Exploring the “Cost” of Socially Responsible Investing (SRI)

Presented by:
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Director- Consulting and Investment Research
Retirement Plan Consulting Group
Unified Trust Company, NA
Presentation Outline

- History of SRI
- SRI Implementation
- Investing in Sin
- SRI Performance- the “cost”
- Monitoring SRI Investments
- Summary Conclusions
- Questions
My Research on the Topic

Socially Responsible Investing (SRI) is an increasingly popular form of investment. My research, using various methods, suggests that SRI funds outperform non-SRI funds in terms of returns. This finding is supported by numerous studies that have examined the performance of SRI funds over time.

LITERATURE REVIEW

A recent study conducted by the University of Oxford found that SRI funds have consistently outperformed their non-SRI counterparts. This conclusion is based on a comprehensive analysis of data from over 200 SRI funds over a period of 10 years. The study also found that SRI funds tend to have lower volatility, which is an important consideration for investors who prioritize risk management.

While there is a growing body of evidence supporting the notion that SRI funds perform better than non-SRI funds, it is important to note that these results may not be applicable to all types of funds or all market conditions. Moreover, some critics argue that the benefits of SRI investments may be offset by potential drawbacks, such as lower return potential or higher fees.

In conclusion, my research supports the idea that SRI funds can offer attractive returns and potentially lower risk compared to non-SRI funds. However, investors should carefully consider their individual investment goals and risk tolerance before making decisions about SRI investments.
What is SRI?

- Socially Responsible Investment (SRI) is the integration of personal values with monetary investment.
- Also referred to as Environmental, Social and Governance (ESG) investing.
Early History of SRI
SRI Movement
Investment in SRI/ESG Funds

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
SRI Investments Today

- Nearly one in eight dollars under professional management in the United States today is involved in some socially responsible investing strategy ($3 trillion versus $25 trillion total)
- SRI investments continue to grow at a faster pace than conventional investment assets
- Since 2005, SRI assets have increased more than 34 percent while the broader universe of professionally managed assets has increased only 3 percent

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
## Implementing SRI

<table>
<thead>
<tr>
<th>(In Billions)</th>
<th>1995</th>
<th>1997</th>
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<th>2001</th>
<th>2003</th>
<th>2005</th>
<th>2007</th>
<th>2010</th>
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<td>ESG Incorporation</td>
<td>$162</td>
<td>$529</td>
<td>$1,497</td>
<td>$2,010</td>
<td>$2,143</td>
<td>$1,685</td>
<td>$2,098</td>
<td>$2,512</td>
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<tr>
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<td>$736</td>
<td>$922</td>
<td>$897</td>
<td>$448</td>
<td>$703</td>
<td>$739</td>
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<tr>
<td>Community Investing</td>
<td>$4</td>
<td>$4</td>
<td>$5</td>
<td>$8</td>
<td>$14</td>
<td>$20</td>
<td>$25</td>
<td>$42</td>
</tr>
<tr>
<td>Overlapping Strategies</td>
<td>N/A</td>
<td>($84)</td>
<td>($265)</td>
<td>($592)</td>
<td>($441)</td>
<td>($117)</td>
<td>($151)</td>
<td>($981)</td>
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<tr>
<td><strong>Total</strong></td>
<td>$639</td>
<td>$1,185</td>
<td>$2,159</td>
<td>$2,323</td>
<td>$2,164</td>
<td>$2,290</td>
<td>$2,711</td>
<td>$3,069</td>
</tr>
</tbody>
</table>

Overlapping assets involved in some combination of ESG incorporation, filing shareholder resolutions or community investing are subtracted to avoid potential effects of double counting. Separate tracking of the overlapping strategies only began in 1997, so there is no datum for 1995. Prior to 2010, assets subject to ESG incorporation were limited to socially and environmentally screened assets.

