. This is a challenge because few large mainstream funds are currently willing to take a position promising to become and remain Sudan-free. This leaves investors in the awkward position of researching a fund and then later finding that it acquired shares in targeted companies. Only by switching to a fund that is committed to ethical investing can these organizations avoid constant monitoring and switching to ensure they remain "clean".

Beyond the specific investments that SRI funds make, they also work to be a positive force in other ways. Using Shareholder Advocacy the funds use their proxy and other influence to work to improve corporate governance and support social issues of importance to the fund's shareholders. Using Social Venture Capital the funds find and finance small companies that are making positive contributions (e.g., new medical technology) before they go public. Through Community Investing funds invest in small companies denied traditional financing to help them create local jobs, housing, and improved facilities.

### **Returns and Risks**

Investment professionals react strongly to restrictions that limit their selection of investment vehicles. They fear the "slippery slope" will restrict them to a subset of possible investments and thereby limit their ability to achieve optimal financial results. In the restricted case of investments funding the genocide in Darfur this concern is easily countered with the "threshold argument" which states that there are some investments that are too offensive to be considered acceptable, regardless of their financial return. When considering the full SRI agenda, the argument has more merit because of the larger number of companies excluded and the less extreme social issues involved.

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The short answer to this concern is that there is a wide universe of stocks and bonds to choose from and so the effect of removing any small subset of investment vehicles is lost in the noise of the many other decisions an investor must make. There are more than 6,000 different companies listed between the NY Stock Exchange and the NASDAQ Exchanges alone and these do not count the many international and other investments available. Removing a small number of investment choices does not seriously restrict a mutual fund or fiduciary's choices.

Fiduciaries make dozens of subjective judgments when choosing their investments. Notable among these are: asset allocation (e.g., stock vs. bond), style (e.g., growth vs. value), sector (e.g., healthcare vs. energy), capitalization (e.g., large vs. small), approach (e.g., active vs. passive), timeframe (e.g., review history based on annual or 5 year results), volatility (e.g., high or low beta), liquidity (e.g., easy or hard to sell), geographic distribution (e.g., domestic vs. international), and vehicle (e.g., traditional funds vs. ETFs). In a classic 1986 study, "Determinants of Portfolio Performance," Gary Brinson found that 93.6% of the total return variation of the pension funds studied was due solely to asset allocation. Many others have since questioned the exact percentage but few would argue with the basic assertion that asset allocation is by far the most significant decision a fund manager makes and that selection of individual SRI vs. traditional funds within various categories is a relatively small contributor to overall performance.

Every decision fiduciaries make represents a trade-off along the risk and return spectrum. When they choose large cap funds over small cap ones they are making a judgment about the relative performance of companies in these categories. These decisions are accepted as a necessary and routine part of the fiduciary's role. Why are similar trade-offs to ensure investments are consistent with the organization's social mission considered extraordinary and detrimental?

Today's SRI mutual funds offer many fund options so even accepting SRIs still leaves the fiduciary with the more significant decision of which SRI investments to make. For example, on May 30, 2007 Fidelity offered 48 Calvert funds. Even comparing two funds with very similar objectives yields markedly different results. Calvert's Large Cap Growth CL A fund had a five year load adjusted Return After Taxes on Distributions of 8.18% while the Large Cap Growth Average benchmark was only 3.28%. The similar Calvert Social Index CL A fund had comparable results of 2.92% versus the same benchmark. The point is that investors can as easily find both excellent and below average choices within the SRI universe as they can within the full universe of fund offerings and that these outcomes are the result of subtle differences in their fund objectives, not that they are socially responsible.

A related concern on SRIs is whether the additional research done by the SRI funds leads to higher than average fund expenses. As with other aspects of return discussed above, there does not appear to be any clear pattern. As with the general fund universe, some SRI funds charge loads and have high expenses and others do not. As with all such costs, it is up to the organization's fiduciary to ensure that the best value is being received.

