Photo Credit: *Private Client*

A Brief History of Socially Responsible Investing

Thomas M. Denkenberger

Executive Summary

Socially Responsible Investing (SRI) is any investment strategy which considers both financial return and social/environmental outcomes. Due to rebranding and great marketing, interest in SRI has grown significantly in recent years. At Sankala Group, we are excited to work towards the unique social and environmental outcomes our clients want to see, but as fiduciaries, we must clearly understand the costs and benefits of SRI on a deeper level. This letter traces the history and evolution of SRI, and carefully analyzes the pros and cons of each strategy. It will examine the main segments of the space including (1) Negative Screening, (2) Environmental, Social, and Governance (ESG) Screening, (3)

Shareholder Advocacy, (4) Community Investment, (5) Impact Investing, and (6) Investing to Give.

(1) Negative Screening

Negative screening excludes certain securities from investment based on social or environmental criteria. It was the earliest form of SRI, first practiced by the Quakers in 1758 when they banned participation in the slave trade. Since then, such screening has been used in conjunction with many social and environmental movements through to today. The most commonly excluded industries are fossil fuel, tobacco, alcohol, gambling, adult entertainment, and weapons. There are two ways this strategy can potentially impact realities on the ground:

1. Increase the cost of capital for excluded companies.
2. Increase societal awareness, which then puts pressure on the excluded companies to change.

In a brilliantly logical article, "Virtue is its Own Reward: Or, One Man's Ceiling is Another Man's Floor," Cliff Asness clearly explains how exclusionary screening economically hurts bad[1] companies. Negative screening results in a subset of investors who will not own bad companies. Because every stock must be owned in a publicly traded market, this means that other investors must be tempted to buy more than they otherwise would. The efficient market moves the price of the bad companies down to the point that their expected rate of return is higher than normal, which induces the non-exclusionary investor to buy more. The higher expected return is equal to a higher cost of capital for bad companies. Thus, these companies are constrained to only doing those projects which have the highest rate of return and thus can't do as many projects. And this is the whole point: the higher cost of capital makes bad companies do less of the bad things than they would otherwise do.

Conversely, the cost of capital is lower for good companies, so they can economically undertake more of their good projects. While all of this is economically logical, we don't want to believe it as investors because we don't like to be punished for doing what we think is right. But this is exactly what we may find in the final analysis. *The more that the cost of*

[1] We acknowledge that there is significant moral uncertainty surrounding the value judgement of what is considered to be a good or a bad company. Such philosophical and ethical debates are important, but beyond the scope of this letter. Please use your personal definition of good and bad while reading this piece.

capital is driven up for bad companies and down for good companies, the lower the expected rate of return is for new negative screening investors. When we compare the long term performance of the largest negatively screened fund, the Vanguard FTSE Social Index Fund (VFTSX) against the largest standard fund, the Vanguard 500 Index Fund (VFINX), we find that since its inception on June 1, 2000, it has underperformed by 0.74% per year.

Interestingly, there is the potential to garner excess returns by being one of the first to exclude an industry that will face increased exclusion in the future. In the phase while more investors are adopting exclusion, the price of the excluded company does fall (on its way to becoming a higher rate of return investment). As an early adopter, not owning the investment during the price drop phase helps relative performance.

The second way negative screening can have a positive impact is by raising public and political awareness which puts pressure on bad companies to change. This mechanism does not directly affect investment performance and is perhaps more powerful. The most famous example of how this can work is the 1980's movement to divest from companies doing business in South Africa. During the 1970's the United Nations and many countries publicly condemned apartheid in South Africa. Even so, nothing changed. In the early 1980's a movement began, mostly on college campuses, to convince endowment funds to divest from companies doing business in South Africa in an effort to protest against apartheid. This movement raised societal awareness to the point that it raised political awareness. Finally, by the late 1980's, there was enough political will for the United States congress to pass economic sanctions against South Africa. These sanctions were powerful enough to cause South Africa to change, ending apartheid by 1994, when Nelson Mandela was elected president of South Africa. While there were multiple factors that contributed to the ultimate fall of apartheid, the divestment movement is given significant credit. Bill McKibben, the current leader of the fossil fuel divestment movement, pointed out that, "when Nelson Mandela got out of prison, the first place he came was not the White House - it was California to thank University of California students who had helped get their system to divest $3 billion in holdings in South Africa."

So, we must conclude that to magnify your impact as a negative screening investor, it is important to spread the word about what you are screening out and why. For example, I am proud to say that 4.5 years ago I worked with my local Unitarian Universalist church to explain how divestment works and to get it to commit to divesting from the Carbon Underground 200 fossil fuel stocks within 5 years. Now, as a member of the church's endowment committee, I have helped the church completely finish divesting from the

Carbon Underground 200 stocks. This divestment was done to highlight the importance of climate change, and to express the moral stand the church wanted to take against an industry that they feel is polluting our environment and endangering future generations.