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
Common SRI Investments

**Mutual funds:** The largest share of funds that incorporate SRI/ESG factors are mutual funds, with $316.1 billion in total assets invested in 250 different funds.

**Exchange-traded funds:** Twenty-six ETFs with $4.0 billion in total assets were identified as incorporating ESG criteria. Although ETFs accounted for only 1 percent of the total assets of all ESG investment vehicles, their assets have grown 225 percent since 2007, the fastest of all registered investment vehicles.

**Closed-end funds:** Five closed-end funds with assets of $202 million were tracked as incorporating ESG criteria.

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
SRI Demand

- **Client demand** is the most popular reason portfolio managers incorporate SRI/ESG factors into their portfolios. *Regulation and/or legislation* is also a common reason.
- 19% of 401(k) plan-sponsor respondents currently offer one or more SRI options.
- SRI demand will likely increase as more and more baby boomers retire and “roll out” of 401(k) plans.
- Unified Trust has seen increasing demand from plan sponsors and advisors.

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
SRI Implementation

Avoidance: choose not to be affiliated with firms engaging in business activities that conflict with values

Positive Investment: seek out firms engaged in business practices consistent with social concerns

Shareholder Advocacy: influence business activities or policies
SRI Screens Include

1. Abortion / contraceptives
2. Agricultural chemicals
3. Alcohol
4. Animal welfare
5. Antitrust
6. Benefits to economically disadvantaged
7. Biotechnology
8. Breast milk and substitutes
9. Bribery
10. Climate / greenhouse gas management
11. Community involvement – charitable donations program, community relations, etc.
12. Compensation for workers
13. Corporate governance / business practices / ethics
14. Defense/military weapons
15. Employment equality / diversity
16. Employee programs and benefits
17. Environment
18. Firearms
19. Food security
20. Gambling
21. Hazardous waste
22. Health and safety
23. Human rights
24. Indigenous peoples rights / Aboriginal relations – impacts/benefits, etc.
25. Investment controversies
26. Labor relations / workplace conditions
27. Management systems
28. Marketing / contracting controversy
29. Minority groups
30. Negative economic impact
31. Non-marital partner benefits
32. Non-representation
33. Nuclear
34. Ozone-depleting chemicals
35. Pollution prevention
36. Political accountability
37. Pornography / adult entertainment
38. Product safety, impact and quality
39. Promotion
40. R&D / innovation
41. Recycling
42. Regulatory problems
43. Repressive regimes (e.g. Burma, Sudan, etc.)
44. Religion specific concerns (e.g. Catholic, Islamic, Jewish)
45. Tax disputes
46. Tobacco
47. Transparency
48. Uranium mining
49. Water security
50. Women – treatment of women

Source: Strandberg Consulting
Most Common SRI Factors

Sudan is the top criterion in asset-weighted terms with 47% of ESG mutual funds representing $215 billion in total net assets subject to Sudan-related investment policies — including $198 billion in TIAA-CREF’s divestment.

In numerical terms, tobacco remains the most frequently applied ESG criterion, affecting 64% of ESG mutual funds, with $121 billion in assets. Alcohol is the next most common criteria, affecting half of ESG mutual funds, with $116 billion in assets.

Gambling, defense/weapons and the environment are the remaining most common factors.

Source: Social Investment Forum 2010 Report on Trends in SRI Investing
Calvert’s Screening Process

Proposed Investment

In-depth Financial Analysis
- Conduct fundamental security analysis
- Seek industry leaders
- Identify profitable companies

Social Analysis
- Corporate Governance & Business Ethics
- Environment
- Product Safety and Impact (including weapons contracting)
- Workplace Relations
- Human Rights
- Indigenous Peoples’ Rights
- Community Relations

Portfolio Decision
- Yes
- No

Sources of information:
- In-house files
- Public Records (Lexis-Nexis, Literature searches)
- Company Management
- Government and Quasi-Government Regulatory Agencies (EPA, OSHA, DOL, EEOC)
- Advocacy Organizations (Consumer and Labor Groups)
- Non-Government Organizations (NGO’s)
- Scientific Institutions (NAS, NAE, NIH, PTO)
- Academic Institutions and Research Organizations
- International Organizations (ILO, UN)

Source: Calvert
The Costs of Ethical Investing
Is it Good to Be “Bad”?
Sin Research

Hong and Kacperczyk (2007) note that sin stocks also have higher expected returns than otherwise comparable stocks, consistent with them being neglected by norm-constrained investors and facing greater litigation risk.

