"SOCIALLY RESPONSIBLE INVESTING":
AN EVOLVING CONCEPT IN A CHANGING WORLD

Peter D. Kinder
President
KLD Research & Analytics, Inc.

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Peter D. Kinder
KLD Research & Analytics, Inc.
4th Floor
250 Summer Street
Boston, MA 02210
(617) 426-5270 (vox)
(617) 426-5299 (fax)
PDKinder@KLD.com (EMail)

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"SOCIALLY RESPONSIBLE INVESTING":
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Introduction

> *Investment is essentially about making judgments and decisions in the present, typically with reference to the past, to cope with or exploit an uncertain future.* - Watson Wyatt Worldwide (2003)[1]

"Socially responsible investing": Few terms are so unloved by the people who rely on them. Still no one has devised a better term. And, it has locked itself into the usage of the public, the press and the financial services industry. We are probably going to have to live with it.

Living with a term and giving it meaning are very different things. Beyond its awkwardness, "socially responsible investing" (SRI) is unloved because, as I show in this paper, it has come to harbor apparently differing views of what SRI is and is about.[2] My analysis of these views centers on three fundamental questions:

- What meanings attach to "socially responsible investing" today? [3]

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[1] Watson Wyatt Worldwide Thinking Ahead Group, "Remapping Our Investment World" (Reigate, Surrey, UK: Watson Wyatt Worldwide, 2003), p. 20 (hereafter "Watson Wyatt, 'Rethinking'").

[2] "The language used to describe SRI funds, including the term 'SRI' itself, is vague and indiscriminate and leads to misperception and distortion of investor goals." Paul Hawken & The Natural Capital Institute, "Socially Responsible Investing" (Sausalito, Calif.: Natural Capital Institute, Oct. 2004), p. 22. http://www.naturalcapital.org/images/NCI_SRI_10-04.pdf (hereafter "Paul Hawken, *et al*."). The World Economic Forum report cut the phrase to "responsible investing". World Economic Forum Global Corporate Citizenship Initiative, "Mainstreaming Responsible Investment" (Geneva: World Economic Forum, 2005) (hereafter, "Mainstreaming Responsible Investment").

[3] Paul Hawken has asked, "Are the terms 'socially responsible investing' or 'social investing' so broad as to have little meaning? In other words, are the screening criteria and language employed by the SRI community adequate to express the scope and complexity of current business models as well as the problems facing humanity?" Paul Hawken, *et al.*, *op. cit.*, p. 6. The second question does not flow from the first; they are separate and will be so treated below.

- Who are SRI's constituents and what are (and will be) their objectives and methodologies?

- How do financial and social performance relate to and interact with its constituents' objectives?

The answers – or more accurately, the shape of emerging answers – to these questions I suggest in this paper.

I begin by describing how SRI came to mean different things to different investors. I then classify the approaches termed SRI and analyze the sources of the dissonance among the approaches in terms of their social, legal and political characteristics. I conclude that the differences, while real, should not prevent SRI's constituents from making common cause on issues of corporate accountability and – in its broadest sense – corporate governing.

Woven into the fabric of this paper are strands from the on-going debate over "short-termism", the mentality common both in investing and amongst publicly traded companies that focuses on quarterly or annual financial returns to the exclusion of medium- and long-term benefits. I end the paper with some observations on "performance" and SRI.

My positions on the issues this paper discusses are not unknown and are not hidden here. However, my objectives here do not include scoring debating points. Rather, I have focused on definitions, distinctions and descriptions. My hope is that they will clarify SRI's workings and offer a basis for reaching common understandings.

I. SRI Today: Some History and Context

A survey conducted in late 2004 by Mercer Investment Consulting of 195 investment managers world wide found that they believed “the adoption of SRI practices and strategies will become commonplace”. Specifically,

- almost 80% predicted that active ownership will be a mainstream practice within 5 years (89% in 10 years)

- almost 40% predict that positive or negative screening will be mainstream within 5 years (65% in 10 years)

- 37% predict that the incorporation of social and/or environmental … corporate performance indictors will become mainstream within 5 years (73% in 10 years)

The report concludes:

> The SRI trend has been percolating for some time, but time frames have been less clear in terms of these practices becoming mainstream. Our survey of manager expectations suggests that managers believe it to be set on a mainstream trajectory – perhaps more strongly than many in the industry would have assumed.[4]

How did SRI reach this trajectory? More importantly what is it, precisely, that is on this trajectory?

“SRI” Defined

Few exercises better illustrate the evolution of a concept than comparisons of its definitions over time. Since 1983, I have used this definition: “Socially respon-

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[4] Jane Ambachtsheer, “SRI: What do investment managers think?” (Toronto: Mercer Investment Consulting, 2005) http://www.merceric.com/summary.jhtml/dynamic/idContent/1174905;jsessionid=NLSBTBELJUFRUCTGOUGCIIQKMZ0QYI2C

sible investing" is the incorporation of the investor's social or ethical criteria in the investment decision-making process.[5]

In 2001, ABN-AMRO defined the term somewhat differently:

> An investment process in which sustainability criteria relating to a company's social and/or environmental behaviour play a decisive role in the admittance of that company's stocks to the investment portfolio.[6]

In 2005 a World Economic Forum report suggested this:

> Responsible investing is most commonly understood to mean investing in a manner that takes into account the impact of investments on wider society and the natural environment, both today and in the future.[7]

Note the change in the actor in the three definitions. In the first, the investor is the decision-maker. In the second, there is no apparent actor, only a "process". In the third, it is not clear by whom, how, when or why the factors are considered.

The emphasis on process, the vagueness of terms and, in the WEF's definition, the omission of "social" from "responsible investing" signal the emergence of a new perspective. This change in actor marks the entry into SRI of a group of institutional investors who do not have a mission-related commitment to social or environmental causes and who are uncomfortable with the responsibility for moral judgments which decisions on non-financial criteria imply.

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[5] Almost certainly, I developed this definition with Amy L. Domini. As discussed in later sections, this definition is not valid in some cases for what I've termed the "value-seeking approach" to SRI, nor is it valid in almost all cases for the "value-enhancing approach".

[6] ABN-AMRO, *Do socially responsible equity portfolios perform differently from conventional portfolios?*, (London, Sept. 2001), p. 6. This is an indispensable study.

[7] "Mainstreaming Responsible Investment", *op. cit.*, p. 7.

The differences between and among these definitions reflect SRI's expansion. New types of investors have brought new perspectives.[8] For now, however, it is only important to note the differences among, and the continuing applicability of, the three definitions.

An Emotionally-Charged Phrase. Presumably, one reason the WEF sought to replace "socially responsible investing" as a term is the deeply negative reaction it arouses in.... And there's the problem: how do you describe someone who is not a socially responsible investor? As "irresponsible"?

Few SRI proponents realize how the term clangs in the ears of others, how much it sounds like an assertion of a standard of moral merit which is not the hearer's.

If we must live with "socially responsible investing", we must understand what arouses the ire of people we want to join us – or at least not oppose us.[9] These definitions describe the phenomenon of SRI. To appreciate fully our problem, we have to explore the three words themselves – in reverse order.

The Nature of "Investing". I have chosen to use "investing" rather than "investment" to make clear that the ***act*** – not the ***investment vehicle*** or the security's ***issuer***[10] – is of the essence. "Socially responsible" describes a conscious decision to behave in a particular way toward a defined end.

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[8] One commentator has argued, "SRI can be characterized as a form of investment that not only seeks financial return but social and environmental returns as well, also called 'triple bottom line' returns." Paul Hawken, *et al.*, *op. cit.*, p. 7. In my experience, the "triple bottom line" has rarely attracted investors to SRI. But, it becomes important to values-based investors as their relation to SRI evolves from consistency alone toward social justice objectives. The role of consistency is discussed at length below.

[9] This subsection and the next three were suggested by Dr. Thomas Welsh in an email to the author, July 5, 2005.

[10] A security's issuer is, for example, the company that originally sells a share of stock.

> Think of the uses of the word *invest*. "I've invested years in this project." "She invested every ounce of strength she had." The word means something far beyond just buying something. Too often the investor forgets this simple truth. When you invest, you put a part of yourself into a corporation. In return, you own a piece of it.[11]

The actor decides to invest and how to invest. The investors this passage describes are mission-based organizations and individuals. However, the principle applies generally to any investor for whom companies are more than numbers on a screen.

Investment in that sense distinguishes social investors from most – but not all – others. Over the past 100 years, investment has taken on a passive character. It has become a mere financial transaction, like buying a certificate of deposit. SRI restores something of the former meaning of the term by affirming the investor's commitment to the company. In today's economy, that assertion takes on a crucial significance.

"Responsible" and "Accountable". The second word in "socially responsible investing" is at once deeply offensive to non-adherents and accurate. Just as the term "ethical investing" was taken to imply non-practitioners were "unethical", so "responsible" carries the implication of irresponsibility in those who do not factor social and environmental criteria into their investment decision-making. So, the WEF's choice of a substitute phrase for SRI does not achieve its intended goal.

In common usage, "responsible" has two interchangeable meanings:

- exhibiting an empathetic attribute of a person's character that is usually thought of as making a good person.

- conforming to legal and moral strictures.

The second usage actually describes "accountable", a concept discussed later in this paper.

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[11] Amy L. Domini & Peter D. Kinder, *Ethical Investing* (Reading, Mass.: Addison-Wesley, 1984), p. 1.

The distinction between "responsible" and "accountable" is a critical one. Think of the difference between a socially responsible investor and a socially accountable investor, between a religious order that divested its South Africa holdings on principle and a public pension that divested after legislation forced the issue.

For an individual acting for only him/herself, responsibility is a choice. Nowhere is it written that one shall not do foolish things socially or financially. For an individual or an institution holding assets for another, responsibility – at least financially – is not a choice: it is a duty, a *fiduciary* duty, enforceable in court.

Between these poles – the responsibility-free individual and the duty-bound fiduciary – are many types of investor. Even among fiduciaries, there are many different types of duties imposed by the trust.[12] Those variations signal the variety of outcomes an investor can point toward. Put differently, there is no single outcome toward which social investors aim. Indeed, there cannot be.

"Socially". In the context of "socially responsible investing", "socially" can imply:

- the individual's concerns and aspirations and society's must be given equal weight in investment decision-making, or
- society's interests take precedence over the individual's.

Both of these implications deeply disturb non-SRI adherents. The semantic connection between "socially" and "socialism" magnifies the upset.

Again, SRI proponents must deal with this emotional response. Particularly in the US but generally in the West, since the Enlightenment the political – ethical assumption has been that the individual has priority over the collective. Putting

[12] I explored the evolving nature of the pension trustee's duties in an earlier paper, "Pensions and the Companies They Own", *op. cit.*

the individual and society on an equal footing in investing challenges the ground of western liberal states, especially the United States. It is less of a challenge in Europe due to the existence of socialist political parties and governments since the 1920's.

The second perspective is much more radical. While the first view asks that the individual and the social interests weigh equally, the second insists that the social must take precedence in all decison-making and process management for investing. This is seen as reflecting a "socialist" model.

One must resist the temptation to "pooh pooh" such thinking. Of course, the law of fiduciary responsibility forbids any trustee from substituting social objectives for the interests of the beneficiary.[13] Of course, individuals acting for themselves may do whatever they please with their money. But neither fact addresses the perception.

There is no addressing the fear "socially" arouses except through experience. For those whose world views revolve around individualism informed by mis-statements of Adam Smith, the notion that social interests should be factored into investment decision-making is "radical". That this notion of property is conservative in a fundamental sense and has ancient roots is of less importance than the fact that it *is* radical in today's context.[14] And right.

Toward A New Understanding of "SRI"

The definitional framework in which SRI operates has existed in the US since the 1960s. Shareholder activism appeared with Saul Alinsky at Eastman Kodak in 1966;[15] screened portfolio investing arrived in 1971 with the Pax World Fund.

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[13]Of course, the trust instrument may so provide, and in that case the trustee may put social interests first. Otherwise, no.

[14]See generally R. H. Tawney, Religion and the Rise of Capitalism [1926] (New York: Mentor Books, 1947). *Compare* George Monbiot, "Save Us from Ourselves", *New Statesman*, June 30, 2005. http://www.monbiot.com/archives/2005/06/30/save-us-from-ourselves/

[15] David Vogel, *Lobbying the Corporation* (New York: Basic Books, 1978), pp. 31-35.

Since then, much has changed. SRI has grown to what the US Social Investment Forum estimates to be a $2.16 trillion phenomenon.[16] New data support SRI strategies not dreamt of 35 years ago. New investors, particularly institutions, have entered the field. New investment strategies are being presented to them and by them.

The New Factors. In re-thinking "socially responsible investing", we must start with the basics: who, why, what and how – especially how did we get here? "Here" is a niche in which:

- institutional investors play an increasing role,
- social and environmental criteria have taken on an investment significance, and
- SRI's moral dimension is at least implicitly de-emphasized.

