

SOCIALLY RESPONSIBLE INVESTING: THE MATURING OF FINANCIAL ANALYSIS

Brenda Plant

Can one get rich by being responsible? Yes, one can: "To look beyond the investment bottom line does not imply forgetting profits," says Brenda Plant. To help shed light on this issue, she reviews the state of socially responsible investment in Canada, the evidence regarding its economic performance and the strategies available to implement it. She observes that the financial community remains skeptical and ill-prepared to provide that type of service and that, overall, Canada is lagging behind. To keep pace with other jurisdictions world wide, she recommends that Canada amalgamate the multitude of securities regulators into a single national body.

Peut-on à la fois s'enrichir et être socialement responsable ? Oui, croit Brenda Plant : « On peut voir au-delà du rendement d'un placement sans nécessairement renoncer aux profits », dit-elle. Pour éclairer la question, elle analyse l'état des investissements socialement responsables au Canada, leur rendement et les stratégies favorisant leur implantation. Les milieux financiers restent sceptiques à leur égard et mal préparés pour offrir ce service, observe-t-elle, et, d'une manière générale, le Canada accuse en la matière du retard par rapport à d'autres pays. Pour rattraper ce retard, elle propose de fusionner en un seul organisme national la multitude des organismes de réglementation du commerce des valeurs mobilières.



The recent crisis in confidence elicited by a string of corporate governance scandals from Enron to WorldCom may be an indication that financial analysis needs to evolve. The governance and criminality issues raised by Enron and WorldCom are not directly related to social responsibility and sustainability, but they are indicative of the neglect by management of the concerns of stakeholders like investors, communities, employees and environmental groups. Socially responsible investors see the Enron scandal in the context of the systems that allowed it to happen right under our noses. These scandals give all investors the opportunity to advocate for some fundamental systemic changes.

Socially responsible investing offers investors some useful tools to help close the gap between business as usual and the contemporary global challenges of social and environmental responsibility. And while the government should avoid being overly interventionist, it has an important role to play in making capital markets more responsive to some complex social and environmental issues.

Investment capital does not neutrally make us money to put our children through university or provide us with security in our retirement. Social and environmental exter-

nalities are not adequately priced, valued or disclosed in the market. Market imperfections cause anti-social distortions for which we nonetheless pay in other aspects of our lives, be it in the form of increased personal taxes (or cuts in government services), the need to purchase personal protection products like air purifiers for the home, or reduced overall health and quality of life. The marketplace, with its quarterly obsessions, simply isn't designed to be especially effective in promoting positive and innovative initiatives that create long-term value.

To look beyond the investment bottom line does not imply forgetting profits. It involves seeking modes of wealth creation that pursue personal, social and ecological benefits *in addition* to financial gains.

Social and environmental issues are not disconnected from financial value. As the Conference Board of Canada points out, intangible assets, like brand and reputation — which are themselves increasingly connected to social and environmental performance — now compose over 50 percent of a company's value. The exposure to such intangible assets has brought increased risks to investors, and neither the risk nor the true value of the firm are captured in traditional financial metrics.

While it has existed for centuries, socially responsible investing (SRI) is now occupying new and wider space, in response to some of the limitations of conventional financial markets.

A number of individual and institutional investors, such as charitable foundations, religious organizations, trusts, investment pools and pension plans, have begun to question the prudence of ignoring social and environmental considerations related to the companies held in their investment portfolios. The Social Investment Organisation, the Canadian national network promoting the practice of socially responsible investment, estimates that as of June 30, 2004, \$63.65 billion falls under the SRI umbrella; that is, 3.5 percent of the total investment market in Canada. This amount represents a 24 percent increase from the \$51 billion in 2002.

SRI has been defined as the process of selecting or managing investments according to social or environmental criteria, while still including all the financial decision-making processes that are a part of prudent investment management.

Social and environmental issues are inherently complex, and there is no universal standard or recipe for taking them into consideration. Perfection in SRI is unattainable. Corporate activities, and investment in them, have social and environmental effects that do not yield to ready quantification. Still, these effects could affect investment performance as profoundly as currently quantifiable and measurable criteria.

