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Responsible investment: Five tests of an SRI/ESG policy

For a number of reasons – legislation, organized lobbying or simply the desire to do the right thing - responsible investment is growing and becoming harder for many institutional investors to ignore. In this paper we describe a framework – built around five key areas of consideration - for assessing a responsible investment policy within the context of established investment best practices and the broader investment program.

Background – responsible investment is becoming harder to ignore

Responsible investment (RI) is hardly new. Indeed, biblical prohibitions on the charging of interest¹ mean that we can trace that particular form of investment restriction back at least 2,500-3,000 years. (Restrictions on the charging of interest can be found to this day in the practices of those who follow *sharia* Islamic law.) The influence of various faith-based groups, increasing social activism, the anti-apartheid movement, growing environmental focus and the emergence of organized lobbying efforts - all have played a part in shaping the RI field.

Responsible investment's demands for the attention of institutional investors have been growing louder for many years and do not appear likely to die down anytime soon. The United Nations Principles for Responsible Investment (UNPRI) were launched in 2006 and by the start of 2008 had been signed by more than 200 investors and investment firms, representing more than \$10 trillion. Public awareness and activism around environmental issues has increased. 15 states and more than 50 universities in the U.S. have adopted policies restricting investment in companies linked to Sudan. And according to the consulting firm Celent, the European market for responsible investment already exceeds €1.7 trillion and that of the U.S. is likely to exceed \$3 trillion within four years². The field has

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¹ Exodus 22:25: If you lend money to my people, to the poor among you, you are not to act as a creditor to him; you shall not charge him interest. (New American Standard Bible.)

² The sources for the statistics quoted in this paragraph are: United Nations Principles for Responsible Investment (UNPRI), www.unpri.org, (May 2008), Republic of the Sudan Ministry of Investment, www.sudandinvest.org, (May

moved beyond its traditional realm of faith-based groups and mission-oriented foundations and appears set to find its way onto the agendas of an ever-increasing number of investors in the coming years.

As more investors move to adopt explicit policies, our purpose in this paper is to ensure that they do so thoughtfully, and that they do not compromise sound investment principles or their fiduciary duties in doing so. Some will consider RI through choice, others through compulsion; all should approach it in the context of their broader obligations and objectives.

“Responsible” means different things to different people

Defining *responsible investment* is fraught with challenges.

Even the way that responsible investment is referred to varies widely. We have chosen to use the term “responsible investment” throughout this paper, following the United Nations’ choice for its own 2006 Principles. More familiar to many is the term “socially responsible investment” (SRI), which has a long history of usage throughout the world. The acronym ESG (environmental, social and corporate governance) is also increasingly popular, reflecting the growing importance of environmental concerns to many investors. Other flavors of responsibility are captured in terms such as sustainable investing, social investing, values-based investing, ethical investing, mission-driven investing and others, all of which are in current usage under the broad umbrella that we will simply refer to as responsible investment.

To a large extent, these differences in terminology flow from the different objectives underlying responsible investment programs. It soon becomes obvious to anyone who studies this field that what one person or group means by “responsible” is not what another means. These differences are more than simply varying views about particular activities, such as the sale of alcohol or tobacco.

For example, at the time of writing, investors who decide to pursue a Sudan-free investment policy are able to obtain, from a variety of sources, lists of corporations that have ties to that state. The lists vary widely, however, in whom they identify as offenders – one source named 35 companies and another more than 200 in one recent comparison.

Another illustrative case is that of Pax World Funds and Starbucks: in 2005, three of Pax’s mutual funds were forced to divest from Starbucks because it was classified as... an alcohol stock. This was a consequence of Pax’s zero-tolerance policy on alcohol being applied to the coffee giant’s decision to co-brand a coffee liqueur with Jim Beam. (The Pax funds dropped the zero-tolerance policy the following year.³)

Exclusion and engagement: the tactics of responsible investment

Not only does the definition of responsible investment vary from case to case, but there are also differences in how those policies are implemented. Most importantly, a distinction can be drawn between exclusion-based approaches and engagement-based approaches.

The exclusion-based approach is simple in concept: do not invest in activities deemed beyond the pale. There are all sorts of activities to which this might apply, including the sale of alcohol or tobacco, the use of child labor, the running of a brothel or allowing the same individual to be both Chairman and CEO of your corporation. These exclusionary, or screen-based, approaches have a long history. A variant is the inclusion-based approach, which does not focus on prohibited activities but rather on favored ones (action on climate

2008), and “Socially Responsible Investing in the US and Europe: Same Goals but Different Paths,” press release, Celent, March 13, 2007.