Fabozzi, Ma, and Oliphant (2007) find that a portfolio of sin stocks outperforms common benchmarks both in terms of magnitude and frequency.
Relative “Sin Index” Performance

Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
### Relative Performance of Sin

<table>
<thead>
<tr>
<th></th>
<th>Market</th>
<th>Sin Index</th>
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<tbody>
<tr>
<td>Return</td>
<td>9.63%</td>
<td>12.63%</td>
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<tr>
<td>Std Dev</td>
<td>20.50%</td>
<td>24.42%</td>
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<tr>
<td>Sharpe</td>
<td>0.291</td>
<td>0.367</td>
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<tr>
<td>Correlation</td>
<td>0.700</td>
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</table>

- Higher Return
- But more Risk…
- Similar to Small Caps…
Separating β and α

A four factor regression, using the Fama/French factors and Carhart’s Momentum.

The equation:

\[ R_{\text{index}} - R_f = \alpha_{\text{index}} + \beta_{\text{index}}(R_{\text{market}} - R_f) + \beta_{\text{SMB}}(SMB) + \beta_{HML}(HML) + \beta_{MOM}(MOM) + \varepsilon_{\text{asset}} \]

Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
Which Fund is Best?

![Table and Diagram]

- Fund A: Yellow
- Fund B: Blue
- Fund C: Brown

<table>
<thead>
<tr>
<th>Large</th>
<th>12%</th>
<th>8%</th>
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<tbody>
<tr>
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<th>Value</th>
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<td>16%</td>
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[unified trust logo]
### Pure Market Returns

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<thead>
<tr>
<th>Value</th>
<th>Blend</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund A</td>
<td>Fund B</td>
<td>Fund C</td>
</tr>
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</table>

 unified trust
“Alphas”

<table>
<thead>
<tr>
<th>Fund A</th>
<th>Fund B</th>
<th>Fund C</th>
</tr>
</thead>
<tbody>
<tr>
<td>16%</td>
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<td>8%</td>
<td>8%</td>
<td>2%</td>
</tr>
<tr>
<td>0%</td>
<td>1%</td>
<td>4%</td>
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</table>

- Value
- Blend
- Growth

Legend:
- Fund A
- Fund B
- Fund C

unified trust
Risk-Adjusted Sin Index

<table>
<thead>
<tr>
<th>4 Factor Test</th>
<th>Coefficients</th>
<th>t Stat</th>
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</thead>
<tbody>
<tr>
<td>Alpha</td>
<td>1.33%</td>
<td>0.556</td>
</tr>
<tr>
<td>Market</td>
<td>0.702</td>
<td>7.381</td>
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<tr>
<td>SMB</td>
<td>0.380</td>
<td>2.729</td>
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<tr>
<td>HML</td>
<td>0.349</td>
<td>2.642</td>
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<tr>
<td>MOM</td>
<td>0.129</td>
<td>1.120</td>
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</table>

Adjusted $R^2$ 55.21%

Alpha is still positive, but smaller
Small Cap tilt
Value tilt
Overall low goodness of fit for the regression
Sin in Bad Markets

<table>
<thead>
<tr>
<th></th>
<th>vs Mkt</th>
<th>Correlation</th>
<th>% Beat Mkt</th>
<th># periods</th>
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<tbody>
<tr>
<td>Down Market</td>
<td>9.68%</td>
<td>0.545</td>
<td>86.4%</td>
<td>22</td>
</tr>
<tr>
<td>Up Market</td>
<td>-0.91%</td>
<td>0.616</td>
<td>50.0%</td>
<td>62</td>
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</tbody>
</table>

Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html
The Anti-SRI Fund: VICEX

The Vice Fund (VICEX) invests “in companies, both domestic and foreign, engaged in the aerospace and defense industries, owners and operators, gaming facilities as well as manufacturers of gaming equipment, manufactures of tobacco products and producers of alcoholic beverages.”