One can find various types of SRI in the marketplace. One strategy is "screening," where investment attractiveness is based on certain social and/or environmental indicators. This may involve excluding certain companies from the portfolio because of non-financial material risks, an inconsistency with investor values, or concerns with the collateral damage the stock generates.

CalPERS, (California Public Employees' Retirement System), for

example — the largest pension fund in the US, with US\$180 billion under management — engages in a number of exclusionary screens. As of 2000 they decided to exclude tobacco stock from the portfolio due to the unprecedented amount of legal, regulatory and legislative action in the industry, which could substantially reduce share value.

CalPERS also excludes emerging markets that ignore international labour standards, on the grounds that these countries are not able to support institutional investments. A few months ago, they adopted a policy that restricts the system's private equity general partners from investing in companies that outsource public sector jobs. The then president of the board, Sean Harrigan, said that "money provided by public workers should not be used to cannibalize public jobs and cost taxpayers more money in the end."

Inclusionary screening, on the other hand, involves proactively seeking corporate social opportunity leaders and companies that generate collateral benefits: this includes investing in alter-

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native energy companies, natural food companies, and companies that have outstanding relations with employees and other stakeholders.

Another SRI strategy is referred to as community development investing, or economically targeted investment (ETI). This involves redeploying capital to neglected sectors like innovative environmental technologies, inner-city redevelopment and micro-enterprises or cooperatives, which are typically excluded from mainstream financing but often have market-grade returns commensurate with risk and collateral (social) benefits. Sustainable private equity, or sustainable venture capital, is another important

emerging area, by means of which investors can encourage eco-innovation.

Finally, an increasingly prevalent SRI strategy is to use the leverage of share ownership to improve companies' social and environmental performance. This strategy is often called "shareholder engagement," and it encompasses various means, including negotiating with companies for change, using voting rights at the annual general meeting (referred to as "proxy voting") to vote according to certain principles, and filing shareholder resolutions to persuade other shareholders to support and mandate management taking certain actions.

A record number of shareholder proposals have been submitted for voting at Canadian annual meetings this year (110 by the time of writing). Significant issues raised include excessive executive payouts and poor corporate social and environmental disclosure. Shareholder action can make companies more responsive to changing external conditions, increasing long-term profitability and sustainability. Management

does not always see the wisdom of this approach. Blinded by history, tradition and self-interest, corporate management often opposes such measures, arguing that they are impractical or too expensive. But shareholder advocacy can give clout to stakeholder voices that would otherwise be silent or ignored and that represent material risks to the company.

How shareholders vote on corporate business can affect financial performance and investment returns. New requirements for mutual funds to provide information on their proxy voting policies and voting records to unit-holders on request are set to take effect June 30, 2005, but no such requirement is on the table for pen-

sion funds. The Shareholder Association for Research and Education (SHARE) attempts to fill this gap. Each year, SHARE surveys Canadian investment managers and proxy voting services on how they voted proxies on behalf of pension plan clients. The 2004 survey results raised concerns that votes are being decided based solely on management's recommendations rather than on the merits of the proposal, concerns that echo an August 2004 report from the US Government Accountability Office (GAO), which found that "conflicts of interest exist in proxy voting and occur because of the various business relationships that may influence a proxy voter's vote."

Meanwhile, another private-sector disclosure development has emerged that gives further credence to SRI: the Carbon Disclosure Project (CDP). This project has significant institutional investors signing a global request for disclosure of information on greenhouse gas emissions from the FT 500 largest companies in the world. In 2003, 35 institutional investors, representing \$4.5 trillion, had signed on; in 2005 there were 145 institutional investors, representing \$20 trillion; and today 300 of the 500 largest corporations in the world report their emissions through the CDP Web site.

Cynics will argue that no one gets rich by being responsible, but despite commonly held assumptions, research shows that there is no financial penalty for investing in a socially responsible manner. Socially and environmentally responsible stock indexes outperform their conventional counterparts. In the past 10 years, the Domini Social Index (a basket of 400 socially responsible stocks in the US) has returned 12.9 percent a year (to December 31, 2004). This is considerably higher than the Standard & Poor's 500-stock index, at 12.1 percent.

In Canada, the Jantzi Social Index (a basket of 60 socially responsible stocks) has been operating for only five years, but in the five years ending December 31 2004, the Jantzi index returned 4.1 per cent a year, compared

with 2.3 percent for its conventional counterpart, the TSX 60 index.

