

**Socially Responsible Investing**  
**It is not an Option – but a Necessary Economic**  
**and Social Imperative**

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# **Socially Responsible Investing** **It is not an Option – But a Necessary Economic** **and Social Imperative**

## **Introduction**

The most common definition of socially responsible investing (SRI) implies that companies and institutions take into account the long-term impact of their decisions on their organizations, the overall economy and other issues that impact the health and welfare of society. For the critics of SRI, this multiple decision criteria would cause the institutions involved to deviate from their main economic role, i.e., preservation of the principal and a suitable return on investment that is commensurate with the risk profile of the assets to be acquired. Using this classic definition as self-evident truth and the bedrock of the theology of economic rationalism, critics further argue that SRI approach to investing is counterproductive and socially undesirable – both at the individual and the institutional level.

At the individual level, by combining economic and social objectives, the individual is likely to sacrifice efficient economic returns. Since un-coordinated individual choices have extremely limited impact on the decisions of large economic institutions, there is little assurance that these actions would yield desirable social outcomes. The best choice for the individual investor would be to focus on maximizing economic returns and allocate the surplus to his/her preferred social choices.

As far as institutional investors are concerned, for the purpose of this presentation, I would like to make a distinction between two kinds of institutional investors.

Type A: Privately–Owned Mutual Funds that actively manage pools of money collected from individual investors. They are guided by the investment objectives and risk profiles prescribed by their investors. These may also include retirement-oriented pools of money from employees of large corporations.

Type B: Public Pension Funds representing the retirement-oriented savings of employees in public sector organizations. These include local, state and national government agencies and departments, public sector enterprises, and other public service and not-for-profit organizations.

In this case, the argument against institutional “socially responsible investing” is also based on the notion of economic rationalism. It is suggested that for Type B institutional investors, the funds’ trustees have a fiduciary duty to maximize the economic return for their beneficiaries. Furthermore, in the absence of specific mandates given by the fund’s owners, the trustees are legally and ethically restricted from using non-economic criteria in their investment decisions.

### **Focus and Scope of Paper**

The thesis of this paper is that SRI is a must for pension funds because there is no better alternative. The scope of this paper, however, is much broader while its focus remains on pension funds and SRI. We assert that under prevailing conditions of imperfect markets, and concentration of capital and

technology, an exclusive or even primary emphasis on return on capital, which is generally narrowly defined and has a short-term time perspective, would inflict enormous harm on the sustainability of free enterprise system, however imperfect. The rapid trend toward globalization, and its concomitant the large multinational corporation, has severely constrained the notions of free and competitive markets allocating rewards to different factors of production in direct proportion to their contributions. In the long-run, such a highly skewed allocation of returns to various factors of production would undermine not only the market-based capitalism, but also the foundations of democracy and rule of law.

In this paper, my principal arguments against the so-called conventional wisdom are two-fold:

1. When applied to individual investor, the criticism is both condescending and self-serving. In competitive markets, individuals have every right to allocate their investments based on different time horizons, risk profiles, and the types of companies and businesses whose shares they want to own. Therefore, investment advisors, i.e., financial and brokerage firms, should either provide the advice sought by the individual investors or remove themselves from the transaction.
2. In the case of public pension funds, the fund trustees have a right and an obligation to protect and enhance the quality and safety of their investments. Given their size and magnitude, these large pools of money must take into account macro-economic and socio-political considerations

that transcend the short-term economic fluctuations and fortunes of individual companies.

### **Growing Importance of Institutional Investors**

Public pension funds have become a major force in the private sector through their holding of equity positions in large publicly held companies. In the U.S. alone, the top 10 pension funds now control over \$1.0 trillion in assets. This phenomenon is likely to become even more pronounced as these funds must continually find suitable investment opportunities for their pension fund beneficiaries.

In the past, when confronted with poor performance and lower returns, pension funds, like most other investors, had opted to divest from the poorly performing companies rather than seek to intervene in the management of these corporations. The fiduciary responsibility of the pension fund trustees was to their own shareholders. They had neither the time nor the resources to intervene in the management of individual corporations. They also faced considerable resistance and hostility from the prevailing power structure in the corporate and financial community, which feared their coordinated action and influence as contrary to the efficient working of financial markets and also their own pecuniary interests.