This new "here" conflicts with another, older, "here" represented by SRI's core North American constituency.

Two Types of Exchange. The differences between the two "heres" are cultural. First, there is the difference in culture between individuals and mission-based entities on the one hand and institutional investors on the other. Second, there are differences in culture among the national approaches to SRI. Cross-cultural problems are submerged in a financial services sector that is rapidly globalizing. But they have not drowned.

The people on the sides of cultural chasms can choose to fight for their causes like crusaders of yore. That seems a bit counterproductive where the contending SRI cultures share concerns about the financial well-being of investors and stakeholders, the future of corporate capitalism and the survival of the planet.

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[16] US Social Investment Forum, *2003 Report on Socially Responsible Investment Trends in the United States* (Washington, DC: Social Investment Forum, Dec. 2003), p. i.

The alternative is one in which cultures recognize their differences – and accept them – in order to work toward common goals. This paper attempts to describes SRI's competing cultures in what I intend to be an effort to focus on objectives rather than the routes by which these cultures came to them.

Successful cross-cultural exchanges depend upon respect and words with shared meanings. The terminology used to describe SRI has not kept pace with the field it should describe. An old definitional framework – still valid for a significant part of SRI – must now be refitted into a more expansive construct.

SRI Old and SRI New

In some circles, it is fashionable to dismiss one approach to social investing as "old" or "first-generation" in contrast to a "new" or "second-generation" style.[17] Indeed two new forms generally categorized as SRI have appeared in the last decade or so. But the "old" has not waned at least in the US.

Socially responsible investing emerged in the US in the late-1960s, and in the UK, Canada and Australia in the mid-1980s.[18] In all four countries, SRI's character and shape remained fixed, more or less, until the late 1990s.

Values-Based SRI. SRI began as what I will call a "values-based" approach. It sought to align – to the extent possible – an investor's portfolio holdings with his/her/its beliefs. Along side of it and based on the same values developed share-holder activism or engagement.

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[17] *See e.g.*, SustainAbility & Mistra, *Values for Money: Reviewing the Quality of SRI Research* (London: SustainAbility, 2004), p. 3 and my rebuttal in Peter D. Kinder, "Values *and* Money: A Research Practitioner's Perspective on *Values for Money*" (April 15, 2004), p. 14n.26. http://www.kld.com/resources/papers/values_and_money.pdf (hereafter referred to as "*Values and Money*")

[18] For SRI's earlier antecedents, *see generally*, David Vogel, *Lobbying the Corporation* (New York: Basic Books, 1978); Joan Shapiro, "The Movement Since 1970" in Peter D. Kinder, *et al.*, *The Social Investment Almanac* (New York: Henry Holt & Co., 1992), pp. 8*ff* and Marcy Murninghan, "Corporations and Social Responsibility: A Historical Perspective", in *id.*, pp. 86*ff*.

A recent opinion piece by Tony Curro of Mercer Wealth Management nicely summarizes this approach using a novel vocabulary:

> An "avoidance" strategy precludes organizations that violate a portfolio's SRI standards. A "preference" strategy includes companies that are environmental, social or community leaders. Lastly, a "confrontation" strategy involves buying traditional stocks then challenging management via corporate governance to create more socially responsible policies. Managers may also use "best in sector" or "index-based" strategies.[19]

Value-Seeking SRI. By the late 1990s, SRI had developed a second distinct approach which I term "value-seeking". It seeks to identify social and environmental criteria which may affect financial performance and therefore share price.

In the next two chapters, I will examine these two approaches which co-exist somewhat uncomfortably, although they are not mutually exclusive. Then, I will conclude with a look at a third approach which might best be termed "value-enhancing". *See* Table 1.

Value-Enhancing SRI. The value-enhancing approach to SRI is quite different from the values-based and value-seeking approaches in one regard: for the most part, the institutions who have adopted it reject the notion that they are SRI investors.

Investors in this camp use the techniques of "shareholder activism" and "engagement" to maintain or increase the financial value of their investments. They tend to operate on a much narrower scope of issues than the other two approaches. Their issues tend to appear almost wholly under the heading of "corporate governance".

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[19] Tony Curro, "Fund Managers Building Enthusiasm for Feel-Good Investing", *The Age* (AU), April 16, 2005, p. 5. Mercer Wealth Management in Australia and Mercer Investment Consulting are not related.

An Alternative Framework. The framework I have just describe allows me to parse the syntax of "socially responsible investing". An alternative structure for approaching this task might begin with this question: What problems, needs or opportunities did SRI arise to answer?[20]

My focus in this paper is more applied and forward-looking than the direction that question suggests. Nonetheless, it is worth pausing a moment to address it, for the literature is largely silent on it. As Figure 1 shows, the forces driving SRI's development have distinct and varied origins. They merit study.

Who is "Investing" Today and Why?

No small part of the perceptual problems surrounding "socially responsible investing" arises from the order of its words. Proponents and critics alike tend to focus on the adjectival phrase rather than the noun it modifies. That is backwards.

We must talk first about investing and then about "socially responsible investing". So in analyzing SRI, we must begin with why Americans invest.

The Necessity of Investing. In 1997 Joseph Nocera wrote, "[we're] no longer merely rooting for the bull market to continue; by now, we have come to count on it to provide some of the real basics of middle-class life in America -- from the education of our kids to our retirement."[21] Later, he noted: "People are pouring money into the market like there was no tomorrow -- but not because they're giddy or euphoric. It's because they feel they have no choice."[22]

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[20] This question and the discussion that follows it were suggested by Dr. Thomas Welsh in an e-mail to the author, July 5, 2005.

[21] Joseph Nocera, "Betting it All on the Market," *Washington Monthly*, January 1997, pp. 11-12.

[22] *Id.*, p. 14.

For individuals, a central fact of American life is the necessity of investing. Consequently, it is a central fact for the financial institutions that serve them. Last year, the anti-tax crusader, Grover Norquist, pointed out:

> The biggest demographic shift in the past thirty years is not the number of people who speak Spanish; it is the number of Americans who own stocks. It was twenty per cent of adults when Reagan was elected. Now it is between sixty per cent and seventy per cent of voters.[23]

Whether one regards today's Americans as enjoying the benefits of free choice in savings and an "ownership society" or as struggling in a neo-Social Darwinian jungle,[24] the prescribed answer is the same: protect your future through investing – not "saving" as traditionally understood.[25]

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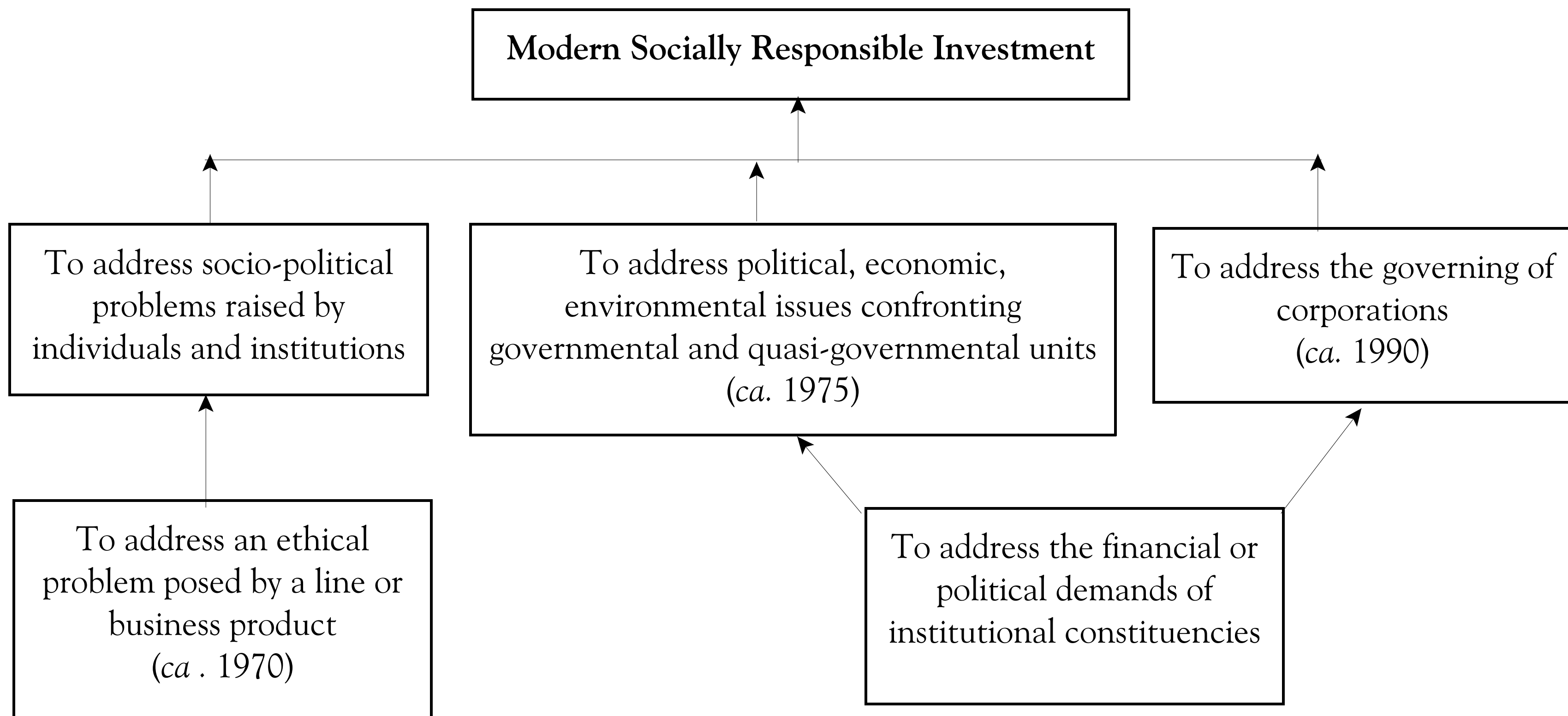
[23] John Cassidy, "Tax Code", *New Yorker*, September 6, 2004, p. 75. Norquist's shift in subject from "adults" to "voters" is highly significant. About 55 percent of those eligible voted in the 2004 election, and that was considered an extraordinarily high turn out.

[24] From 401k's and 403b's to the proposed individual accounts which would replace parts of social security, individuals are being forced to invest to protect their futures. This social re-engineering does not take into account the evident inability of even professionals to monitor – much less manage – their investments. The stories that appear every day in the business press of advisers who steal from their well-educated, legally-competent clients prove this point.

[25] Even those fortunate enough to participate in a defined benefit pension plan feel this compulsion. Not only have private ones been raided, looted or abolished, but as the proposals floating among the California Public Retirement System's enemies reveal, the public funds are under attack, too. Their size reflects market power but not political power. Their beneficiaries are relatively few and unloved, since they are/were civil servants. *See* Mary Williams Walsh, "CalPERS Ouster Puts Focus on How Funds Wield Power", *New York Times*, Dec. 2, 2004; Tom Petruno, "Business Applauds Shake-Up at CalPERS", *Los Angeles Times*, Dec. 2, 2004, p. A1.

Figure 1. Impetuses to SRI's Development



Note: "Quasi-governmental organizations" here includes entities ranging from the World Trade Organization to trans-national corporations.

"Speculating". It is difficult to see a difference between this all-but-compulsory investing and what in the past was called "speculating", the buying of securities with insufficient skills and inadequate information . The typical individual 401(k) plan participant fits that description. As to the risks of investing for ordinary people, attend to John Maynard Keynes on the British investors wiped out by the post-World War I inflation:

> He who neither spent nor "speculated", who made "proper provision" for his family, who sang hymns to security and observed most straitly the morals of the edified and the respectable injunctions of the worldly wise -- he, indeed, who gave fewest pledges to Fortune has yet suffered her heaviest visitations.[26]

Periodically, a segment of the public comes to see the stock market as a slot machine that spits out money with a pull of the lever. Most of this group learn that the stock market is a unique money machine: when it stops paying out, it can actually suck in all the money gained, all the original stake, and more beyond.

Social investors have their enthusiasms. But they very rarely plunge. Because they care about the social characteristics of the companies they own, they tend to be better informed than their peers. Nonetheless like Keynes' prudent British investors, they suffer from the "acute informational asymmetry"[27] that characterizes the relationship between securities buyers and sellers.

The necessity of investing means investors must find prudent, tolerable vehicles with decent prospects for a financial return. Inevitably, they must make compromises. They must be responsible investors and socially responsible as well. For that reason, the social investor's equivocal stand – investor on the one hand, social change actor on the other – is a considered, principled one.

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[26] Robert Skidelsky, *John Maynard Keynes: The Economist as Saviour* [1992], (New York: Penguin Books, 1995), p. 160. For an interesting description of what "speculation" meant prior to the Securities Acts and a perspective on its resurgence as "performance", *see* Walter Werner "Management, Stock Market and Corporate Reform: Berle and Means Reconsidered" 77 Columbia L. R. 388, 401-02 (1977).