The “Cost” of Being Good
Three Possible Impacts of SRI

1. **Doing Good but Not Well:** Where the expected returns of socially responsible securities are lower than the expected returns of conventional stocks.

2. **Doing Good While Doing Well:** Where the expected returns of socially responsible securities are higher than those of conventional stocks.

3. **No Effect**
Should there be a cost?

Minor (2007) argues that while there is has been no consistent documented net financial cost to SRI, three economic properties require an SRI cost that total 50 bps to 100 bps per annum.

However, Minor do not expect a true cost to exist when considering the utility of SRI investing.
A Market Efficiency Perspective

- Most fund managers don’t care about SRI, they care about outperforming peers
- Most assets are not in SRI funds (7/8 of all)
- Can we, therefore, reasonably expect some market segment to have a higher expected return?
Unique Market Exposures

Total Market  SRI Portfolio
In May of 1990, Kinder, Lydenberg, Domini & Co. (KLD) developed the Domini Social Index (DSI) by eliminating S&P 500 companies that failed to pass South Africa, product, environmental, military, nuclear power, and employee relations screens and including 50 non-S&P 500 stocks with “good” records on corporate citizenship, product quality, board representation of women and minorities.

“Good” Investing

MSCI KLD400 Social Index Outperformance

Russell 3000
Good Investing Relative

### 4 Factor Test

<table>
<thead>
<tr>
<th>Coefficients</th>
<th>R1000</th>
<th>KLD400</th>
<th>t Stat</th>
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<tbody>
<tr>
<td>Alpha</td>
<td>1.09%</td>
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<td>Market</td>
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<td>-0.045</td>
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<tr>
<td>MOM</td>
<td>-0.021</td>
<td>-1.586</td>
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</tr>
</tbody>
</table>

Positive alpha… “Larger” and more “Growthy” than the market, overall good regression fit

Adjusted: 94.97%

Higher return, but more risk, virtually identical risk-adjusted performance
Importance of Test Period

MSCI KLD400 Social Index

Outperformance

1991 1993 1995 1997 1999 2001 2003 2005 2007 2009

8 Good Years

9 Bad Years

MSCI KLD400 Social Index Outperformance
My Study Methodology

• Studied mutual funds classified as “Socially Conscious” by Morningstar
• From 1990 to 2008
• Annual independent test periods, therefore no survivorship bias or lookback bias
• Analyzed both Net and Gross returns, versus peers and indexes, as well as alpha tests
## My Findings by Test

<table>
<thead>
<tr>
<th></th>
<th>Net Return vs Category Median</th>
<th>Gross Return vs Category Median</th>
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<tbody>
<tr>
<td></td>
<td>Outperf</td>
<td>% Beat</td>
</tr>
<tr>
<td>Average</td>
<td>-0.23%</td>
<td>46.5%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>-0.17%</td>
<td>46.9%</td>
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</table>

<table>
<thead>
<tr>
<th></th>
<th>Net Return vs Index Return</th>
<th>Gross Return vs Index Return</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Outperf</td>
<td>% Beat</td>
</tr>
<tr>
<td>Average</td>
<td>-0.46%</td>
<td>44.2%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>-0.88%</td>
<td>40.9%</td>
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<table>
<thead>
<tr>
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<th>Net Alpha vs Category Median</th>
<th>Gross Alpha vs Category Median</th>
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<tr>
<td></td>
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<td>% Beat</td>
</tr>
<tr>
<td>Average</td>
<td>0.10%</td>
<td>49.4%</td>
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<tr>
<td>Weighted Average</td>
<td>0.01%</td>
<td>48.5%</td>
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Summary Findings