The timing was fortunate as the fossil fuel industry has under-performed during the past 4.5 years, such that the church's endowment fund actually outperformed due to the exclusion of the 200 largest fossil fuel stocks.

(2) Environmental, Social, and Governance (ESG) Screening

Other than a few high profile divestment movements, negative screening did not gain much mainstream investment interest during the 1980's and 90's. In a culture that praises positivity, negative screening just didn't sell well. But in the early 2000's, a new model of SRI began to gain popularity. Unlike negative screening, which excluded bad companies, ESG screening positively selected those companies which were ranked highest on environmental, social, and governance metrics. Instead of shunning the bad, it rewarded the good; this was better marketing.

While most SRI was focused on environmental and social issues, ESG's secret to success was its focus on corporate governance. Robert Levering and Milton Moskowitz published the *Fortune 100 Best Companies to Work For* and Moskowitz went on to study the performance of these companies. He found that these companies scored highly on corporate governance by treating their employees well, and that this resulted in higher productivity, higher corporate efficiency, and easier recruitment of top talent. This research suggested that selecting good companies with high corporate governance rankings might actually achieve a higher rate of return than normal. The growth of ESG really took off in 2011 when Alex Edmans, a finance professor at Wharton, published a paper showing that the stocks of the *100 Best Companies to Work For* grew 2-3% more per year than the average from 1984 to 2009. People could invest with a conscience and earn more; it was a win-win! With these findings and a massive marketing campaign, the amount of money managed in ESG strategies has grown ~40% per year since 2011.

Unfortunately, the story doesn't end there. There is no universally accepted set of ESG criteria. As investors look under the hood to see what their ESG funds hold, they have been horrified to find companies that do not align with their values. For example, environmentally focused investors trying to divest from the Carbon Underground 200 have been shocked that their "good" ESG fund holds ExxonMobil. Others can't believe that their "good" ESG fund holds Philip Morris, the largest tobacco company in the world.

Despite a few glaring holdings, ESG funds generally hold more good companies and fewer bad companies. This brings us back to what is the actual effect of ESG investing: it is basically the same as negative screening. In general, ESG screening directs investment away from bad companies and towards good companies. This increases the cost of capital for bad companies and raises societal and political awareness to put pressure on bad companies to change. The largest ESG fund is an ETF called iShares MSCI USA ESG Select (SUSA). Since its inception on January 24, 2005, it has underperformed the largest standard ETF, the SPDR S&P 500 (SPY), by 0.72% per year.

(3) Shareholder Advocacy

While ESG investing has seen a meteoric rise in popularity, the amount of assets managed with a shareholder advocacy approach has remained relatively flat for the past 25 years. Shareholder advocacy is an SRI strategy in which shareholders attempt to positively influence corporate behavior. Shareholders talk with management, file shareholder proposals, and vote on proxy resolutions. This engagement can encourage or even force a company to change its behavior.

Unlike the indirect effects of negative screening and ESG screening, shareholder advocacy works directly on specific issues to improve corporate actions. Here are a few examples of actual outcomes from this work:

- Michale Kors agreed to protect migrant workers in global supply chains
- UPS agreed to renewable energy goals
- Best Buy agreed to adopt principles for minimum wage reform
- Whole Foods and Avon Products agreed to sustainable palm oil sourcing
- Lowes agreed to stop selling pesticides linked to honeybee declines

The positive impacts listed above are very encouraging, so the question becomes, what are the costs? Many, but not all, actively managed SRI mutual funds engage in shareholder advocacy. These funds not only have to pay the mutual fund managers, but they also have to pay the staff that specifically works on shareholder advocacy. These costs lead to higher than average expense ratios and slightly lower than average rates of return. Most funds practicing shareholder advocacy also employ some level of negative screening and ESG screening. Mutual funds that engage in shareholder advocacy are likely to yield a higher positive impact per investment cost than a simple negative screening index fund or ESG index fund. With deep research, we can find funds that align with investor values, directly work to positively influence corporate behavior, and cost only moderately more than average funds. In fact, the largest SRI fund that engages in shareholder advocacy, the Parnassus Core Equity Fund (PRBLX), has actually outperformed the Vanguard 500 Index Fund (VFINX) by 1.06% per year since its inception on August 31, 1992.

(4) Community Investment

While negative screening, ESG, and shareholder advocacy all work on the level of publicly traded companies, community investment involves investing directly in an institution that works to help a community. Generally, money is loaned, in the form of a bond which pays interest and is ultimately repaid at maturity. This money is then loaned within a community to help fund socially beneficial projects such as affordable housing, education, healthcare, childcare, and other community services.