[27] Keith Ambachtsheer, "Beyond Portfolio Theory: The Next Frontier", *The Ambachtsheer Letter* (Toronto, Ont.), July 2004, p. 2.

Who – Not What – is "Socially Responsible"?

> *The objective of those who advocate social investing is to make corporations behave in a socially responsible way by denying them capital if they do not. Therefore, if the debate over the social responsibility of the corporation is resolved in the negative, the social-investing issue is resolved as well. -* John H. Langbein & Richard A. Posner (1980)[28]

SRI's critics have long claimed that its primary objective is to deny capital to offending companies or to punish their share value. Leaving aside the improbability – indeed, impossibility – of such aims, the critics miss the essential characteristic of values-based investors. For them, SRI is not about companies; it is about them and their view of themselves.

"Corporate Social Responsibility". This misperception of values-based investors regularly leads to confusion about "socially responsible investing" (SRI) and "corporate social responsibility" (CSR). SRI would seem to be the one side of a coin with CSR on its reverse. In fact, they are so very different that they could be unrelated. Their differences clarify much about SRI.

CSR is about a corporation and the aspirations of its people. Sir Geoffrey Chandler recently contrasted what CSR is with what it ought to be:

> In its proper definition CSR should not be an optional activity giving competitive advantage or marketing opportunity, but should represent a set of core principles which are the point of departure for any business and which condition the totality of its operations. It should encompass a spectrum from the running of a profitable business to care for its social and environmental impact.[29]

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[28] John H. Langbein & Richard A. Posner, "Social Investing and the Law of Trusts", 79 Mich. L. Rev. 72, 74 (1980) (hereafter "Langbein & Posner").

[29] Sir Geoffrey Chandler, "Corporate Social Responsibility: The International Aspects", Keynote Address, Conference on Corporate Social Responsibility and the Role of the Lawyer, Amsterdam, June 25, 2004. Quoted by permission of the author.

In contrast, SRI describes an assertion of personal or institutional responsibility by an investor for what s/he owns. The investor knows his/her social objectives and tries to align the available investments with them.[30]

"Corporate Accountability". The two phrases – SRI and CSR – lead to confusion because one might assume – not illogically but wrongly – that socially responsible investors buy stock only in socially responsible companies. To avoid this confusion, it is best to think of SRI's social change objectives in terms of "corporate accountability".[31]

Historically, that approach is consistent with SRI's modern origins and continuing evolution. In 1940 (in a different context) the future four-term New York governor and US Vice President, Nelson A. Rockefeller, made this distinction: "We must recognize the social responsibility of corporations, and the corporation must use its ownership of assets to reflect the best interests of the people. If we don't, they will take away our ownership."[32]

In all its approaches SRI is about corporate accountability: how corporations use their "ownership of assets to reflect the best interests of" their stakeholders.

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[30] Alignment is discussed below in terms of "consistency" in the context of "values-based" investing. Institutions that successfully pursue SRI define their programs in terms of their missions. For that reason, KLD has described it as "mission-based investing". *See generally* Steven D. Lydenberg & Peter D. Kinder, *Mission-Based Investing* (Boston, Mass.: KLD, 1998-2004).

[31] Corporate accountability or reform did not emerge as an aspect of SRI until the advent of shareholder advocacy in the mid-1960s. *See* the discussion below and generally David Vogel, *Lobbying the Corporation*, *op. cit*. The two aspects of SRI did not merge in vehicles accessible to retail investors until Calvert and Domini made the link in the early 1990s. Hence, Paul Hawken is wrong when he says "The SRI industry began as a means to communicate a higher set of values than the mere accumulation of financial return. Responding to both the environment and the oppressive apartheid regime in South Africa, investors were able to hold corporations accountable for their practices, both socially and environmentally." Paul Hawken *et al.*, *op. cit.*, p. 20.

[32] Geoffrey C. Ward, "A Charmed Life -- Almost," *New York Times Book Review,* November 3, 1996, p. 10.

Priorities & Tolerances. Social investors tend to take a clear-eyed view of securities issuers. They see that there is no such thing as a "perfect" company, just as there is no perfect person. At least among values-based and value-seeking investors, few think a "socially responsible" company is conceivable. So, investment universes limited to "socially responsible" companies are quite rare.

Most individual and mission-based institutional social investors want to own stocks, bonds, mutual fund shares, certificates of deposit, *etc.* whose issuers do not fall below the investor's minimum standards for ethical behavior. Investors' decisions on minimum standards for companies are personal, individual, institutional. What is an appropriate investment for someone who cares deeply about nuclear proliferation may not be for someone for whom labor rights is the central issue.

At the same time that they order their social priorities, social investors also consider their tolerances. Tolerances, too, are matters of individual weighting. An investor might accept some poor performance on environmental issues but none on human rights.

The Orthodoxy Trap. Some have criticized SRI for its lack of uniform standards for what is "socially responsible" in investments.[33] They are right that there are no such standards; they are wrong in implying there should be.[34]

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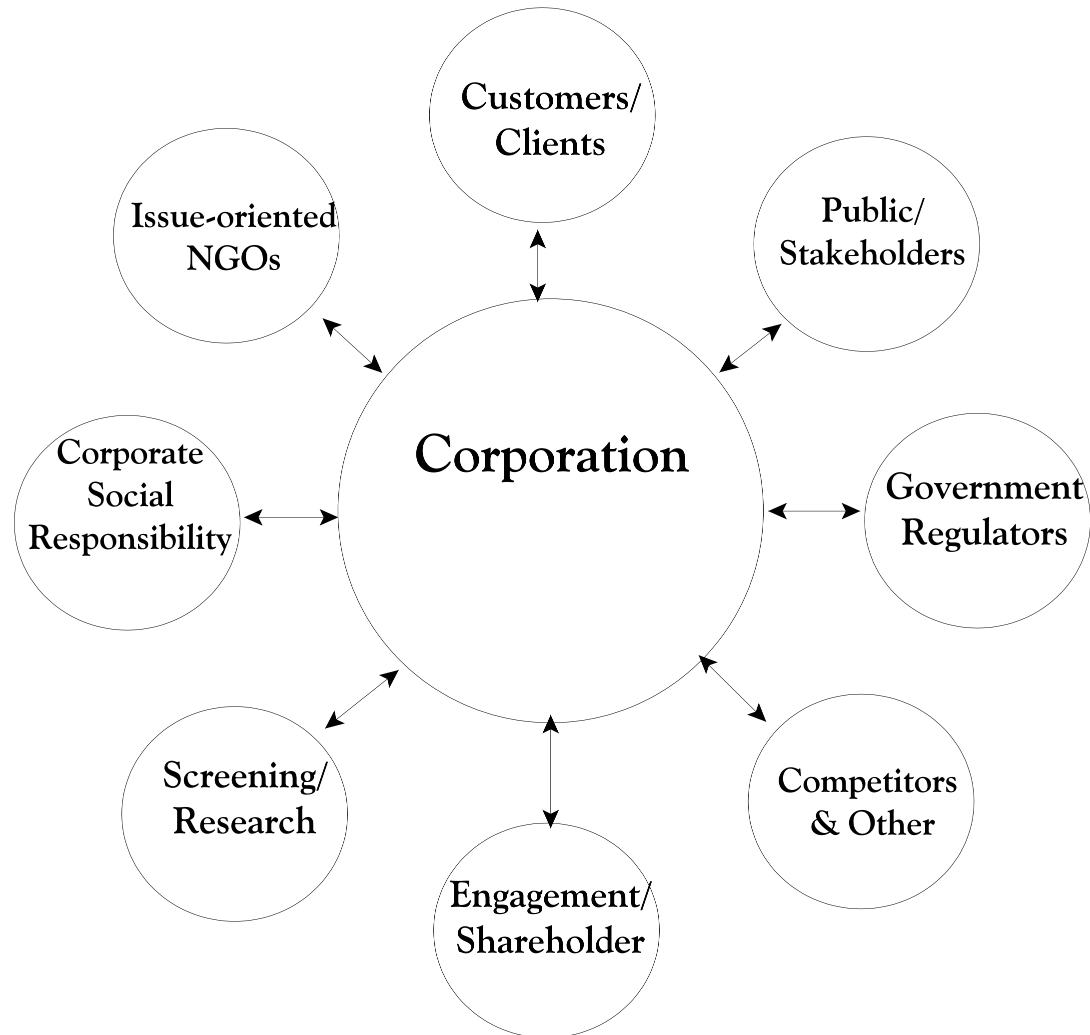
[33] *See e.g.* Paul Hawken, *et al.*, *op. cit.*, pp. 25-26, 29, which focuses on the search for socially responsible vehicles.

[34] Sir Geoffrey Chandler disagrees (e-mail to author, May 31, 2005). "I accept that this is a matter of evolution, of continuous improvement, not revolution, but we do know what we are aiming for if capitalism is to survive – that is a point of departure based on principle, not one motivated solely by profit with something added on. The [Universal Declaration of Human Rights] UDHR enunciates these principles and … [is] embraced as a foundation of policy by a growing number of leading companies today." He is right on both counts: SRI did evolve without an express foundation, and it is time to consider one. However as to individual screens evolving from that principled base, there must be room for them to evolve over time.

Figure 2. Corporations in Society



Note: Corporations interact with their larger social environments in numerous ways. This figure illustrates the range of their interactions, including those discussed in this paper. As the arrows indicate, these interactions affect both parties, not just one.

Take McDonald's. Is it a decently-run company with forward-looking employment policies and practices and a commitment to reduce environmentally-unfriendly packaging. Or, does it force-feed junk food to an over-weight nation? Social investors disagree on these questions. They even differ on what "yes" might imply to either.

Comparing opposing views on issues such as those McDonald's poses – dozens of other examples exist – highlights SRI's apparent and real incoherence. But in this jumble lies a strength: SRI's criteria evolve as social investors' understanding of the world about them changes. Even Paul Hawken, who faults SRI for its lack of an orthodoxy, recognizes that:

> What constitutes environmental social responsibility depends on the times and the common knowledge of those times. What might have been a responsible act by a company twenty years ago might be common practice but irresponsible today.[35]

Consider South African divestiture. A decade elapsed between apartheid becoming a domestic issue and divestiture's emergence as a viable objective in the late 1970's. And, it was controversial for another decade and a half until sanctions ended in 1994. In no small part, public awareness grew in response to the debate over engagement and then divestiture. In 1991 in the midst of the controversy over sanctions, the *Financial Times* editorialized:

> To measure the effectiveness of an ethical sanction by whether it caused a country to make a U-turn makes as little sense as to describe sanctions against South Africa as futile because they have failed to destroy apartheid before now. The aim is to influence for the better. And opportunism as well as absolute values must play a part.[36]

No one has ever better summarized SRI's means and objectives.

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[35] *Id.*, p. 22.

[36] "The Ethical Ways to Invest," Financial Times, April 14, 1991, p. 6.

An orthodoxy would restrict the debate with corporations, government and society at large from which progress may emerge. An orthodoxy would drive dissenters from the field and inhibit socially responsible investors' ability to grow in understanding. Hence, it is futile to try to enforce a single set of standards for what is "socially responsible" on the evolving ethical standards of diverse investors.

The Centrality of Intention.

Whatever their differences in their approaches to SRI, social investors share an intent to act responsibly with their money, to try to achieve social objectives while reaching their financial aims.

This shared intention keeps social investors who may disagree on some important issues working in partnership to advance causes on which they agree through shareholder activism. The Interfaith Center on Corporate Responsibility (ICCR) has fostered this pragmatic approach for 35 years on issues ranging from apartheid to strip mining.

Providers of mutual funds – the securities of choice for most individual investors today – deal with a quite similar problem. Domini, MMA Praxis, Parnassus, Pax, TIAA-CREF – their task is to determine the composition and bounds of social investors' objectives and tolerances and to offer a vehicle that corresponds to them. They – and their research providers – receive continuous criticism on their decisions.

Trading today's relatively free-form, active intentionality for the imposed coherence of an orthodoxy is a deal few social investors – whether individuals or mission-based groups – would make. I would argue an orthodoxy, despite its simplifying appeal, would ill-serve value-seeking and value-enhancing investors as well. It would defeat their purpose: to take responsibility for what they must own.

The need to make this purpose – this intention – reality informs the new framework for understanding "socially responsible investing" presented in the following pages. For it is the foundation on which SRI stands.