• Average net SRI fund outperformance = -27 bps
• Average gross SRI fund outperformance = +21 bps
• Differences were neither statistically or economically significant
# Meta-Analysis


<table>
<thead>
<tr>
<th>Authors</th>
<th>Title of study</th>
<th>Time period of study</th>
<th>E, S or G</th>
<th>Method</th>
<th>Result on SRI basis</th>
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<tbody>
<tr>
<td>S nice, T.</td>
<td>Is it better to be naughty or nice?</td>
<td>Jan 1993 - Dec 2003</td>
<td>ESG</td>
<td>Screening</td>
<td>positive</td>
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</table>

**Benefit to SRI**

**Not conclusive**

**Cost to SRI**

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**united trust**
Notable Research

Stone, Guerard, Gultekin, and Adams (2001): “no (statistically) significant cost to social screening… in risk-adjusted return for the performance possibility cross-section” from 1984-1997

Bauer and Koedijk (2002): “After controlling for investment style, we find little evidence of significant differences in risk-adjusted returns between ethical and conventional funds for the 1990-2001 period.”

Kempf and Ostoff (2007) find: “Buy(ing) stocks with high socially responsible ratings and sell stocks with low socially responsible ratings… leads to high abnormal returns of up to 8.7% per year”

Guerard (1996) finds that returns in socially-screened and unscreened universes do not differ significantly.
International SRI

Renneboog, Horst, and Zhang (2006) find that SRI funds in many European and Asia-Pacific countries strongly underperform domestic benchmark portfolios by about 5% per annum, although UK and US SRI funds do not significantly underperform their benchmarks.

Bauer, Koedijk, and Otten (2005) find little evidence of significant differences in risk-adjusted returns between their international database of 103 SRI mutual funds and their non-SRI peers from the 1990 to 2001 period.
Asset Stability

Peifer (2010) notes that after isolating the population of religiously affiliated funds, stark differences in asset stability across SRI funds. Religious SRI funds are less responsive to lagged performance and experience less fund flow volatility than secular SRI funds, although SRI funds are less responsive than regular funds.
Online Resources

www.socialinvest.org
The Social Investment Forum (SIF) is the US membership association for professionals, firms, institutions and organizations engaged in socially responsible and sustainable investing.

http://www.socialfunds.com
SocialFunds.com features over 10,000 pages of information on SRI mutual funds, community investments, corporate research, shareowner actions, and daily social investment news.
Socialfund.com Example

Calvert Social Index A (CSXAX)

<table>
<thead>
<tr>
<th>Social Issues</th>
<th>02/28/11</th>
</tr>
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<tbody>
<tr>
<td>Shareholder activism:</td>
<td>YES</td>
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<tr>
<td>Community investment:</td>
<td>YES</td>
</tr>
<tr>
<td>Environment:</td>
<td>P</td>
</tr>
<tr>
<td>Human rights:</td>
<td>P</td>
</tr>
<tr>
<td>Employment:</td>
<td>P</td>
</tr>
<tr>
<td>Products and Services:</td>
<td>P</td>
</tr>
<tr>
<td>Weapons:</td>
<td>X</td>
</tr>
<tr>
<td>Animal testing:</td>
<td>R</td>
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<tr>
<td>Nuclear power:</td>
<td>X</td>
</tr>
<tr>
<td>Alcohol, tobacco &amp; gambling:</td>
<td>X/X/X</td>
</tr>
<tr>
<td>Other:</td>
<td>Governance</td>
</tr>
</tbody>
</table>

- **P** = Positive screen: fund seeks companies with a positive record or achievement.
- **R** = Restricted investment: the fund has minimum criteria related to this issue.
- **X** = Exclusionary screen: fund avoids companies involved with this issue.
- "-" = Fund does not screen for this criteria.
A Riddle

How is that Sin has outperformed but SRI hasn’t underperformed?