³ Akst, D. (2006). *The give and take of ‘socially responsible’*, New York Times (October 8.)

change, for example, or economically targeted investment). The inclusion-based approach would typically be applied with only a portion of the total assets.

A different tactic, open to larger investors, is shareholder engagement. Here, the investor attempts to influence corporate behavior through proxy voting, shareholder resolutions or other lobbying activities. While this has the same end objective as exclusion-based approaches, it is a quite different tactic and it places a different set of demands on the investor.

Responsible investment policies typically cover the equity or debt of corporations, and could extend also to government-issued debt (for instance, some organizations avoid the government debt of certain countries, because that debt is used to finance war) and even to other areas of investment such as real estate.⁴

The role of the five tests

However, among all of the differences between the objectives, terminology and tactics of responsible investment, some things should remain the same. Most importantly, the normal standards of prudent investment should continue to be applied.

This means that investors who decide to adopt some form of responsible investment policy, or who are considering doing so, need a framework for evaluating that policy. We describe below one such framework, built around five key areas that should be considered. We refer to these five areas for consideration as tests although it should be noted that the answers to the questions they raise will rarely be as simple as “yes” or “no.” Rather, fiduciaries should be prepared to think through the issues raised under each of those headings in the context of their own investment program’s goals, resources and other policies.

This framework is not new; it is a generalization of a framework that was designed specifically for UK pension funds in response to legislation enacted there almost ten years ago⁵. Indeed, the framework is in a sense even older than that: it simply involves asking the same questions that should be asked of any aspect of an investment policy, whether driven by social responsibility or any other consideration.

TEST #1: WHAT IS THE IMPACT ON THE EXPECTED LEVEL OF INVESTMENT RETURN?

When considering whether a proposed policy is sound and prudent, it is natural to look first at its expected impact on the overall level of investment return earned by the program. This is the question that our first test explores.

Fiduciaries need to consider whether a proposed RI policy could have a systematic negative impact on returns. For example, other things being equal, “virtuous” stocks may attract greater interest than “vice” stocks, and hence command a price premium. Put another way: in a world that is moving towards responsible investment the law of supply and demand may mean that lower returns are available from responsible investment strategies in general.

In contrast, the argument is also made by proponents of responsible investment that, far from reducing expected returns, RI policies actually enhance them. Their arguments may rest on better use of resources and risk management, for example. To the extent that those arguments rely on market inefficiencies (e.g., the failure of the market to incorporate into the stock price of Company X the fact that it is attractive to consumers because it has a reputation for excellent environmental practices), we should note that few market

⁴ For a discussion of the increasing importance of environmental issues to real estate investment, see Nikodem, P. *Commercial Green Building Update*, Russell Research (forthcoming.)

⁵ Collie, R., M. Clark and J. Ilkiw (1999). *Socially responsible investments: Does your SRI policy pass five tests?* Russell London Monograph (August).

inefficiencies are persistent. We prefer to take the view that an RI policy should not attempt to justify itself on the grounds of return enhancement. After all, most investors *already* have a policy of return enhancement; why go to the trouble of producing another policy if the intent is the same? But while we do not believe a responsible investment policy needs to enhance expected returns, it is usually the case that it would be unacceptable for such a policy to reduce them⁶.

It is possible to gain some insight into the likely future impact of RI policies by looking at what has happened in the past. A considerable amount of work has been done on this question.

One theoretical and empirical assessment of this question can be found in a research paper produced by Russell Australia⁷. The authors consulted more than 40 empirical studies. These studies varied greatly in their approaches, definitions of RI, robustness, time periods and markets covered. The authors categorized the studies into “negative”, “neutral” and “positive”, with the great majority falling into the “neutral” category – that is, they found that ethical, SRI or sustainable approaches neither materially impair nor materially enhance investment performance. This paper concluded that: “Sustainable investments are unlikely to generate returns statistically different from any other shares when account is taken of different operational risk levels, different industries, capital structure and so on.”

Investors who are seeking to pursue responsible investment policies need to apply our first test to their own specific policy, but general conclusions such as this one provide support for the argument that such policies do not necessarily involve any reduction in expected return.

There is one point of clarification that we should make here: we are not saying that the *actual* return must be at least as high under the responsible investment policy as without it. That would be an unreasonable hurdle to set in a world in which there are no guarantees. A responsible investment policy, just like any investment decision, may be perfectly appropriate on the balance of probabilities at the time it is entered into, yet still result in a reduced return. Indeed, it is almost certain to do so over some time periods – just as a poorly-designed policy will sometimes enhance returns. That is simply the nature of investments.