Table 1. A General Categorization of SRI Approaches

Approach	*Descriptors*	*Social/Governance Screen – Purpose*	*Criteria of Success*	*Primary Investor Types*	*Usual Vehicles/Means*
Values-Based	1. Mission-based 2. First generation 3. Sustainable	1. Consistency with own values 2. Social change	1. Return adjusted for risk tolerance 2. "Triple Bottom Line"	1. Individual investors 2. Faith-based and social-cause institutions	1. Mutual funds 2. Separately-managed accounts 3. Indirect engagement
Value-Seeking	1. Second generation 2. Sustainable	1. Spot investment prospects 2. Corporate change	Market return on investment	1. Foundations & endowments 2. Fund managers 3. Pensions	1. Separately-managed accounts 2. Pooled vehicles 3. Direct & indirect engagement
Value-Enhancing	1. Shareholder activist 2. Engagement	1. Identify under-performing companies 2. Corporate Change	Market return on investment	Public pensions	Direct engagement

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II. SRI: The Values-Based Approach

In one way only can we influence these hidden currents -- by setting in motion those forces of instruction and imagination which change opinion. The assertion of truth, the unveiling of illusion, the dissipation of hate, the enlargement and instruction of men's hearts and minds, must be the means. - John Maynard Keynes (1920)[37]

The values-based approach was, until the late 1990s, what the public, the press and the financial services industry meant by "socially responsible investing".

The earliest of the "SRI" definitions captures this approach: the incorporation of an investor's ethical or social values in the investment decision-making process. Its constituents include individual investors, mutual funds which serve individuals and small institutions, and institutions with a social or religious mission. In North America, values-based investors are SRI's core constituents.

The Core Constituency

SRI's core constituency consists of individuals and mission-based institutions. This group dominates the North American SRI retail market and social/environmental shareholder advocacy. The importance of these values-based investors lies in their numbers and, hence, their ability to mobilize opinion. Their strength comes from their commitment to causes and to effecting them through SRI.

As we shall see, the main defining line for the new approach to SRI has been that they are **not** the core constituency's form of SRI. Therefore in order to understand the new, one must have an appreciation of who gave them life – SRI's core constituency.

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[37] Skidelsky, *op. cit.*, p. 30.

Consistency. Values-based investors come to SRI because they want consistency, alignment between their principles and their investments.[38]

It would seem uncontroversial to assert an investor may choose to be comfortable from an ethical perspective with what s/he owns. After all, the courts have long insisted that it is unethical or worse to put widows and orphans into vehicles suitable only for risk-takers.[39] Consistency with the investor's ethics stretches this notion hardly at all.

Yet controversial it is. For a generation, a claque of scholars has attacked values-based approaches to investments by trustees.[40] One vigorous criticism appears in the Comments to the section on the duty of loyalty in the Uniform Prudent Investor Act.[41] It is probably not a coincidence that the UPIA received its final adoption in 1994, the year the South African divestiture movement reached its successful end.[42]

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[38] One commentator has argued (without supporting citations), "[T]he raison d'etre of SRI was to challenge the process and purpose of publicly held corporations." Paul Hawken *et al.*, *op. cit.*, p. 25. While partly true of shareholder activism, it was not true for screened portfolios and is not today the purpose for a significant number of social investors. Consistency is the *raison d'etre* of portfolio screening.

[39] Not the least important result of *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446 (1831) (the "prudent man" case) is that it approved trustees' inclusion of common stock in a widow's portfolio.

[40] *See* Langbein & Posner, *op. cit.*, the ur-text for these attacks and its spawn whose citations are collected in KLD's Resource Guide http://www.kld.com/resources/index.html. *See also* the discussion of the law on this point in the Appendix to Peter D. Kinder, "Pensions & the Companies They Own", paper delivered at the University of Colorado Leeds Business School Symposium on Business & the Broader Culture, "Corporate Retirement Security: Social & Ethical Issues", March 11, 2005, pp. 25ff. http://www.kld.com/resources/papers/UniversityOfColorado_050311.pdf

[41] The Uniform Prudent Investor Act §5 and the Comment to it are to be found at: http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm One reaches that site via the National Conference of Commissioners of Uniform State Laws site, http://www.nccusl.org The UPIA is discussed further below.

[42] South Africa's role in the growth of SRI is a complicated subject which has not received, as yet, the scholarly attention it requires. While it is rightly viewed as an SRI success – in conjunction, of course, with many other campaigners – it produced a backlash with which SRI proponents still must deal. *See* "Pensions & the Companies They Own", *op. cit.*, pp. 17-18.

Long-Term Investors. Values-based investors are long-term, buy-and-hold investors.

Values-based investors seek a range of returns consistent with other investors of their class and type. Experience indicates that they are somewhat more conservative and risk adverse than others. They tend to define their objectives in terms of a real return, a return that after taxes exceeds the rate of inflation by some figure. Individual and, to a lesser extent, institutional investors of this type tend not to be benchmark driven.

Hence, for these investors the question of social investing's "costs" tends to be quite different than it is for value-seeking or value-enhancing investors. As one would expect, there is little hard data on this point. The evidence, while anecdotal, seems supported by the flourishing social mutual funds.

These characteristics produce loyal, involved clients and activist shareholders. Individuals tend to involve themselves in the portfolio screening process and in proxy voting. Institutions tend to focus less on screening portfolios than they do on proxy voting and engagement with companies.

Among both types of values-based investor one will find a close attention to what they own and why they hold them. That manifests itself in the screening process.

The Screening Process

Applying criteria to differentiate companies in the investment process is called "screening". The screening process applies to both the selection of investments and the identification of companies presenting issues on which an investor may wish to engage.

As a verb, "screen" means to select securities based on a pre-determined set of criteria. These criteria always include financial ones but often include non-financial criteria . As a noun, "screen" refers to a criterion or a group of related criteria used to winnow a universe of investable securities.

All investors apply screens to their investments. They are many and varied, and they might relate to the stock's price-earnings ratio or to the issuer's lines of business. Social screens are non-financial criteria which relate to business activities or products.

Objectives. Screening divides an investable universe between those companies suitable for the investor and those that are not.

The process does not yield a list of "socially responsible" or "sustainable" companies nor, conversely, a list of "socially irresponsible" or "unsustainable" companies. No set of investment screens, however comprehensive, can identify "socially responsible companies", if such exist.[43]

What social screens can do, are designed to do, is to identify characteristics and behaviors the investor finds useful, relevant, tolerable. Screening is not about companies – securities issuers. It is about investors and the criteria they want their portfolios to meet.

Alignment. Screening is simple. As that pool hall philosopher, Rudolf "Minnesota Fats" Wonderone, replied when asked why he – unlike most pool pros – neither smoked nor drank, "I learned everything I know not from intelligent people, but from imbeciles. It's automatic. You don't do what they do."[44] And in the view of values-based investors, it is immoral to profit from their doing it.

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[43] Adam Smith was probably the first to argue that corporations by their nature cannot be "responsible". He based his argument primarily on the corporation's limited liability and secondarily on the dynamics of boards and management. Adam Smith, *The Wealth of Nations* [1789] [Glasgow ed.] (Indianapolis, Ind.: Liberty Press, 1981), p. 741 [V.i.e.18]. Later insulating devices, such as the "business judgment rule", have further removed responsibility from the corporation. The identification of the corporation's purposes solely with its shareholders' financial interests by Milton Friedman and others makes arguing for the existence of "socially responsible corporations" very difficult. *See* Milton Friedman, "A Friedman Doctrine – The Social Responsibility of Business is to Increase its Profits", *New York Times Magazine*, September 13, 1970, p. 126

[44] "Ask the *Globe*", *Boston Globe*, Oct. 2, 1991, p. 36.

Values-based investors began applying social screens to stocks in the early 20th century. As noted above, they sought consistency, alignment of their holdings with their values.

Using what are now termed "exclusionary screens", they barred classes of businesses based on the nature of the goods or services they produced. The earliest screens eliminated alcohol and tobacco companies from portfolios held by investors who believed drinking and smoking to be sinful.[45] Quakers, concerned about the morality of war, have avoided arms companies for generations.

For 35 years critics have mocked social investors for this "negativity" with a kind of "real investors own tobacco stocks" attitude. But none has explained why, if sound investors do not invest in companies whose businesses they do not understand, social investors should invest in businesses they *do* understand all too well.

Screening's potential subjects have grown far beyond simple product exclusions. Still for values-based investors, consistency remains the key objective.

Today social investors also screen stocks on qualitative social criteria such as employee relations and corporate governance. These screens often require nuanced appraisals of corporate behavior. Whether a company has a "good employment record" rarely yields a quick yes or no. Reaching an answer for a large, complex company, such as DuPont, can take hours of analysis. In contrast, whether a company is in the gambling industry always produces a "yes" or a "no" for an answer, often in a matter of seconds.

SRI Research. All screens rely on research for implementation. The three types of SRI investors described in this paper use – to varying degrees – non-financial research of a type that has come to be called "social research": informa-

[45] For a more detailed discussion of screening's history, *see* "Values and Money", *op. cit.*, pp. 4-7.

tion about how corporations perform on issues social investors consider in the investment decision-making process.[46]

As values-based investors use it, social investment research, in its analysis of the past performance of a corporation against the screening standards, can hint how the company will perform in similar situations in the future. Put differently, a corporation's history forms a mosaic of management decisions in which one can discern patterns revealing its culture.

This approach is neither new nor novel nor unique to SRI. In 1933, for instance, Parker Follett wrote:

> Management not bankers nor stockholders is the fundamental element in industry. It is good management that draws credit, that draws workers, that draws customers. Whatever changes should come, whether industry is owned by capitalists, or by the state, or by the workers, it will always have to be managed. Management is the permanent function of business.[47]

The Nature of Corporate Culture. Marvin Bower, McKinsey & Company's long-time managing director, described corporate culture as "the way we do things around here."[48] Two McKinsey alumni who did much to popularize the concept described "a robust culture" as:

> a unifying cultural tapestry woven over time as people cooperate and learn together. It is woven from the interplay of a set of interlocking cultural elements:

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[46] For an extensive discussion of the differences between values-based and value-seeking applications, *see generally* "Values *and* Money", *op. cit*. The definition of "social research" here is drawn from it. The next section deals with the research modifications value-seeking investors have brought about.

[47] John Micklethwait & Adrian Wooldridge, *The Company: The Short History of a Revolutionary Idea* (London: Weidenfeld & Nicolson, 2003), p. 109.

[48] Terrence E. Deal & Allan A. Kennedy, *Corporate Cultures* [1982] (Cambridge, Mass.: Perseus Books, 2000), p. 4.

History yields values. Values create focus and shape behavior. Heroic figures exemplify core values and beliefs.. [49]

The importance of corporate culture in assessing a company's prospects – social and financial – is not to be underestimated. As an Australian human resources consultant commented, "We are on the cusp of companies recognizing that all of their failures are failures of culture, not of systems. Companies are beginning to reward the behaviour that produces good results, rather than the results themselves."[50]

In their investment decision-making, values-based and value-seeking SRI investors emphasize corporate culture far more than other investors. It is also an essential element in shareholder activism amongst all types of investors. For "corporate culture" is to the company what "character" is to the individual.

***Positive Social Change*.**

Values-based social investors often have an objective beyond consistency: they want to use their holdings to effect positive social change. They often see screening, itself, as a means. It is a public statement that a significant body of shareholders – indeed of stakeholders – hold publicly-traded companies accountable on these bases.

Shareholder activism on social issues is a more visible expression. The accountability it represents may be the most important contribution of values-based investors.

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[49] Terrence Deal & Allan Kennedy, *The New Corporate Cultures* [1999] (London: TEXERE, 2000), p. 3.

[50] Alan Kohler, "Get a Conscience – Mindless Capitalism Fails The Test" *Sydney Morning Herald* (AU), August 3, 2004.

Jack Meyer, head of Harvard Management Co., has pointed out, "Companies would prefer you divest, rather than harass them with proxies as shareholders."[51] The recent "push back" by publicly traded corporations to shareholder activists supports Meyer's point. Cintas and ExxonMobil in the US and Gunns in Australia,[52] among others, have sued shareholder activists.

Most people think of values-based social investors using shareholder activism or engagement for this purpose – especially the orders of nuns and the mainline Protestant denominations who pioneered this technique in the 1970s and 1980s on issues ranging from strip mining to South Africa. While a few individuals and small institutions directly involve themselves in shareholder activist efforts, most rely on socially screened mutual funds or their investment managers or the growing number of opportunities for collaborative engagement such as those of the Inter-faith Center on Corporate Responsibility.[53]

The Future of the Old

In North America, at least, SRI's "first generation" – whom I term "values-based" investors – will continue to be influential and to grow. These individuals and mission-based institutions money and numbers support the SRI mutual funds which generate much of the publicity for all aspects of SRI. Their demand creates institutional responses.

The vehicles values-based investors own – Domini, MMA Praxis, Pax, and other mutual funds – engage companies on social issues. So do managers such as Trillium Asset Management and Walden Asset Management. They, in turn, work with other institutions from CalPERS to the Presbyterians on proxy issues and SEC

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[51] Garrett M. Graff, "Social Investing." *Harvard Magazine*, July 2003, pp. 76, 81. Harvard Management runs the university's $17.5 billion endowment.

[52] Justine Nolan , "Style Over Substance Clouds Corporate Value Judgments", *The Age* (AU) April 9, 2005, p. 4. Nolan is a lecturer in law at the University of New South Wales.