Because the money is invested directly in an institution dedicated to working on improving social or environmental conditions, the positive impact can be very large. For example, community investment bonds issued by the International Finance Facility for Immunisation have provided the funding for Gavi, the Vaccine Alliance, enabling it to provide vaccinations to 700 million people.

This sort of direct investment is usually illiquid, but there are actively managed SRI bond mutual funds which dedicate a portion of their portfolios to community investment. This hybrid model has enough liquidity to trade on a daily basis for normal mutual fund investors. This type of investing requires extra work so these funds usually charge slightly higher fees and slightly underperform. Like actively managed shareholder advocacy funds, you get what you pay for: it takes time and money to do good in the world, so these costs are the investment price that you pay. Fortunately, within the realm of SRI active management, it is possible to deliver benchmark-beating returns despite these cost headwinds. For example, TIAA-CREF Social Choice Bond (TSBRX), the largest bond mutual fund which does community investment (30% of its portfolio) has actually outperformed the Vanguard Total Bond Market Index Fund (VBMFX) by 0.86% per year since its inception on September 21, 2012.

(5) Impact Investing

Where community investing is direct bond investment in institutions designed to do good, impact investing is direct private equity investment in companies with business models focused on doing good. The seed capital invested into these firms enables them to grow and expand so they can do more good.

The potential positive impact can be high as illustrated by the following two examples:

- A private equity company installed more than 40,000 solar energy systems that produce electricity for lighting and refrigeration in rural Indian households, schools, and hospitals.

- A company set up water purification plants in rural villages. The plants are owned by the local community and operated by the installation company, which sells the purified water to the village at affordable rates.

Due to the non-public nature of private equity funds, it is difficult to find reliable performance numbers to compare impact investing to standard private equity. But in theory, like all the above SRI strategies, impact investment funds on average are likely to charge slightly higher fees and have slightly lower performance than standard options; the cost of doing good.

(6) Investing to Give

Unlike all the above SRI strategies, investing to give does not necessarily employ any social, environmental, or governance constraints. In its simplest form, it is investing for financial return only, and then giving away some of the gains to the most effective nonprofit organizations. This SRI strategy is directly tied to the Effective Altruism movement which is dedicated to rigorously and quantitatively analyzing which nonprofits achieve the most good per dollar given to them.

The effects of investing to give are directly proportional to the amount that is given to the selected nonprofits. Here are some examples of the most effective nonprofits which have received funding because of investing to give:

- Schistosomiasis Control Initiative (SCI) - works with governments in sub-Saharan African countries to develop sustainable programs against parasitic worm infections. These infections affect over 1 billion people, impairing child development, reducing school attendance, decreasing productivity, and causing internal organ damage. SCI is one of the most effective ways to reduce human suffering because it takes about 1 USD to cure an infected person.

- Coalition for Rainforest Nations (CfRN) - is an intergovernmental organization established by forested tropical countries to collaboratively reconcile forest stewardship with economic development. It works to create economic incentives for the preservation of areas of high biodiversity and to reduce rates of deforestation in general. CfRN is one of the most effective ways to preserve biodiversity and fight climate change by saving the carbon sequestration capacity of rainforests.

- Alliance to Feed the Earth in Disasters (ALLFED) - coordinates research and planning to recover quickly from agricultural disasters such as abrupt climate change or nuclear war. As the only organization in this highly neglected space, each marginal dollar is extremely valuable in protecting us from potential future food shortages.

The investment costs of investing to give are equal to standard investing, because it is standard investing. The value of the investment returns that are given away is the cost of the strategy.

Conclusion

SRI has grown and evolved to become an important component of the asset management conversation. At Sankala Group, we believe it is essential to learn about our client's values, and to help them prudently live their values through how they invest.

In this letter, we have carefully examined the pros and cons of the major types of SRI so that you will be fully informed about your options. Now, your homework is to think deeply about your values. What is the change you want to see in the world? Are you a utilitarian who wants their actions to maximize good in the world? Or, do you subscribe to deontological ethics in which each action must be judged as right or wrong? Once you know where you stand, and what you stand for, the selection of which strategies are best for you becomes clearer. We will be honored to be part of this discussion to help you live your values through your investments.

Best,

Thomas M. Denkenberger

Thomas M. Denkenberger
Sankala Group LLC
T: (720) 549-3355

Sankala Group

Sankala Group LLC's communications should not be considered by any client or prospective client as a solicitation or recommendation to affect any transactions in securities. Any direct communication by Sankala Group LLC with a client or prospective client will be carried out by a representative that is either registered with or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. Sankala Group LLC does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information presented in this communication, or by any unaffiliated third party. All such information is provided solely for illustrative purposes.