TEST #2: WHAT ARE THE RISKS ASSOCIATED WITH THE POLICY?

Prudent investment does not concern itself only with returns; it also considers risk. Hence, our second test focuses on what risk(s) might be introduced by a responsible investment policy.

Of particular importance here is the question of diversification, because reducing the opportunity set of investments can clearly reduce the ability of an investor to diversify.

Now, in one sense no investor is ever perfectly diversified because no investor holds every possible investment. So the question of whether a restriction on the opportunity set materially impacts the ability to diversify is to a large extent a question of degree. Of particular concern in this regard should be the possibility that a responsible investment policy may introduce unintended biases at the total portfolio level. For example, some responsible investment policies may lead to the exclusion of a major sector of the stock

⁶ In some cases, a reduction in expected returns might be acceptable: For example, in the case of program-related investments by a private foundation (i.e., investments directly related to the foundation’s mission). And certainly, individuals investing on their own behalf are quite free to decide that an expected return shortfall is an acceptable price to pay for the application of their personal principles. For institutional investors in general that would be very much the exception.

⁷ Taylor, N. and S. Donald (2007). Sustainable Investing: marrying sustainability concerns with the quest for financial returns for superannuation trustees. Russell Research (August).

market (such as oil, power generation or other heavy industry) or to a bias toward medium or small cap companies.

Responsible investment policies may also have other implications for risk beyond simply the question of diversification. There are many facets of risk for an institutional investor and a well-designed RI policy can have a positive impact in some of these areas. For example, company-specific risk considerations lie behind many of the main principles of corporate governance, a field focused on the appropriate management and control structures of a company. Some other facets of risk will be discussed in the next section, which covers the question of implementation of the policy.

TEST #3: HOW WILL THE POLICY BE IMPLEMENTED?

It is not enough to consider only the likely impact on returns and on risk. Indeed, we believe that our third test – which addresses the question of implementation – is the one that usually throws up the greatest challenges for investors seeking to pursue responsible investment policies.

The exact nature of the challenges varies depending on the particular tactics on which a policy is based. Exclusion-based approaches, for example, require both ongoing management of the exclusion list and some way of translating the list into actual portfolios without undermining the established investment process. If this cannot be achieved within the existing investment manager structure, would the required changes compromise the quality of that structure, reducing the ability of the plan to generate investment returns, or increasing manager-specific risks? An RI policy is not a substitute for thorough due diligence of investment managers or other service providers, and should not become an excuse for compromising other elements of an investment program.

We noted above the definitional issues that surround responsible investment. The fact that definitions of “responsible” differ so much makes it harder for the market to produce standardized solutions. Navigating these issues can prove surprisingly time-consuming and frustrating.

Under this test also falls the question of costs, both direct and indirect. Some policies may lead to increased manager fees or other direct expenses. Nearly all policies demand time and attention from the governing bodies and staff of institutional investors. Engagement-based policies can be particularly demanding to put into effect. Even a policy based around increased disclosures (e.g., of carbon emissions) would lead to a need for the disclosures to be subjected to consideration.

Any change to an investment structure or approach carries with it the risk of unintended consequences: an engagement-based policy may, for example, lead to conflict with corporate management, which may in turn lead to negative publicity.

Thought should also be given to how the policy will be monitored. Ideally, the impact of the policy would be clearly identified and tracked. In practice, this is easier to do for some types of policy than for others. Likewise, to the extent that it is feasible, it is desirable to have separate measures of the impact of the policy itself and the impact of the agent(s) retained to implement the policy.

The challenges and demands around implementation of a responsible investment policy can be significant, and they vary greatly depending on the details of the chosen policy and the tactics upon which it is based. Because of this, consideration should be given – before a policy is adopted - to how that policy will be implemented and to what the indirect consequences may be.

TEST #4: DOES THE POLICY HAVE BROAD STAKEHOLDER ACCEPTANCE?

Even where a policy has been weighed against our first three tests and judged to be appropriate, it is still necessary to consider the question of stakeholder buy-in. Responsible investment policies frequently receive a great deal of attention, and can create strong emotions (both in favor and against). And, as we have stated already, RI policies will, like any other investments, almost certainly go through periods of disappointing performance, as well as periods of strong performance. That can be a dangerous combination.