SRI fund performance has been the subject of academic research. The 2002 study by Bauer, "International Evidence on Ethical Mutual Fund Performance and Investment Style," used an international database containing 103 German, UK and US ethical mutual funds, to review and extend previous research on ethical mutual fund performance. After controlling for investment style, the study found little evidence of significant differences in risk-adjusted returns between ethical and conventional funds for the 1990-2001 period.

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An additional argument made by SRI proponents is that over the long-term, SRI investing policies will help the funds choose fundamentally sound and sustainable companies and avoid big mistakes made by less socially conscious investments. For example, taking into account governance and transparency considerations may help a fund avoid investments in a future Enron, consideration of environmental records avoid being caught in an oil company when an Exxon Valdez incident occurs, and avoiding tobacco stocks avoid the financial risk of large legal settlements. Backing this assertion is Russo and Fouts 1997 study titled "A Resource-Based Perspective on Corporate Environmental Performance and Profitability." It found that after controlling for many other factors environmental rating has a statistically significant positive impact on the firm's return on assets.

### **SRI Fund Social Positions**

When an organization invests in an SRI fund they are endorsing the social agenda of the fund. This requires due diligence on the part of the investor as with other aspects of the investment decision. For example, a Jewish congregation may want to ensure that the fund's objectives do not rule out investments in Israeli companies and an environmental group may wish only renewable, not petroleum, energy investments.

The good news is that SRI funds are proud to publicly display their objectives and constraints in detail so that investors are fully informed. For example, the Domini funds clearly detail their objectives on their site at <http://www.domini.com/GlobInvStd/index.htm/>. Their general objectives relate to how corporations measure up in terms of their relationships with Communities, Customers, Ecosystems, Employees, Investors, and Suppliers and they take specific positions with respect to the Darfur Crisis, Climate Change, Human Rights, Community Development, Alcohol / tobacco /gambling, and Nuclear power / military weapons.

Traditional funds carefully avoid taking any positions on these issues and so leave the investor to "trust them" on what their money is supporting. The recent outrage over how this trust is being abused in the case of Darfur highlights how risky the traditional approach is for organizations that care about the effect their investments have.

### **Fiduciary Responsibilities**

The U.S. Department of Labor's Pension and Welfare Benefits Administration (PWBA) issued an official Advisory Opinion, sometimes known as the "Calvert letter," in 1998 regarding the offering of socially responsible mutual funds in retirement plans. This letter can be found at [http://www.calvert.com/pdf/sri\\_DOL\\_Letter.pdf](http://www.calvert.com/pdf/sri_DOL_Letter.pdf). While this letter applies only to retirement plans some have concerns that fiduciaries in other circumstances will violate their trusts if they invest in SRI funds.

The ruling states that "the fiduciary standards of sections 403 and 404 do not preclude consideration of collateral benefits, such as those offered by a 'socially-responsible' fund, in a fiduciary's evaluation of a particular investment opportunity". Rather it calls for, as we have argued above, "taking into account such factors as diversification, liquidity, and risk/return characteristics" when choosing an SRI or any other investment. It concludes that "the selection of a "socially-responsible" mutual fund as either a plan investment or a designated investment alternative for an ERISA section 404(c) plan would not, in itself, be inconsistent with the fiduciary standards set forth in sections 403(c) and 404(a)(1) of ERISA".

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When making a decision on the part of an organization or congregation's endowment or other savings, it seems clear that a fiduciary is free to make an SRI selection as part of their overall investment strategy and as long as due diligence is performed to ensure that it is an otherwise appropriate selection. In the case of organizations offering 401k or 403b plans to employees, the prudent alternative seems to be offering employees a choice of SRI and traditional investments so that individuals may express their preferences.

### **Conclusion**

SRI funds are a sound investment decision for organizations and congregations who, not only want good returns and appropriate management of financial risk, but also seek to ensure that their investments are working to support their missions rather than against them.