Further, the Canadian public supports SRI. In 2003, Environics International found that 88 percent of Canadian investors believe the financial community should pay more attention to social and environmental issues. Nine in ten Canadians strongly (55 percent) or somewhat (35 percent) support "requiring companies to publicly report their social and environmental performance"; over eight in ten Canadians strongly (39 percent) or somewhat (43 percent) support "requiring pension funds to publicly report whether or not they take the social and environmental performance of the companies they invest in into consideration"; and nine

in ten Canadians strongly (54 percent) or somewhat (36 percent) support "making tougher laws around corporate environmental and social behaviour."

Despite increased real-life evidence of the value of SRI, and despite Canadian public support for SRI, the greater financial community remains skeptical, ill-prepared and unwilling to provide Canadians with socially responsible investment services. According to its 2004 industry survey, the Social Investment Organization found only 37 out of 173 asset management firms that manage assets with social responsibility or sustainability screens. In the mutual fund industry, out of an estimated 2,000 funds available to Canadians, only 55

A Quick Glance at SRI Developments around the World

- As of July 2000, all pension funds in the UK are required to declare in their statement of investment principles "the extent (if at all) to which social, environmental and/or ethical (SEE) considerations are taken into account in the selection, retention and realization of investments; and the policy (if any) directing the exercise of the rights (including voting rights) attaching to investments."
- The Asia Development Bank and the International Finance Corporation (the private finance arm of the World Bank) are developing policies on sustainable investment and believe that the comprehension of risk is changing among financial companies as environmental and social issues rise up the agenda.
- As of January 2002, newly conceived private pension schemes in Germany "must inform the members in writing on whether and in what form ethical, social, or ecological aspects are taken into consideration when investing the paid-in contributions" in order to be certified and qualify for tax deductions.
- The Australian *Financial Services Reform Act* has been in effect since March 2002. This comprehensive piece of legislation includes an amendment that compels providers of investment products to disclose "the extent, if any, to which labour standards, environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment."
- As of May 2001, French companies are required to report on social and environmental issues in their annual financial reports. In addition, SRI is now reflected in legislation overseeing retirement savings contributions and retirement fund regulations under changes to the Code monétaire et financier that came into effect in winter 2002.
- As of 2002, Belgian legislation obliges supplementary retirement schemes to issue an annual report containing information on the financing method and the "investment strategies for the long and the short term and how social, ethic and environmental aspects are being taken into account."
- As of September 1, 2003, all companies listed on the Johannesburg Securities Exchange (JSE) have to comply with codes created in 2002 by the second King Report on Corporate Governance for South Africa. These codes address core corporate governance issues, and require the use of Global Reporting Initiative (GRI) guidelines for disclosing social and environmental performance.

screen their investments according to social or environmental criteria.

No doubt, the financial community's training has something to do with it. Business education fails to educate students on roles and responsibilities, despite the reality of an increasingly interconnected planet. A recent task force report by the business-school accreditation body AACSB International (the Association to Advance Collegiate Schools of Business) found Canadian and US schools wanting in the whole area of teaching corporate social responsibility and ethical leadership. It added that schools must do more to "socialize students in the obligations and rewards of stewardship, including the concerns of multiple stakeholders, and the responsible use of power."

With pressure from the accreditation body, business schools will evolve to provide the new analytical skills required for the new economy, but in the meantime, a minority Canadian government may be tempted to listen to its electorate and take cues from governments around the world, which are beginning to establish clearer boundaries on issues of social, environmental and governance responsibilities. With the appropriate boundaries set, the market can perform fairly while minimizing the need for governmental refereeing. Canada is lagging behind. Advancing on these issues will be a core contributing factor to Canada's competitiveness and stability.

To keep pace with the other jurisdictions across the world that are developing social, environmental and governance rules, Canada needs to amalgamate the current multitude of securities regulators into a single national regulator. While it is important that regulators do not become too prescriptive in terms of governance practice, it is essential that they do establish the basic expectations for public corporations in terms of their operating license. The Canadian

Securities Administrators (CSA) should require public companies in Canada to clearly state their position on issues of social responsibility and sustainability and to disclose these positions to stakeholders and the public. This could mean requiring publicly listed companies to report on these issues using the increasingly globally recognized Global Reporting Initiative (GRI) guidelines.