There is the potential to create no-win situations in bad times if key stakeholders feel that they were excluded from the policy decision. It may lead to criticism of those who adopted the policy or pressure to unwind well-designed policies. It is far better to take steps to earn stakeholder understanding and acceptance of the policy at its origin than to attempt to do so after the event if the results turn out to be worse than expected. Stakeholders are, of course, not always resistant to responsible investment policies – in many cases, a policy's origins lie in stakeholder pressure.

There may be a number of sets of stakeholders to consider, some with a greater say than others. Private foundations have their contributors and beneficiaries; university and college endowments have those, too, and in addition may have a vocal faculty and/or student body; corporate pension plans have their sponsoring corporation and the plan membership; public pension plans have their sponsoring body, plan membership and taxpayers. There may be other stakeholders – some investors in each of these categories are sufficiently large or high-profile that they garner public interest, for example.

The more numerous and more diverse the stakeholders, the harder it can be to reach common ground – a point nicely illustrated by the case of the Dutch civil servants' pension plan ABP.⁸ In 2007, the plan was criticized (along with other large Dutch plans) on an investigative TV show⁹ for investing in companies that produce cluster bombs and anti-personnel land mines. But as a spokesman for ABP pointed out in a written response to *Investments & Pensions Europe*,¹⁰ ABP's 2.5 million participants include "...pilots that can be asked to drop cluster bombs, the minister of defence who is responsible for contracts to buy weapons on behalf of the Dutch government, all members of the government and all members of the opposition." This is just one example of different perspectives on what constitutes a "responsible" investment.

How far it is necessary to go to gain stakeholder buy-in to a policy will vary depending on circumstances, but those responsible for the policy must at least take the time to ask the question.

TEST #5: IS THE POLICY PROPERLY DOCUMENTED?

Good documentation is a general principle of sound investment. It is especially pertinent here because subjects like abortion, the environment and war often involve strongly held religious or ethical beliefs (one's own and those of others) and generate strong feelings. Responsible investment evokes human emotions, more than almost any other area of investment. Whatever you do, you can expect to be challenged by those who would have preferred a different approach.

⁸ Algemeen Burgerlijk Pensioenfonds, one of the world's largest pension plans at close to \$300 billion at the start of 2008.

⁹ VARA Broadcasting Association and Nederlandse Programma Stichting (Dutch Program Foundation). *Het clusterbom gevoel* (the clusterbomb feeling). Zembla, aired March 18, 2007.

¹⁰ Lake, R., senior portfolio manager for environmental, social and governance issues at ABP Investments. Quoted in Röhrbein, N. (2007) *Consequences of a Dutch affair*, in a supplement to *Investment & Pensions Europe* (December).

This means that if a responsible investment policy fails to deliver the expected outcomes or comes under subsequent criticism for other reasons, then fiduciaries will be looking for good documentation, demonstrating prudent process. Naturally, that documentation should include the rationale and objectives of the policy. The considerations and expectations arising from our first four tests should also be captured. If it is believed that the policy will not reduce expected returns (while acknowledging that there will be periods when it does reduce actual performance), then the reasons for that belief should be documented. Likewise, an assessment of the issues around risk, implementation and stakeholder acceptance should be documented.

The application of the five tests in defined contribution (DC) plans

We have couched the tests above in general terms and they do, indeed, apply to any type of institutional investor. We should add a few words on the application of these tests within DC plans.

On the surface, DC plan fiduciaries who offer some form of responsible investment option alongside traditional options may feel that they are on safer ground than fiduciaries for other types of investment programs that pursue responsible investment policies. This is because, in a DC plan, the only participants affected by the policy are those who explicitly select the RI options for themselves. This clearly makes our fourth test – that of stakeholder acceptance – an easy one to assess.

However, participant involvement does not remove the fiduciary obligation to ensure that the selected policy is appropriate in other respects – especially when we recall that in a DC plan, unlike in a defined benefit plan, the participant is directly affected by investment returns. DC fiduciaries should therefore pay the same level of attention to our five tests as do fiduciaries for other types of investment program; they should not assume that the existence of participant choice automatically covers all the bases.

Conclusion: A framework for sound decision-making

Responsible investment is a very broad concept that includes many different strategies, with many different end objectives - a concept that is increasingly being considered by institutional investors, for a variety of reasons.

To help investors considering the adoption of a responsible investment policy we have described in this paper five tests to be used in assessing such a policy. Together, these tests provide a framework for ensuring that best investment practices can continue to be applied.

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