[53] *See also* "Pensions & the Companies They Own", *op. cit.*, pp. 11-18.

petitions. The social research firms, such as KLD, which the mutual funds rely on represent social investors to companies every day.

Though the SRI mutual funds represent relatively little capital when compared to the great pension funds, they have magnified their effect through coalition-building and a very long-term perspective. The “old” social investors had also, until the very late 1990s, funded – directly or indirectly – all social investment research.

“Old” social investing shows no signs of abating. One discerns its continuing strength in the efforts newer SRI forms exert to distinguish themselves from it. But the differences among the old and the new are real and significant. The future of social investing depends on the ability of their proponents to recognize the strength in diversity and to make a common cause on agreed upon ends.

III. SRI: The Value-Seeking Approach

> [Why Mercer Investment Consulting is building expertise in social, environmental and governance issues:] *I'm talking about interested mainstream investors and this is the change I'm seeing taking place. Five years ago, it was just the mission-based players, but now we have a growing number of mainstream investors who believe these issues can have an impact on long-term investment performance.* -Tim Gardener (2005)[54]

Consultants, such as Mercer,[55] are the gatekeepers for foundations, endowments and pensions. Their interests and those of their beneficiaries and stakeholders seem quite close to those of social investors. But the stated barrier of "fiduciary duties"[56] and the unstated barrier of internal politics have proven formidable.

Since the late 1960s, social investors have sought to persuade such institutions and their money managers to join them. Since the late 1990s with the advice of their consultants, these institutions have begun entering the field. As a result SRI is changing in ways that are obvious and not.

"Mainstream Investors"

Take, for instance, this question: who are Mr. Gardener's "mainstream investors" and how are they different from "mission-based" (*i.e.*, values-based) investors?

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[54] Doug Watt, "Mainstream seen moving beyond ethical investing", Advisor.ca, Jan. 31, 2005. http://www.advisor.ca/news/today/article.jsp?content=20050131_145614_5452#

[55] *See above* p. 2. *See also* Robert Bowers & Doug Aaron, "Socially Responsible Investing 2003", Cambridge Associates, LLC, Boston, MA, Oct. 2003.

[56] For a discussion of those duties and SRI, *See generally* "Pensions & the Companies They Own", *op. cit.* and especially its Appendix.

By the late 1990s, a body of research had accumulated that indicated socially screened portfolios did not necessarily under-perform unscreened. For instance, the long-term out-performance of the S&P 500 by KLD's Domini 400 Social Index added significantly to these studies. On the Domini's tenth birthday in 2000, it was up 563.58 percent.[57] Understandably, a curiosity arose as to what factors had produced numbers such as these. That question continues to interest practitioners and professors.

A small group asked an important variation on that question: What aspects of a company's social or environmental performance drive share value? Put differently, ethical considerations aside, which non-financial screens have predictive value for stock performance? Hence, "value-seeking" describes the managers and institutions who focus on this question.[58] They are the "mainstream investors" to whom Mr. Gardener refers.

Characteristics

The first to ask the question about social and environmental factors and stock performance were, of course, managers doing values-based SRI. (And, they are still pushing for answers, not surprisingly.) But as the 1990s passed, a different group, mainly focused on Europe, began probing in this area – first insurers, then financial institutions.

Alignment with Special Needs. Today, driven mainly by the threat of global warming, a growing number of "mainstream" investors[59] have begun looking at the

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[57] KLD Research & Analytics, Inc., "The Domini 400 Social Index Statistical Review", April 2000, p. 4.

[58] Obviously, there is considerable overlap between the two types. Values-based managers and institutions want outstanding performance, too. What distinguishes the two is the value-seekers' rejection of a moral underpinning to the application of these criteria.

[59] The interest and participation in the United Nations Environmental Program's Finance Initiative and CERES institutional investor events are two good gauges of this phenomenon. As I've
(continued...)

performance-predictive ability of environmental, social and governance (ESG)[60] issues. This may be the simplest description of these investors:

> "We're not **ethical investors**," said Colin le Duc, head of research [at Generation Investment Management], who insisted his team would avoid making investments based on moral value judgments. "We're simply saying that companies that align themselves with environmental and societal needs are better companies."[61]

I wish Mr. le Duc had clarified these thoughts. For it seems to me that implicit in his notion of alignment is an ethical premise: alignment "with environmental and societal needs" is good and mis-alignment is bad. So, Generation's investment philosophy appears consistent – if not congruent – with a values-based approach. Indeed in a process such as that of Zurich-based Sustainable Asset Management (SAM), the ESG criteria are woven into each of the five steps in its investment decision-making process.[62]

Institutional Leadership. The "not ethical investors" sketch of the "mainstream" is too broad in this context. Rather, the term refers to non-values-based institutional investors. As a report of the World Economic Forum Corporate Citizenship Initiative (WEF) put it,

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[59] (...continued)
noted, US institutional investors lag the Europeans in this area.

[60] The phrase and acronym are used by Mercer Investment Consulting. *See* Doug Watt, *supra*. They also appear in The Global Compact, "Who Cares Wins: Connecting Financial Markets to a Changing World" (New York: United Nations, Dec., 2004), p. ii. I will use them here because they make clear the distinction between value-based and value-seeking screening.

[61] Rebecca Goldsmith, "Gore pushes responsible investing", *Star-Ledger (*Newark, N.J.*)*, Feb. 8, 2005, p. 59. (Fonts as in original.) Generation, a start-up, has a stated $3 million minimum investment.

[62] Sustainable Asset Management (SAM), "Investment Process" (Feb. 13, 2005) http://www.sam-group.com/htmle/institutional/process.cfm . SAM offers modified versions of its World Index to those who want traditional exclusionary screens applied. http://www.sam-group.com/htmle/djsi/djsi.cfm Otherwise, those screens do not figure, as such, in SAM's process.

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[Its objective:] *"To improve understanding of concrete impediments to and opportunities for broader integration of social and environmental aspects of corporate performance in mainstream investment policies and practices."*

The initiative's core aim has been to identify specific obstacles to wider incorporation of non-financial considerations in the valuation and investment strategies of major institutional investors.[63]

The WEF describes "mainstream" in terms of "major institutional investors." Its concept represents a continuation of a failed policy to achieve environmental objectives by focusing on elite bodies rather than on altering the political environment in which they operate.[64] Put differently, a definition of "mainstream" that omits individual securities owners and stakeholders marks the middle of a political rivulet not a river.

That is not to say institutions can not, will not or do not play a key role in advancing the use of ESG criteria. It is only to say that responsible investing must have a broad, popular base of support. For that reason, the entry of the California, Vermont and Connecticut public pensions – with their tens of thousands of beneficiaries – into SRI holds immense promise, if they bring their constituents with them.

The WEF's advocacy of a "broader integration of social and environmental aspects of corporate performance" appears to be an implicit argument for the adoption of screens of these types. If it is, then the "aspects of corporate performance" must be judged against some sort of standard which could not be value-

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[63] "Mainstreaming Responsible Investing", *op. cit.*, p. 7. (Font and paragraphing as in original.) The second paragraph seems confused. As one reviewer pointed out, if an input has a financial impact (such as management quality), it is just a financial consideration which is just hard to quantify.

[64] *See generally* Michael Shellenberger & Ted Nordhaus, "The Death of Environmentalism" (2004), http://www.grist.org/news/maindish/2005/01/13/doe-reprint/index.html Many values-based social investors – myself among them – have claimed over the years not to care *why* an institution screened on ESG issues; it was the fact they did that was of critical political and social importance.

free.[65] If it is not an argument for screening, then their integration would seem to have the same relation to the confection as a birthday candle to a cake.

The Performance Barrier

> *[W]e reject the argument that the social investor can consistently pick winners by being more sensitive to political and social factors that can impinge on corporate profitability. This is just another theory of how to beat the market, and it has no firmer basis than any other such theory. If, however, the theory were correct, ... it would be a tactic for maximizing investor financial well-being....*-John Langbein & Richard A. Posner (1980)[66]

The efforts to re-brand SRI into the WEF's "responsible investment" or Generation Investment Management's "sustainable investment" assume correctly that a major obstacle to institutional adoption of ESG criteria has been their categorization as "ethical" or "social" or "moral". However, the barrier is much more formidable than that.

"Investment". The WEF describes "investment" as "first and foremost about meeting the needs of the owners of capital [who are] mainly the intended beneficiaries of the pension funds, mutual funds and insurance companies...."[67] Theoretically, the WEF is correct – as far as they go. Practically, they are wrong, as I illustrated in Chapter I.

The portfolio manager's first objective today is to meet or exceed financial performance goals. Achieving those goals may produce results which meet some

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[65] Socially screened mutual funds typically do not supply ethical justifications for their non-financial screens, even though their objective is to serve the needs of values-based investors. So, the explicit absence of such rationales for Generation's "environmental and social needs" and the WEF's "social and environmental aspects" is of little importance when compared to the insistence that they be factored into the investment decision-making process.

[66] Langbein & Posner, *op. cit.*, p. 8.

[67] "Mainstreaming Responsible Investing", *op. cit.*, p. 8.

financial needs of the owners of capital. But the means of achieving financial performance may foreclose other important needs.

One of these means is performance measurement.[68] The main barrier to the use of ESG criteria is the demands of quarter-over-quarter portfolio performance measurement. This short-termism forbids valuing appropriately corporate initiatives that have long-term implications for social, environmental or financial performance.

Short-Termism & Speculation. Short-termism is an infectious disease. In 1996 just as Wall Street's bulls began to bellow, Joseph Nocera wrote:

> [The]central irony in the rise of the institutional shareholder [is] that it is you and I who have made it possible. It is we who have been pouring money into the pension funds and the mutual funds, and it is we who are the ultimate beneficiaries of their actions. We can complain all we want about Wall Street's warped values, but the larger truth is that those have become our values, too. When we move our money away from an under performing mutual fund and into a "hotter" fund sporting a better record, we are putting the same kind of pressure on the fund manager that the fund manager is putting on the C.E.O. And when our fund returns 20 and 30 percent a year ... we don't spend a lot of time wringing our hands about what it took to get those gaudy numbers.[69]

The WEF quotes an anonymous analyst as telling it, "We do look at long-term factors, but they are strictly background to the dominant variables like free cash flow and, to be frank, rumours on the street about the company."[70] A stock-market speculator of another age could have said that. It is timeless. It is real. And it illuminates the barriers ESG criteria must overcome.

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[68] In Part V of this paper, I discuss performance and performance measurement in the context of SRI.

[69] Joseph Nocera, "The Number Crunch," *New York Times Book Review*, June 9, 1996, p. 38.

[70] "Mainstreaming Responsible Investment", *op. cit.*, p. 16. Not the least reflection of the quality of the WEF report is its reliance on unidentified sources and lack of sourcing on which to verify the quotations. This is not something a publication harping on "transparency" should do.

Or, perhaps, it reveals the categories into which they must fit. Put differently, without a change in the dominant fiduciary concepts, ESG criteria must become short-term indicators of performance. It seems extremely unlikely that the quarter-over-quarter culture will change significantly, so the nature of the ESG criteria must, if they are to become factors in institutional decision-making.

Indeed, a leading proponent of value-seeking investment wrote recently:

> Instead of … ethical value judgements, this approach, more accurately described as "sustainability" investing, views companies' ability to manage complex SRI issues primarily as a proxy and leading indicator for their overall management quality. Under this view, strong SRI performance can therefore become a potential source of … share price out-performance.[71]

Leave aside the problem of distinguishing "ethical value judgments" from "sustainability". Such an assertion places value-seeking SRI in what Langbein & Posner described as "just another theory of how to beat the market".[72] Presumably, it will work in some cases, in some industries, with some companies, but only until the market recognizes the importance of "strong SRI performance" and begins to punish companies that do not exhibit it.

"Prudence" and "Permanence"

Few critiques of short-termism have focused on the legal barriers to a long-term perspective. The evolution of the "prudent investor" rule away from a long-term perspective coupled with the incorporation of Modern Portfolio Theory into fiduciary concepts bears no small part of the blame for short-termism.

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[71] Matthew Kiernan, "A New Long Term View", *Pensions & Investments*, Jan. 10, 2005. http://www.pionline.com/article.cms?articleId=48875

[72] Langbein & Posner, *op. cit.*, 79 Mich. L. Rev. 72, 93(1980).

"Modern Portfolio Theory". From Modern Portfolio Theory (MPT), managers and fiduciaries alike have drawn a couple of principles that dictate a short-term focus and work against the incorporation of SEG criteria.

The first is an approach to risk that equates it to deviation from a bench-mark.

The second is the notion that a portfolio should have the maximum diversification within its asset class in order to minimize risk while capturing a market rate of return.