This situation, however, has been changing. Given their large equity positions in individual corporations, it is not always possible for public pension funds – and for that matter all large institutional investors including retail mutual funds, e.g., Fidelity, Vanguard – to divest their holdings without roiling the

markets and causing a precipitous decline in stock prices of the companies with consequent losses to the pension funds' assets. This problem becomes more acute when the undesirable corporate conduct is not limited to a handful of corporations, but reflects a pattern of conduct among a large number of companies. Switching investments, under these conditions, from one set of poorly performing companies to another set of companies facing similar risks in the foreseeable future is a zero-sum game and a losing proposition, which would only benefit the numerous financial intermediaries whose survival and well-being depends on maximizing the number of transactions in the shortest period of time.

The public debate with regard to SRI investing in pension funds has been particularly intense. It has been imbued with political connotations and ideologically loaded pronouncements that often drown out rational arguments on both sides. It has also become stale and closed to new ideas. Like the mating dance of the penguins, all the rituals and movements are pre-determined and predictable. There is greater communication but little dialogue. Each side has its own version of facts, practical logic, economic theory and political philosophy. The other side is disparaged, albeit ever so politely, as free marketers, social liberals, aggressive unaccountable NGOs, and the unabashed defenders of the economic *status quo*, corporate self-interest, and social inequities.

### **What is Socially Responsible Investing?**

One of the difficulties in discussing the legitimacy and efficiency of SRI-based investments emanates from the fact that both its proponents and opponents have widely divergent perspective of what constitutes SRI. As a

starting point of this discussion, we will accept the definition proffered by Social Industry Forum, the industry association of the SRI.

Socially responsible investing (SRI) is investing in companies that meet certain baseline standards of social and environmental responsibility; actively engaging those companies to become better, more responsible corporate citizens; and dedicating a portion of assets to community economic development.

Notwithstanding, the frustration of SRI critics, this definitional ambiguity is quite understandable. SRI as a concept is evolving and would certainly create greater specificity as it matures and embraces larger groups of investors with diverse needs and sensibilities as to economic risks embedded in corporate conduct, and their preferences for good corporate conduct. We would, therefore, find an increasing number of subsets or specificity-oriented definitions under the general SRI umbrella.

From my perspective, however, SRI is not to be defined in terms of someone's notion of ethical or other forms of normative decision criteria. Instead, it can be completely defined as investment choices that at the macro level aim at minimizing the magnitude of negative externalities – economic, environmental and socio-political – that adversely impact economic growth and social well-being; and at the micro level favor enterprises that minimize the creation of negative externalities as an integral part of their operations and long-term strategies.

Therefore, I would like to suggest a more precise definition of socially responsible investing (SRI). From the perspective of institutional investors, SRI is defined as micro level investment choices that recognize and internalize macro-level economic and socio-political considerations and are designed to strengthen overall economic activity while minimizing the level of negative externalities.

The rationale for this definition is based on the following assumptions:

1. Under conditions of competitive markets, individual corporations act to maximize their returns through (a) competitive efficiencies and better use of their resources; and, (b) externalization of all possible costs to society called “negative externalities.” Therefore, a high polluting factory will earn more profit because the pollution-related costs are borne by the community-at-large or by other groups who are unable to force the polluting company to absorb these costs.
2. At the societal level, these costs must be paid from the overall proceeds of the economic activity. Conversely, these costs are imposed on individuals and groups that are least able to protect their interests.
3. An unfair or inequitable distribution of the cost of negative externalities would eventually translate into political unhappiness and manifest itself in greater regulation of business, i.e., imposing non-market approaches to modifying business conduct.
4. Societal expectations also change over time and create both new negative and positive externalities. Under these circumstances, an enlightened

self-interest approach by the economic sector and individual corporations would be to anticipate the inevitability of these changes and create solutions that meet societal expectations while maintaining flexibility and viability of the competitive market.

5. Institutional investors now account for over one-third of private invested capital in the U.S. and other industrially advanced economies. As such, they are both the largest beneficiaries of the economic gains as well as the major victims of negative externalities.