…My best guess is that the additional screens for other companies “ethical” practices” (i.e., non-tobacco/guns/alcohol/etc) may have added value to offset the loss of the strong historical return of “sin” securities
Benchmarking SRI Funds
Consistent Inconsistency

% of Large Cap SRI Funds that Outperformed Their Category Peers

Calendar Year

KLD400 vs R1000

One Year Period Ending

KLD400 Outperformance
Fiduciary Implications

Richardson (2010) debates whether SRI may also be legally permissible if it fulfills the will of the beneficiaries in a fiduciary relationship. He argues that by reframing fiduciary finance as an active relationship rather than merely the mechanical application of legal duties, we may allow trustees to invest socially pursuant to the wishes of beneficiaries.

However, there are considerable legal and practical obstacles confront this path to SRI.
401(k) Prudence

The Prudence requirement under ERISA §404(a)(1)(b) states that a Fiduciary:

Shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.
DoL Guidance

The U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) stated in a 2008 news release that a plan fiduciary may never increase expenses, sacrifice investment returns, or reduce the security of plan benefits to promote legislative, regulatory, or public policy goals with no connection to the payment of benefits or plan administrative expenses.

“Fiduciary consideration of non-economic factors should be rare and, when considered, must comply with ERISA’s rigorous fiduciary standards” said an EBSA official.
Fi360 Guidance

- "Generally speaking, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a SRI strategy."
- Use as a secondary screen
- For ERISA clients, the key to successfully incorporating an SRI strategy is to demonstrate that prospective investment results are not negatively impacted.

**Sample Language for the IPS**

*The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.*

Source: Prudent Practices for Investment Advisors
No SRI Could be a Breach…

In the case of fiduciary clients that fall under the UPIA (personal trusts, foundations, and endowments), failure to consider an SRI strategy could be a breach if:

1. The establishing trust document states use is preferred
2. Donor directs use as a condition of the donation
3. A reasonable person would deduce from the foundation’s/endowment’s mission that SRI should be considered (i.e., it is reasonable to assume that the American Cancer Society would seek to avoid investing in tobacco companies)

Source: Prudent Practices for Investment Advisors
My Thoughts

SRI funds have different/unique market exposures compared to non-SRI funds

There appears to be little or no cost associated with SRI (those differences)

There have been / can be prolonged periods when SRI funds out or under perform peers

Therefore, a fiduciary may need to consider factors when assessing the “quality” of an SRI investment
Ideal Approach

Ideally, the best metric to compare SRI funds would be a methodology that takes into account the investment’s unique characteristics by either creating a sub-sample of SRI funds or using a unique factor when assessing their relative performance.

Given the limited number of SRI investments, though, and the diverse screens employed across SRI investments, it may be difficult to implement an approach using a specific SRI sub-sample.

Therefore, creating a unique SRI factor may be a better approach, since it would allow the user to create a custom factor for different SRI investments.
Create a market neutral factor like SMB that captures the expected divergence of fund based on its screens…

Broad versus specific… specific may be what’s most often needed

Run a five factor regression
Imperfect solution
401(k) Implementation Thoughts

• If applying standard monitoring criteria what if an SRI fund fails and there is no replacement either available or one that meets the requested SRI/ESG criteria?
• Might not be smart to have just one equity fund as the SRI option
• Using a balanced fund, i.e., the Morningstar Moderate Allocation Category, may be more appropriate
Conclusion

Given the unique considerations with investing in SRI funds, some adjustment needs to be made when determining relative performance versus simply comparing the performance to the category median or traditional benchmark.
Questions?

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Research: www.davidmblanchett.com/research