Prudent Investor Rule. One hundred and seventy-four years ago, the Supreme Judicial Court of Massachusetts stated what is now called "the prudent investor rule" for trustees. Trustees should model their stewardship on

> how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[73]

The Uniform Prudent Investor Act (UPIA), which has been adopted in more than 40 states[74] states, in part:

> (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.
>
> (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a

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[73] *Harvard College v. Amory*, 9 Pick. (26 Mass.) 446, 461 (1831).

[74] Uniform Law Commissioners, Fact Sheet - Uniform Prudent Investor Act (UPIA). http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-upria.asp

whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.[75]

The shift from a "permanent disposition" of assets to "an overall investment strategy having risk and return objectives..." may not seem dramatic, but it is. Taken together with the eight criteria listed in the UPIA's paragraph following the ones quoted above,[76] a trustee would realize that peace of mind lies in quarter-over-quarter performance.

Today, investing for the long-term presents fiduciaries with the unpleasant prospect of requiring a defense – perhaps even a legal one – while awaiting the hoped-for return.

Investment Research. Value-seeking investors have sought a different type of research than that used by values-based investors. They have looked for an integration of non-financial and financial criteria which explicitly attempts to value the non-financial.

One pioneer in this area is Sustainable Asset Management in Zurich. But the leadership of this effort probably now lies with the Enhanced Analytics Initiative (EAI) in London. As its chair and co-founder, Raj Thamotheram, recently put it, the EAI is "actively seeking to create a market for research into intangibles." Those intangibles should indicate new sources either of alpha or of "negative alpha" a manager could avoid.[77]

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[75] The Uniform Prudent Investor Act §2 and the Comment to it are to be found at: http://www.law.upenn.edu/bll/ulc/fnact99/1990s/upia94.htm One reaches that site via the NCCUSL site, http://www.nccusl.org The UPIA restates the 1831 rule, clumsily, and omits both the negative reference to speculation and the explicit admonition to manage for the long term.

[76] *Id.* §2(c). See also the introduction to the UPIA which lists as its first objective, "The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term 'portfolio' embraces all the trust's assets. UPIA § 2(b)."

[77] Raj Thamotheram, "Pressure for Positive Change – Option B", *Benefits & Pensions Monitor* (UK), April 25, 2005, p. 29.

The EAI has tried to reflect the interests of long-term investors, especially pensions, whom Dr. Thamotheram believes, “are starting to become much more focused on their core purpose – providing absolute pensions. Invevitably, this is increasing attention on absolute risks and returns.”[78]

Efforts such as the EAI are affecting social research generally. Jantzi Research in Canada has developed a sectoral approach which facilitates ranked comparisons of companies across sectors and against particular screens. New numerical scoring makes it easier for managers to rate performance on non-financial criteria.

The jury, however, is still out on whether these techniques will generate alpha and, more generally, whether these indicators are permanent additions to the canon of indicators of value.

The Value-Criteria Separation

> *How can economists be expected to produce a clear and unanimous diagnosis when the facts they have to go upon are so obscure and imperfectly known?* -John Maynard Keynes (1938)[79]

As I have pointed out in another paper, both value-based and value-seeking investors use, in Mercer’s phrase, environmental, social and governance (ESG) criteria.[80] But they do so differently. The value-seeking approach segregates ethical criteria from the broader causes of positive social and environmental change. The dangers of this approach are four:

- Confusion with values-based approaches and the risks of investor disappointment and public criticism of a lack of consistency;

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[78] *Id.*

[79] Robert Skidelsky, *John Maynard Keynes: Fighting for Freedom 1937-1946* [2000] (New York: Penguin, 2002), p. 22.

[80] “Values and Money”, *op. cit.*.

• Reliance on very narrow sets of indicators to gauge a company's ESG performance;[81]

• Misdirection of attention from a company's past performance on ESG issues toward the promise of future performance; and

• Abandonment, if the ESG criteria fail to yield out-performance or to mitigate risk.

The last is the most important. Every trend has its season,[82] and few seasons are so short – or their ends so merciless – as those in finance.

The risks of reliance on an investment case for doing the right thing, the sustainable thing, are much less to the investor than to the causes SRI has sought to advance for 35 years or more. As Philip Coggan wrote in the *Financial Times* reviewing the WEF's "Mainstreaming" report:

> Mandates are most likely to be changed, however, if trustees believe these factors will help to produce better returns. This is why it is so vital for the movement that the early results from the likes of Generation Investment Management look convincing. All the reports in the world may not help if they do not.[83]

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[81] This danger I discussed in detail in "Values & Money", *op. cit.* A recent report illustrates that hazard. Its author suggests substituting a single indicator for the typical range of SRI screens applied to a company. He identifies two such indicators, one for the auto and one for the airline industries and relegates research on other indicators to the rubbish bin. Christoph Butz, "Less can be more... A new approach to SRI research" (Geneva: Pictet & Cie., 2005). *But compare* the same author's rejection of financial "materiality" as the gauge of sustainability: "To equate sustainability with what is material and, even worse, to deduce that what is not material is not sustainable, would be the worst post hoc fallacy." Christoph Butz, *et al.*, "Time for a Rethink on Responsible Investing", *Financial Times* (UK), Nov. 13, 2006, p. 5.

[82] *Cf.* James Grant, as quoted in "Victorian Values," *Economist*, January 8, 1994.

[83] Philip Coggan, "Some Method in Report Madness", *Financial Times* (Asia ed.), Jan. 24, 2005, p. 1.

At a time when traditional energy stocks are leading the market, this warning bears heeding.

Nonetheless.... Criticism of the value-seekers can obscure their significant contribution to SRI. They have made it safe for important types of institutional investors and their managers to incorporate ESG criteria in their investment decision-making.

And, most importantly they are providing a bridge to the largest and most hesitant of institutional investors – the pensions. Noel Grant, Senior Investment Consultant at Watson Wyatt Worldwide, recently predicted, "SRI will be integrated into mainstream managers' research processes. As issues like climate change become more important so they will more greatly affect share price movements. SRI will become another factor that [pension] fund managers have to consider."[84]

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[84]Simon Hildrey "Taking Responsibility" *FT Mandate* (UK), June, 2005, pp. 42-43.

IV. SRI: The Value-Enhancing Approach

This conflict is fundamental. Shareholder protection and community protection seek different objectives for different reasons. Shareholders demand operation of the enterprise for their benefit – performance that meets … pressures for enhanced growth, profitability, and share value. Other goals are subordinated. The public interest reverses these priorities. It seeks alteration of internal corporate structure to achieve social goals even if that alteration impairs shareholder interest. - Walter Werner (1977)[85]

The value-enhancing approach is what the media and the financial services industry refer to as "shareholder activism"[86] or "corporate governance". Value enhancers are identified with SRI, but they themselves – mainly public and Taft-Hartley pension funds – almost without exception do not so label themselves.

Pensions have the reputation of being the ultimate long-term investors. They have liabilities spanning generations and vast pools of money to invest. And yet, in the main they have helped fuel the very short-termism most now decry.

The "value" they seek to enhance is the company's as expressed in its share price and, therefore, the worth of their portfolios. Should the means to that end coincide with some social good, so be it. As fiduciaries value enhancers seek to maximize the value of their holdings so that they can deliver on their promises to beneficiaries while, in the case of pensions, possibly minimizing the need for employer contributions.[87]

It bears repeating: we are discussing investment. Therefore these are not only legitimate objectives, they are legitimately these fiduciaries' top priorities even where statutes do not set them. Values-based SRI investors, however, argue that

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[85] Walter Werner "Management, Stock Market and Corporate Reform: Berle and Means Reconsidered" 77 Columbia L. Rev. 388, 413 (1977).

[86] For a discussion of the groups to whom this term applies, *see* "Pensions and the Companies They Own", *op. cit.*, pp. 13-18.

[87] *Id*, p. 11.

they should not be these fiduciaries' *sole* objectives, that a more expansive view of their responsibilities would confer benefits to both beneficiaries and sponsors and to the public who are the ultimate – albeit indirect – sponsors and beneficiaries of these schemes.

The Role of Public Pensions

Of the institutions that have entered or might enter socially responsible investing, the most visible are the public and Taft-Hartley pension funds. Their entry has been hesitant for many of the reasons described in the last section and for others as well.

Despite significant obstacles, some pensions have taken an active role on issues at some remove from their traditional limited focus on performance-enhancing issues.

The California Public Employees Retirement System (CalPERS) has authorized divesting its holdings in tobacco.[88] It has begun investigating investments in alternative energy sources and companies with poor human rights records. The Connecticut State Treasurer has led the way on shareholder resolutions on climate change. The Carpenters pension plan has filed resolutions asking for election of directors by a majority vote.

Most pensions have yet to follow. And it is not at all clear whether they will. Still, they do vote their proxies and they do have the potential to affect corporate policy for the good.

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[88] "CalPERS Votes to Sell Tobacco", press release, Oct. 17, 2000. http://www.calpers.ca.gov/index.jsp?bc=/about/press/archived/pr-2000/oct/tobacco.xml

"Corporate Governance"

The differences in objectives between values-based and value-enhancing investors have been fundamental. Only on particular corporate integrity issues, such as auditor independence, has it been possible for them to make a truly common cause. To understand why requires an understanding of the meanings of "corporate governance" and its origins.

Limited Definition. *The American Heritage Dictionary* (3rd ed.) defines "governance" as the "act, process, or power of governing..." and as the "state of being governed".[89] It comes as no surprise then that "corporate governance" is a chameleon-like term that assumes its user's coloration without reference to some observable, definable standard.

The usage of "governance" applied by values-based and value-seeking investors sometimes includes the much more limited approach of the value-enhancers: corporate governance activists, a class of institutional shareholders – mainly pension funds – which have used the proxy mechanism to effect structural changes that "enhance shareholder value". Value enhancements include making board members' terms co-terminus, removing "poison-pill" defenses to take-over bids and the like.

A good example of the term's technical usage comes from Watson Wyatt Worldwide in a paper aimed at pension funds: "Corporate governance relates to the management process of a firm.... [It is:] The allocation of resources, both human and financial capital, to effect an accountable and transparent process that enhances value to shareholders."[90]

Despite its aspirational objective and its limiting last phrase, Watson Wyatt comes close to governance's true nature today.

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[89] Of the dozen or so general and specialist dictionaries I consulted, only two general dictionaries defined the term.

[90] Watson Wyatt Worldwide, "Remapping" *op. cit.*, p. 24. Italics omitted.

Some values-based and value-seeking social investors even apply "corporate governance" when describing companies whose senior management and directors exhibit commitments to social and sustainability objectives. For these reasons, one should think of "governance" as "governing".

Common Cause. For some years, values-based investors have made common cause on governance (narrowly defined) with value-enhancers. Those efforts have brought little benefit to the values-based's main causes. Few pensions vote even occasionally for values-based proxy issues.[91] New York City and State, Vermont, Connecticut and CalPERS are notable, if limited, exceptions.

This situation is changing. European institutions have begun taking strong positions on global warming, especially in the context of the United Nations Environmental Program's Finance Initiative. The CERES Coalition in the US has organized an institutional investor initiative centered on annual summits on climate risk.

Despite the urgency of such challenges, the movement forward seems less rapid than the retreat of the alpine glaciers. The reasons for this are structural and historical. Above and in another paper[92] I have discussed the legal and political barriers pensions encounter when they try to deal with non-financial issues. They are not to be minimized. Here, I will look at the historical context.

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[91] Indeed, their proxy voting guidelines, if they are published, often make clear that pensions will vote almost always with management. *See, e.g.,* State of Wisconsin Investment Board, "Investor Responsibility", http://www.swib.state.wi.us/governance.asp and especially its statement on "Social Responsibility" http://www.swib.state.wi.us/social_responsibility.asp . The Board's "Social Responsibility Proxy Voting Guidelines are explicit on this point. http://www.swib.state.wi.us/socialproxy.pdf . (As of Feb. 27, 2005.)

[92] "Pensions and the Companies They Own", *op. cit.*

Maximization of Shareholder Value

Ideas have a pedigree which, if realized, would often embarrass their exponents. -R.H. Tawney (1926)[93]

At this moment, it is not reasonable for values-based investors to expect more from value-enhancing investors than occasional alliances on corporate structure or management compensation issues. The objectives of the two groups rarely align.

To understand why the two approaches rarely align, one must look at the value-enhancers' origins. They arose when the mantra, "maximize shareholder value", was being used to justify raids on corporations and forced recapitalizations. Few phrases are truly self-explanatory. This one is.

Antidotes for Poison Pills. Corporate governance became the rallying point of institutional – not retail – shareholders in the late 1980s.

Those were the days when raiders attacked fat companies with over-funded pension funds[94] and readily liquidatable assets. T. Boone Pickens and Henry Kraviz and Michael Milken persuaded pension funds and other institutions that their fiduciary duties required them to maximize the value of their shares by supporting leveraged buyouts and aggressive merger strategies – regardless of their effects on their sponsors, beneficiaries, much less the public at large.

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[93] R.H. Tawney, *Religion and the Rise of Capitalism, op. cit.*, p. 24.