There are two other, somewhat related, issues that raise the ire of its critics. SRI research is considered subjective and less rigorous and that it fails to deliver what it promises. We would concede this point at least in part and argue its transitional stage. To wit, the research quality of SRI has considerably improved over the last five years and will surely improve in the future propelled by the demands of prospective investors and competitive pressures from the suppliers of research. Lastly, it is argued that SRI criteria result in reducing the financial returns of the investment choices when compared with stocks picked solely on financial criteria and comparable risk and return profile preferences of the potential investor.

Given the time constraints it is not possible for me to discuss the arguments – pro and con – on the comparability of financial returns based on purely financial and financial plus SRI criteria. The discussion as currently construed is largely irrelevant because the two sides make different assumptions

as to time horizon, the illiquidity of large pools of investment, and the impact of macro environmental factors on micro corporate earnings.

### **The Relevance and Justification for Using SRI** **Criteria by Institutional Investors**

I also argue that contrary to the assertions of prevailing business orthodoxy, SRI would enhance the overall quality of investment decisions by making a more realistic estimation of long-term costs associated with negative externalities. At the individual corporate level, this approach would provide a greater predictability and stability of return to shareholders. At the macro economic and societal level, it would reduce distortion in the resource allocation and thereby contribute to greater economic growth. It is, therefore, vital that we keep the issue open to continuous examination. For in the final analysis, we are talking about allocation of capital; who controls it; and, by what criteria the gains from economic activity are distributed among various factors of production, i.e., capital, labor, management, natural resources, technology, and entrepreneurial risk taker, to name a few.

The current debate on the inclusion of SRI by pension funds centers around two issues:

1. Fiduciary Responsibility: Public pension funds' fiduciary responsibility mandates that funds' trustees must focus solely on the financial criteria in their investment decisions and that any other rationale, applied either wholly or in part, would violate the trustees' legal fiduciary responsibility.

2. Financial Returns of SRI Investments: SRI funds not only introduce non-financial criteria in investment decisions, they also provide lower average returns on average when compared with investments selected purely on financial criteria.

We would like to add two additional issues to our discussion of the legitimacy and appropriateness of public pension funds' investments in SRI-related investment vehicles.

3. Types of SRI based investments to be included in Public Pension Funds.

There are many investment choices, based solely on financial criteria that would not be considered appropriate for public pension funds given their risk-reward profile and the needs of retirees who are the funds' shareholders/ beneficiaries. Therefore, just as not all non-SRI investment choices would be suitable for pension fund investing, the same logic would hold for selecting SRI-based investment choices.

4. Increasing size of Pension Funds and their Ability to Make Changes in their Investment Portfolio: The very large pools of capital to be invested by the pension funds severely restrict their freedom to move in and out of individual stocks without risking a destabilization in the affected securities prices. Thus pension funds must strive to improve their returns in line with macro-economic factors that impact the general health of the economy.

### **Fiduciary Responsibility of Pension Funds and SRI Investing**

Inclusion of SRI-based investment choices present some unique challenges given the nature of fiduciary responsibility on the part of pension fund

trustees. However, these challenges do not alter the fundamental rationale for using SRI criteria in selecting investment vehicles. Where investment choices are directed by a plan's trustee, the fiduciary responsibilities require that SRI preferred companies, like all other companies, should be chosen based on a careful assessment of long-term risks and benefits of such investments. This approach would suggest that SRI-based criteria as defined above, should become an integral component in selecting pension plan portfolios.

There are three arguments advanced by the critics of pension funds of investing in companies on the basis of SRI criteria, which they consider to be non-financial and subjective.

1. The trustees of pension funds have a strict legal obligation to selecting investments based solely on financial considerations. Pension fund trustees have no mandate from their shareholders to redefine their fiduciary responsibility. Therefore, a pension fund trustee must maximize financial returns on the fund's investments to the exclusion of all other criteria. What is left unsaid, however, is the definition of maximization; over what time period and what types of risks are being explicitly or implicitly recognized or ignored; and, the nature of entry and exit barriers, to name a few.
2. Critics of using SRI in pension fund investment selection criteria speak as a matter of established truth and incontrovertible fact that trustees' investment choices will be politically motivated, corrupt, uninformed, and without sufficient accountability. In large measure, this reflects political

dogma and a biased perspective of the critics since instances of misconduct are at best “instances” and cannot measure up to indicate any type of universality. Pension fund trustees can and do make bad choices or poorly informed decisions. However, trustee incompetence and conflict is not confined to SRI but equally applies to decisions made solely on market-based considerations.