Another important boundary-setting zone is around pension funds. Pension-fund assets in Canada represent \$550 billion. Insufficient oversight and accountability in pension-fund management could seriously hamper the pensions' ability to deliver on the

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pension-fund promise to provide for lifetime needs. This crisis would be aggravated by longer lifespans. Following the precedent set in the UK and taken up by other countries, all pension funds in Canada should be required to disclose whether and how social and environmental considerations are taken into account in the selection, retention or realization of investments.

Many pension-fund managers believe that they cannot take a socially responsible stand because of their duty to maximize shareholder value for their clients. But asset managers and trustees have to begin questioning previously held assumptions on what constitutes and contributes to shareholder value. In a presentation on legal issues related to SRI given to the Ontario Society of

Financial Analysts in January 2005, lawyer Murray Gold concluded that "no case rules out — and, indeed, the general fiduciary obligation requires — that trust investments be made with regard to all risk and return variables, including balance sheet risks, business risks, technology risks, legal risks, governance risks and social, environmental and labour risks."

The Canada Pension Plan (CPP) should be leading the way. The CPP Investment Board should undertake a portfolio review in order to understand the extent to which its investment portfolio is currently exposed to environmental, social and governance risks. While many believe the values-

based arguments for SRI are legitimate — that the peace and security of our later years ought not to be financed by investments that undermine the values manifested in our public policies and public opinion — the mounting evidence of the financial case for SRI also underlines the need for the CPP Investment Board to take these issues seriously, to stop dismissing them as a slippery slope into complex social issues that must be avoided.

Charitable foundations are another area of pronounced bifurcation between social/environmental goals and financial goals. Canadian law requires all foundations in the country to annually disburse 3.5 percent of their investment assets, but there are no requirements that the assets be managed with regards to remaining obedient to their social missions. These institutions fulfill a unique purpose and enjoy a privileged tax status: the legislation should be clear and require directors of charitable corporations, when making investment decisions, to consider whether the decision in question would further, or at least not hinder, the fulfillment of those charitable purposes. Again, such regulatory regimes are not just the dreams of tree-huggers — as of 2001, charities in the UK have been required to disclose the extent to



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At its last annual meeting, Wal-Mart came under criticism from socially responsible investors for its management of the union issue. Here, a group of workers from Jonquière, Quebec, protest the closing of their store in a rather imaginative way.

which they take into account social, ethical and environmental issues in their investment policies.

Finally, community development investing and sustainable venture capital are SRI strategies that, if enabled by legislative incentives, could contribute greatly to the future well-being of Canadians. Micro-credit, cooperative enterprises and other social and environmentally conscious small and medium-sized enterprises (SMEs) are typically underfinanced by the mainstream financial institutions and yet, in the majority of countries belonging to the Organisation for Economic Co-operation and Development (OECD), SMEs represent 95 percent of all business organizations and generate more than half of all private sector employment, and the survival rate of cooperative enterprises is almost twice that of investor-owned companies. Community-development investments should

qualify for RRSP tax credits, and the federal government should explore potential frameworks to increase the role of Canadian banks in financing and supporting vibrant communities through community-development investing.

SRI applies a socio-cultural and bio-physical matrix over the dynamics of business, and it draws insight from these complex fields to work toward innovative value creation; it is an important part of maintaining public confidence in financial markets. SRI is about examining all material opportunities and risks, whatever their nature. Socially responsible investing is intuitively right, even if current structures and beliefs incite fear and resistance to the integration of social and environmental criteria and traditional financial analysis.

Jurisdictions around the world are setting disclosure rules related to social

and environmental considerations to reduce the need for more intrusive government intervention, but Canada lags in such initiatives. Simple regulatory changes to securities regulators, disclosure rules encouraging transparency for pension funds, a portfolio review of the CPP portfolio to take stock of current exposure to social and environmental risks, disclosure requirements for charitable foundations on whether investment decisions further the fulfillment of the institutions' charitable purposes, and enabling measures like RRSP credits to encourage Canadian investment in vibrant and sustainable communities are just a few ways that SRI might even raise both our quality of life and our business efficiency.

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