[94] These attacks had a doubly baleful effect on the US pensions scene. First, the runs on the pensions destroyed existing plans putting their beneficiaries at risk. Second, companies that had defined benefit plans but which were not under attack converted them into defined contribution plans – thereby reducing their attractiveness to raiders and externalizing their retirement costs. The confluence of the availability of the 401(k) option and the pension raids created a "perfect storm" for future retirees. Its effects will not be felt fully until Baby Boomers retire.

The obstacles to success in raiding were devices such as "poison pills" and "golden parachutes" for executives, and classified directors' terms.[95] These became anathema to governance reformers. That very strong institutional and public-policy reasons argued for these devices – stability of management, long-term focus on business, recognition of other stakeholder interests in the company's existence – did not deter pensions and investment banks from their laser-focus on creating "shareholder value".

Executive Compensation. The history of executive compensation resolutions – much favored by value-enhancers – reveals similar origins. In the late '80s and early 90s, they focused on officers of "under-performing" companies such as Andrew C. Sigler at Champion International. These efforts held not a hint of social justice or equity. The resolutions served the same purpose as that of the proverbial hillbilly who hits his mule between the ears with a two-by-four: to get the target's attention.

In contrast, no institutions protested as a company widely regarded in the 1990s as among the best governed (*i.e.*, most profitable for shareholders) lavished perks and retirement benefits on its then-CEO, Jack Welch. Nor did many note the irony, even after the General Electric scandal broke, that the same Andrew C. Sigler sat on the GE's board's compensation committee.[96]

As John Cassidy has pointed out, today's imperial executive perks are a continuing inheritance of our myopic drive to maximize shareholder value.

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[95] Typically, companies that adopted this structure divided their directors into three classes, A, B and C. Directors in Class A would be elected in year 1 for a three year term, Class B in year 2 and Class C in year 3. The argument for such a structure – which is the rule amongst NGOs and charities – rests on continuity of leadership and the long-term perspective it brings. In the era of John Kenneth Galbraith's *New Industrial State* (Boston, Mass.: Houghton Mifflin, 1967), a classified board was a sign of good corporate governance.

[96] Sigler's service on GE's board from 1984 to 2004 included the years his compensation from Champion was under attack. General Electric Co. Website, "Past GE Directors", http://www.ge.com/en/commitment/governance/bod/ge_board_of_directors.htm

> The enduring economic lesson of the [1980s leveraged buyout] era was that unleashing greed wasn't enough to raise efficiency. But the message that corporate America took from its ordeal was quite different: senior executives who converted to the new religion of shareholder value tended to get very rich, while those who argued that corporations ought to consider their employees and customers as well as their stockholders often ended up without a job.[97]

Hence, the executive compensation problem will take a restructuring not of individual corporations but of the American corporate system.

The presence or absence of "poison pills" or "golden parachutes" says little of value about "governing". Annual elections of all directors have their intended effect of limiting the board's and senior management's horizon to the next annual meeting. The absence of these protections inhibit, if not prohibit, a focus on stakeholders other than shareholders – and then only on those who seek share-value enhancement.[98] Thus, value-seeking investors impose their short-term mentality on the corporations they own.

The Process of "Governing"

> *A short-term outlook may yield short-term profits for your clients, but this outlook will present an incomplete – and likely distorted – picture of the companies you're covering. To state an obvious, but often-overlooked, fact – quarterly earnings do not reflect companies' long-term viability. Identifying the factors that will drive long-term growth – such as personnel, strategy, financial strength and flexibility, internal corporate governance, innovation, and customer service – may be more difficult to quantify, but they offer a more accurate and complete portrait of a company's future and, by the way, are*

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[97] John Cassidy, "The Greed Cycle", *New Yorker*, September 23, 2002, p. 68

[98] Only those who wonder at self-fulfilled prophecies can find value in studies revealing a positive correlation between "good governance" and share value. "Good governance" of this type has as its only purpose increased liquidity and share value. An interesting study would evaluate "good governance" of this type against environmental or social metrics.

critical criteria for determining executive compensation. -William H. Donaldson[99] (2005)

I have argued elsewhere[100] that pensions and indeed all investors should focus not on the diversions of "governance" but on the substance of "governing". By "governing" I mean how the company is actually being run and for whose benefit management and the board are acting.

Thought of as the process of governing rather than as a class of outcomes, corporate governance could turn into a fruitful area for collaboration across classes of SRI investors.

Yes, "[t]he key questions for pension funds [as fiduciaries] ... are whether good corporate governance adds any value to their fund and, if so, what action they can take to most effectively harvest such a gain with respect to their shareholdings." But as Watson Wyatt goes on to point out, "The benefits gained may be return-enhancing, but may equally be risk-reducing in nature."[101]

Expanding the value-enhancer's objectives to risk-reduction, makes sense from a long-term investment perspective. Secondarily, it broadens the funds' view of their holdings to one more consistent with company – as opposed simply to share – ownership. Then, a greater range for mutually beneficial alliances with Values-based and value-seeking investors opens up for pensions.

Paul Hawken is correct that what matters is "the company's business model and ethos",[102] as well as its culture. For these are means by which managers express their philosophy of corporate governance. They affect long-term investors – which,

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[99]William H. Donaldson, "Speech by SEC Chairman: 2005 CFA Institute Annual Conference", Philadelphia, PA, May 8, 2005, http:\\www.sec.gov\news\speech\spch050805whd.htm Donaldson resigned as SEC Chair seven weeks later.

[100] "Pensions and the Companies They Own", *op. cit.*, pp. 11-13.

[101] Watson Wyatt Worldwide, "Remapping", *op. cit.*, p. 24.

[102] Paul Hawken, *et al.*, *op. cit.*, p. 17. My reasons for disagreeing with his contention that SRI mutual funds do not focus on these essential issues are discussed below.

as I've noted, is what social investors are. They illuminate the attention companies will pay social and environmental issues.

Values-based investors do not advance their causes by supporting value-enhancing investors in their efforts to maximize short-term share price. Both will gain for the long-term as allies in focusing on the process of governing.

V. SRI Performance: The Means and Ends

> *The shareholder value fallacy is also the foundation for the assertion that companies need a 'business case' for doing right. But the 'business case', even if a necessary tactical route into discussion with companies, is unreal in practice and amoral in principle. It is unreal in practice because it does not begin to extend to the whole range of corporate responsibilities and because there is often an equally compelling 'business case' for doing wrong in a market which measures only short-term financial gains. It is amoral in principle because it suggests that you do not do right because it is right, but because it pays. I know of no other legal occupation that requires an economic justification for doing what is right.* -Sir Geoffrey Chandler (2004)[103]

I began this paper by remarking on how unloved is the phrase "socially responsible investment". But, the phrase has a virtue. It highlights the dual nature of the concept: One should be socially responsible and one should be a responsible investor.

Implicitly, the phrase reflects a choice an investor makes. That choice one hears in complaints such as, "If I don't do this, does it mean that I'm 'socially irresponsible' or 'unethical'?" It also recurs in the attempts, such as the World Economic Forum's, to uncouple social and environmental investment criteria from ethical constructs.

Whatever an investor does with social and environmental criteria, s/he cannot escape being an investor. Being an investor means being judged – both by oneself and, often, by others – on the "performance" of one's investments. In this final section, I want to discuss "performance" in its full dimension. For it is performance – of a number of types – that comprises the ends of social investing – and gauges responsibility.

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[103] Chandler, *op. cit*. Reprinted by permission of the author. A reviewer asked if I reject a business case for SRI altogether. I do not. As I said in "Values *and* Money", *op. cit.*, p. 10, a business case for SRI generally or for particular aspects might aid the cause. I do reject absolutely the necessity of a business case in order to justify applying SRI or CSR principles. On this, I agree with Sir Geoffrey.

The Poles of "Performance"

> *The securities laws ... envisioned securities markets that would curb irresponsible speculation but helped to bring about the "performance" of the 1960's, a euphemism for the evil that was originally to be curbed. -Walter Werner (1977)*[104]

> *Foregoing the opportunity to make money is not the same as losing money.* -David R. Montgomery (2003)[105]

Had Vince Lombardi been a money manager, the exacting coach might have said, "Performance isn't everything; it's the only thing."[106]

"Winning" in football is precisely defined by the scoreboard at the end of the game and by the standings at the end of the season. In contrast, investment "performance" requires a definition of the "game" (bonds or stocks? value or growth?) and "season" (one quarter? one year?) every time it is used. And, the relevance of league tables and standings is regularly questioned.

Nonetheless, in financial services people talk about "performance" as if it were absolute, timeless and commonly understood without modifiers. But, if one is to understand socially responsible investment's "performance", one must know what sport, league and game one is measuring.

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[104] Walter Werner "Management, Stock Market and Corporate Reform: Berle and Means Reconsidered", 77 Columbia L. Rev. 388, 416n.168 (1977).

[105] David R. Montgomery, *King of Fish: The Thousand-Year Run of Salmon* (Westview Press, 2003), as quoted in "Casting Light", *Economist*, September 13, 2003, p. 77.

[106] Lombardi is wrongly believed to have said, "Winning isn't everything; it's the only thing." What he said was more ambiguous. Gene Collier, "Roddick's unusual actions put a different spin on ethics", *Pittsburgh Post-Gazette*, May 12, 2005. http://www.post-gazette.com/pg/05132/503182.stm

A Common Definition. In two general and twelve specialist dictionaries in finance, economics, business, accounting and law I looked to no avail for a working definition of "performance" as applied to investments.[107]

I found what I sought in a doubly relevant passage in *Capital Ideas*, Peter L. Bernstein's history of the theoretical origins of today's finance. Describing the days before the 1973 bear market and the revolutionary emergence of institutional investors – numbers-driven, performance-driven – as the equities markets' dominant figures, he noted:

> Before the revolution, the clients of our family-oriented business would come to us and say, "Here is my capital. Take care of me"…. They … stayed with us because we understood their problems and the myriad kinds of contingent liabilities that all individuals must face. They recognized that we shared the delicate texture of their views about risk. We joked that we were nothing more than social workers to the rich – but skilled social workers to the rich, confident that our performance was being measured in human satisfaction rather than in comparative rates of return.[108]

Bernstein's juxtaposition of two measures of investment performance – "human satisfaction" and "comparative rates of return" – brackets the concept for values-based investors. It suggests a working definition of "investment performance" in their context.

"Human Satisfaction" and "Consumption Value". Writing in 1980, those early foes of SRI, John Langbein and Richard Posner described a similar finding as to "human satisfaction":

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[107] All were published in the last 20 years by presses in the US and UK including MIT, Oxford, The Economist/Blackwell, Barron's, West and the New York Institute of Finance.

[108] Peter L. Bernstein, *Capital Ideas* (New York: Free Press, 1992), p. 10. Bernstein is a master of historical perspective, the telling anecdote and the lucid explanation of mind-numbing theoretical constructs. Few books are essential; this one is for anyone seriously interested in investing and the lenses through which economic arguments are passed.

> It is not only possible, it is strongly implied by economic theory, that people who invest in mutual funds dedicated to social investing derive a consumption value from their investment, since the pure investment value is, at least on an expected basis, inferior to that of alternative investment vehicles.[109]

Langbein and Posner wasted little time on the individual investor's right "to derive a consumption value", but they fired on institutions that might look for the same thing.

> Because there is no practical mechanism by which pension fund trustees can make the felicific calculations necessary to decide which social principles they should adopt in order to maximize the overall utility of the fund beneficiaries, there is no basis for a judgment that the positive consumption aspects of social investing will on average exceed the negative.[110]

This argument restates a position offered by many classes of institution when confronted by constituent demands for some sort of SRI-type action.

A moment's reflection on pensions funded by arms of the Roman Catholic Church or, say, the United Methodist Church reveals the law professors' over-statement. Indeed in rejecting Langbein and Posner's conclusions, the Maryland Court of Appeals said:

> As one commentator stated, a "trustee is under no duty to open a brothel in Nevada, where prostitution is legal, in order to maximize return to beneficiaries."

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[109] Langbein & Posner, *op. cit.*, p. 94. As is true of most of the two scholars' "economic" speculations, these were not inhibited by such fettering factors as data. In a recent review of his *Catastrophe! Risk and Response* (2005), Clifford Geertz captured the Posner essence: "…a hectic flurry of piled-up fact-bites, speculative calculations, passing quarrels, and offhand policy dicta – an orderless mixture of assertion, guess, remark, and opinion for which the term "farrago" would seem to have been invented…." Clifford Geertz, "Very Bad News" *New York Review of Books*, March 24, 2005, pp. 4, 6.

[110] *Id.*, p. 95 (footnote omitted). "[The] reader will not go far wrong if he understands social investing to be pursuit of an investment strategy that tempers the conventional objective of maximizing the investor's financial interest by seeking to promote non-financial social goals as well." *Id.*, p. 73. So, Langbein and Posner assume (or assert?) that the maximization of shareholder value is the primary objective of investors. In this context, they make no concession to factors such as risk or risk-tolerance that might convince an investor to seek less than maximal returns.