3. By the same token, there is no evidence to suggest that financial intermediaries would always provide advice that is in the best long-term interest of the pension funds. There is no shortage of instances where financial sector intermediaries that play an important role in directing pension fund trustees towards inappropriate investment choices, which are otherwise more profitable to the financial advisor. Recent disclosures of corporate scandals, e.g., the sub prime loans and their concomitant securitized structured investment vehicles seemed to have engulfed some of the largest and most prestigious financial institutions, law firms, and rating agencies who seemed only too willing to enhance their profits at the expense of their clients.

The issue, therefore, is not the inappropriateness of SRI criteria per se, but to protect pension funds from incompetent fund trustees and unscrupulous financial advisors. Pension fund trustees have a broad mandate and discretion. While they must seek long-term improvement in micro corporate performance, they cannot do so outside the context of economic and socio-political environment, which is essential to the growth of private enterprise. By the same

token, companies that engage in practices that put them in conflict with broad societal consensus of acceptable conduct increase the risk and volatility of their future stream of earnings. Hence, it is reasonable, even necessary, that pension funds take these factors into consideration in making their investment choices.

### **SRI and Corporate Governance**

Apart from financial intermediaries, amongst the most severe critics of SRI have been the senior management and board members of large corporations. SRI has been criticized for its unwarranted intrusion in corporate decision making through injection of non-financial considerations and also favoring one group of shareholders, e.g., public sector employees, union members, over other shareholders of the company. Although, the issue is often couched in terms of special interest, the underlying concern is that of corporate governance where top management and board members are reluctant to subject themselves to greater transparency and accountability.

I maintain that one of the most important functions of the SRI would be to improve corporate governance by controlling agency costs. This approach would require that pension funds and other institutional investors become more actively involved in improving the conduct of the entire private sector and thereby create a larger pool of companies that are well managed and make good investment prospects. Thus breaking with the prevailing conventions and traditions of the marketplace, henceforward pension funds would behave as active shareholders with the mission of reducing agency costs by making corporate management more accountable to shareholders; linking top management compensation more

closely with a company's real long-term performance rather than easily manipulative measures of increase in stock price; short-term sales growth; and , rise in corporate assets through mergers and acquisitions, to name a few. It must also require improved measures of corporate governance through a more independent and knowledgeable board, greater transparency and communications of corporate actions, and real engagement with all of a company's stakeholders so as to create a more hospitable and sustainable economic and socio-political environment for corporate operations in particular and private enterprise in general.

### **Concluding Remarks**

Let me conclude by saying that the current direction of debate on the relevance and justification of SRI is inadequate and inconsequential. This would be true even if all the criticisms heaped upon SRI were taken at face value. It should be apparent to the adherents of the *status quo* that the current economic system and its governance and oversight institutions have largely failed in meeting the advocated standards of economic performance, fealty to shareholders, accountability for performance, and commensurate management rewards. The current system is a blatant grab at unearned and unconscionable level of rewards disguised under the rubric of the so-called "control by competitive markets."

Our primary assertion with regard to SRI is that it is not antithetical to the notion of maximizing returns to shareholders. SRI is intended to introduce a more realistic long-term assessment to the health and well-being of economic

activity and the deployment of the community's resources that does not sacrifice public good at the expense of private gain. Nor does it penalize private initiative, innovation, and merit-based reward for a flawed notion of public good. Instead, it complements the prevailing financial criteria of measuring returns, which are essentially short-term oriented, and have a bias towards understating, if not completely ignoring, many long term trends. These trends have the potential for significantly and adversely affecting the financial well being and survival of both individual companies and specific industries. When allowed to perpetuate, their cumulative effect may be catastrophic and may threaten the entire system of private enterprise, free and competitive markets, and rule of law, and democratic capitalism.