> Thus, if, as in this case, social investment yields economically competitive returns at a comparable level of risk, the investment should not be deemed imprudent.[111]

And so we return to Bernstein's poles of performance: "human satisfaction" and "comparative rates of return".

"Comparative Rates of Return". One of the profound changes in institutional money management since 1973 has been the ability to compare rates of return. Those comparisons are to a "benchmark".

A "benchmark" is a standard against which something is measured. It is a reference point. The proper benchmark for a portfolio's performance is an index that reflects how the market for similar securities did over the same period. Hence to gauge comparative rate of return, a proper benchmark for a broadly diversified, large cap equity portfolio would be the Standard & Poor's 500 Composite Index (S&P 500).

An entire consulting business exists to serve institutions based on what they know about the risks and returns produced by managers. Those consultants are the institutional gatekeepers. Beyond them are the *Value Lines* and *Morningstars* that offer means of comparing stock performance and mutual fund performance which clients can use to monitor managers.

Investment advisers typically observe standards for reporting performance that were developed by the CFA Institute.[112] Its standards require that a manager's performance be compared to a benchmark:

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[111] *Bd. of Trustees v. Mayor of Baltimore City*, 317 Md. 72, 562 A.2d 720, 737 (1989), *cert. den. sub nom. Lubman v. Baltimore City*, 493 U.S. 1093, 107 L.Ed. 2d 1069, 110 S.Ct. 1167 (1990). (Citation omitted.) The court quoted J.C. Dobris, "Arguments in Favor of Fiduciary Divestment of 'South African' Securities", 65 Neb. L. Rev. 209, 232 (1986). This case is the only one dealing with SRI and fiduciary duties to be decided by a court of last resort in an English-speaking jurisdiction. Its significance is described in "Pensions & the Companies They Own", *op. cit.*, pp. 30-33.

[112] Formerly the Associaton for Investment Management & Research (AIMR).

> The total return for the benchmark (or benchmarks) that reflects the investment strategy or mandate represented by the [manager's] composite [return] must be presented for the same periods for which the composite return is presented. If no benchmark is presented, the presentation must explain why no benchmark is disclosed....[113]

Further, the Securities and Exchange Commission (SEC) Form N-1Arequires mutual funds to report their investment performance in comparison to "an appropriate broad-based securities market index...."[114] Such an index "is one that is administered by an organization that is not an affiliated person of the Fund [or] its investment adviser ..., unless the index is widely recognized and used."[115]

That is the environment in which socially screened mutual funds and managers who apply social screens work.

Comparative Performance: An Illustration. An investment manager who died in 1955 and miraculously revived today would find much in his profession unchanged. But with Peter Bernstein, he would find stunning the emphasis on comparative performance and benchmarks.

Table 2 appeared in the March 2005 *FT Mandate*.[116] It summarizes the Lothian Pension Fund's mandates to their asset managers and the performance expectations for each. Our Lazarus would be startled, first, at the almost casual, public statement of these objectives for a £2 billion fund.

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[113] *Association for Investment Management & Research Performance Presentation Standards* (AIMR PPS) (May 20, 2001) §5.A.7. http://www.cfainstitute.org/standards/pps/pps_outline/content.html#present

[114] U.S. Securities & Exchange Commission Form N-1A, §22(b)(7)(ii)(A), p. 50. http://www.sec.gov/about/forms/formn-1a.pdf

[115] *Ibid*., Instruction item 5, p. 51. *See also* the discussion of "Social Benchmarks & Benchmarking" in the next section.

[116] Roxane McMeeken, "Lothian's high risk-taking route is just the ticket", *FT Mandate* (UK), Mar. 2005, p. 16.

Of the benchmark indexes Lothian uses, only the S&P was in existence in 1955 and then in a significantly different form than today. That fact alone indicates the profound shift in performance measurement and evaluation.

Finally as the last line of Table 2 reveals, an SRI strategy informs Lothian's investment strategy. Lazarus would find incomprehensible Lothian's principal investment officer, Colin Hay, statement: "Our policy is to encourage best practice within industries by engaging with companies and driving change, preferably by co-operation rather than coercion.... The companies ..., hopefully, will realise increased shareholder value as a sign of a well-run organisation with forward-thinking management."[117]

Social Benchmarks & Benchmarking

One commentator has argued, "The obsessive drive to compare SRI funds with conventional funds should cease. The difference in yield is largely irrelevant. What is relevant is what a company does, how it does it, and then, and only then, is yield relevant."[118]

It is hard for a provider of socially screened benchmark indexes to disagree with an assertion that screened funds should be benchmarked to such indexes. But as we've seen, the SEC and CFA Institute disagree.

On an "apples-to-apples" basis, the rationale for using SRI benchmarks seems compelling. The SEC offers some support in the instructions to its Form N-1A.

> A Fund is encouraged to compare its performance not only to the required broad-based index, but also to other more narrowly based indexes that reflect market

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[117] *Id.*, pp. 16-17.

[118] *Id.*, p. 28. Hawken's final assertion is wrong. As discussed above, AIMR and the SEC require such comparisons.

> sectors in which the Fund invests. A Fund also may compare its performance to an additional broad-based index …, so long as the comparison is not misleading.[119]

As a practical matter, however, social funds will always be compared to unscreened benchmarks. The SEC, consultants, *Value Line*, *Morningstar* and the business media dictate that. Benchmark index results accompany *Barron's* quarterly mutual fund performance tables, for instance. But socially screened funds and portfolios could – and should – be gauged against screened benchmarks, too. Fund managers and investment advisers (with a nudge from consultants) could dictate that choice.

"The obsessive drive to compare SRI funds with conventional funds", if it is a fault, lies with the investor protection structures constructed over the past 70 years to allow investors to understand their investments. The ability to compare investment yields was a significant step forward in disclosure.

For individual investors who have only to answer to themselves, the question of yield can take a subsidiary position to a company's social record. An astute trustee who recognized the 2001 California energy squeeze for what it was might have ordered Enron dropped from his/her portfolio regardless of the stock's projected yield. No court would fault that decision.

Still the reality remains: a court, a consultant and a client will all evaluate the trustee or manager at least in part on comparative performance. That is true of value-seeking, value-enhancing and values-based investors.

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[119] U.S. Securities & Exchange Commission Form N-1A, §22(b)(7)(ii)(A), Instruction item 6, p. 51. http://www.sec.gov/about/forms/formn-1a.pdf. See also the discussion in the preceding section.

Table 2. Lothian Pension Fund's Managers & Mandates

Manager	Area	Benchmark (over 3-year rolling period	Appointed
Baillie Gifford	UK	FT 350 + 1.5-2%	2004
UBS	UK	FT All share + 1.5-2%	2000
Martin Currie	UK	FT All share + 2%	2002
Internal	UK	FT 350 + 1%	2000
BlackRock	Europe	FT Europe xUK +2%	2001
Bank of Ireland	Europe	FT Europe xUK +2.5%	1997
Bank of Ireland	Global	FT Index: 1/3 US/Asia Pacific/Europe+2%	2002
Baillie Gifford	Japan	FT Japan	2003
Baillie Gifford	Pacific ex-Japan	FT Pacific xJapan +1%	1986
Baillie Gifford	Lothian Buses*	WM All Funds +1%	1986
Oppenheimer	US	S&P +1-2%	1994
Goldman Sachs	US	S&P +1-2%	2004
Lloyd George	Emerging mkts	IFC Investable +3%	1998
Hendersons	Fixed Interest	(50% Merrill Lynch Non-Gilt All Stock/ 50% FTSE All Stocks Gilt Index)+0.75%	2000
Standard Life	Property	IPD +1%	2001
ISIS	SRI	n/a	2002

Note: "Lothian Buses" is a subsidiary pension fund.

Source: Lothian Pension Fund as reported in Roxane McMeeken, "Lothian's high risk-taking route is just the ticket", *FT Mandate* (UK), Mar. 2005, pp. 16,17. Reproduced by permission.

A Trade Off?

It may be that, from a philosophical standpoint, values-based investors have lost something important by the intrusion of comparative performance into their decision-making. After all, consistency could hardly be more attuned with "human satisfaction".

Nonetheless, it is easy to see the benefits disclosure and comparability have conferred on the investing public, while it is hard to see what has been lost to values-based investors. The deeper question to which I have alluded is whether a business case must exist for the adoption of SRI criteria.

While chair of Unilever, Niall FitzGerald commented,

> Corporate social responsibility is not a soft issue. There are times when tensions between commercial opportunity and social impact involve issues that are not clear cut or straightforward, requiring tough trade-offs. CSR is a hard-edged business issue.[120]

To say that such questions pose "business" issues is not to prejudge them. He is not saying that economics trumps ethics, only that their collision forces hard calls. What is true of CSR is true of SRI.

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[120] Niall Fitzgerald, "CSR: Rebuilding Trust in Business: a perspective on corporate social responsibility in the 21st century" (London: Unilever PLC, 2003), p. 15.

Conclusion

Social investing is usually discussed as if it was the opposite of something else: Call it "pure" investing, which banishes anything but return from consideration in deciding which assets are appropriate and which are not. But the truth is that social concerns permeate institutional investment. The real issue is not whether to have social guidelines but only how many and where to set them. -Plan Sponsor (1997)[121]

I began this paper with the suggestion that people who used the term "SRI" did not know precisely what it entailed, that their identities, affiliations and interests constrained their understanding . I have argued that the term now covers three distinct approaches to SRI. And, I have urged that the moral case for SRI be acknowledged, if not adopted, by those applying environmental, social and governance (ESG) criteria.

A Confluence of Interests

The divisions in SRI represent real differences in culture and approach. For some whose perspective is values-based, the possibility of a concerted effort among the three groups has seemed increasingly unlikely. I believe that to be wrong.

Since the SEC's adoption of its proxy voting rules in January 2003, the question first raised implicitly by the earliest shareholder activists has become explicit and urgent: Who owns – in a practical, operational sense – publicly-traded corporations?

That issue is one on which all three schools of SRI will probably develop similar views which will bring them into closer alignment. Should – as I think likely – shareholders gain the ability to nominate board candidates and reject unopposed nominees, they will have to address the problem of who to nominate – and elect –

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[121] Eric Laursen, "Editorial Comment," *Plan Sponsor*, July-August 1997, p. 2.

and what interests that person will represent. The moral questions cannot be avoided.

The Ethical Focus

The environmental, social and governance (ESG) criteria values-based investors apply have their roots in moral choices, moral criteria. They may have validity as input in other models which lack any connection to moral frameworks. Value-seeking and value-enhancing investors have grasped that possibility.

The loss of the moral grounding to these criteria seems a great one. The efforts of organizations such as the World Economic Forum to craft "responsible investing" out of SRI and, one must assume, the general course of fiduciary capitalism appear to have no purpose other than the concealment of their moral roots.

In this light, it seems fitting to give a final word to, perhaps, the greatest "worldly philosopher" of the twentieth century as he argued for maintaining the moral focus in his discipline. John Maynard Keynes' language could describe SRI today:

> I want to emphasize strongly the point about economics being a moral science. I mentioned before that it deals with introspection and values. I might have added that it deals with motives, expectations, psychological uncertainties. One has to be constantly on guard against treating the material as constant and homogeneous. It is as though the fall of the apple to the ground depended on the apple's motives, on whether it is worth while falling to the ground, and whether the ground wanted the apple to fall, and on mistaken calculations on the part of the apple as to how far it was from the centre of the earth.[122]

It is worth comparing this quotation with the discussion above of "corporate culture" and SRI research.

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[122] Letter, John Maynard Keynes to Roy Harrod, July 16, 1938, as quoted in Skidelsky, *John Maynard Keynes: The Economist as Saviour*, *op. cit.*, pp. 619-20.

The Challenge

Mercer Investment Consulting's 2004 survey of money managers revealed a distinct geographic pattern in responses.

> Almost three-quarters (73%) of the managers surveyed predicted that the integration of social and/or environmental corporate performance indicators would become mainstream within 10 years. ...US managers stray from the global trend with over 60% of them forecasting that social and/or environment performance indicators will never be a mainstream investment practice.[123]

One message to Americans from the Mercer report is that our leadership in SRI is a thing of the past. Sixty-three percent of pan-European managers surveyed forecast integration within five years as opposed to sixty-three percent of US managers who predicted never.[124]

Another message, a much more significant one, prompted this paper. We American SRI advocates have not convinced the constituencies that drive opinion at investment managers – their clients. Whatever our differences, whatever our persuasions, we share an urgent need to enlist broad support for our efforts.

Now is not too early to start.

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[123] Jane Ambachtsheer, *op. cit.* In all probability, this result comes from the Europeans' not institutional dominance and from the absence of a significant values-based clientele.

[124] *Id.* By contrast, 34 percent of Canadian managers saw integration within three to five years. Only 20 percent thought it would never come.