The rapid growth in “socially responsible investment” (SRI) in the UK has seen the fund management process evolve considerably over the past five to ten years. What started as an approach based on negative screening of “bad” industries (typically tobacco, armaments, alcohol etc.) has matured into a sophisticated, thematic style of investment.

Negative screening, the original basis of ethical investment, prompted critics to voice their concerns over the more restricted investment universe that inevitably follows such a process. As the top-performing sector in the Financial Times Stock Exchange index during 2000 was tobacco, it could be argued that they have a point. What is more, when the investment cycle turns away from growth stocks (the traditional focus of SRI or ethical funds), those not convinced of the merits of SRI are concerned over the ability to operate sector rotation. A move towards sectors such as banking or pharmaceuticals brings with it concerns over “ethical” issues. Indeed, a relatively “dark green” screening process might preclude holding these sectors because of uneasiness about debt in the developing world and animal testing of drugs.

So what has been the actual experience of SRI managers in the UK, and what evidence exists to support these concerns? Logic might suggest that SRI funds would be more volatile than the norm and likely to underperform when sector rotation is compromised — but does experience in the UK bear this out?

An example in the UK is the NPI Global Care range of funds. The past performance of the NPI funds shows that the concerns outlined above do not have to apply. Global Care funds consistently perform better than mainstream, non-SRI, funds. They also exhibit lower-than-average volatility.

Regression analysis of the alpha/beta returns supports this observation, over periods that include considerable volatility and the substantial correction of the TMT sector. Figures 1 and 2 show the risk/return correlation over a three-year period for two funds, NPI Global Care Managed and NPI Global Care Growth.

These funds have been selected because they have different negative-screening criteria. The managed fund has a pragmatic, relatively “light green” approach while still screening out the major negative sectors such as arms and tobacco; the growth fund has stricter criteria that exclude areas such as animal testing. This might make a difference where sectors such as pharmaceuticals are concerned, as the managed fund can invest in some “best of class” companies, which the growth fund cannot.
Both portfolios demonstrate above-average returns with below-average to average volatility. The stricter screening criteria may explain to some extent why the growth fund has a higher beta than the managed fund, but the growth fund still has volatility competitive with the sector while having a strong growth-stock orientation.

**A focus on investment, not just ideals**

Attributing the performance to different sectors shows that a strong thematic style of investment has been successful. Investment in environmental technology has paid off, as the funds had been making plays in the wind-power, fuel-cell and general renewables and recycling sectors long before they became mainstream. Balanced against these generally mid-cap plays has been more mainstream investment in public utilities, transport and retail, for example. These traditionally more defensive plays are quite possible in the context of a screened portfolio and have provided the required level of diversity, away from the obvious environmental technology sector that so dominates descriptions of SRI investment strategy.

The key to success in SRI is to focus on the thematic approach and identify the “industries of the future”. Simply applying a screening process to filter out “undesirable” industries will not itself generate superior returns. While the focus in the past in the UK has been on the criteria for exclusion, the future focus needs to be on the positive.

A sector-based, thematic investment discipline brings its own set of issues. In the case of SRI, one of the major considerations is the effect of globalisation which, coupled with the need for a rigorous approach to social and environmental research as well as financial, can test the resources of a management team.

Globalisation has been accompanied by a growing emphasis on the social responsibilities of international corporations. Attention has shifted from corporate philanthropy to responsible business practice — making the promotion of human rights, high standards of environmental stewardship and social accountability core elements of business operations, including relations with suppliers and customers. Civil organisations are targeting markets and corporations as key agents of global change. This has been highlighted in campaigns on forest certification and sweatshops, involving companies such as Shell, Rio Tinto and Nike. Governments are backing this trend by introducing supporting “soft law” initiatives such as the OECD’s Guidelines for Multinational Enterprises and the UN’s Global Compact. And as society raises its expectations of corporate behaviour, the role of the investors that finance the corporations becomes ever more central.
SRI in the new century
The integration of sustainable development and corporate responsibility factors into the investment process has been effective in helping fund managers to anticipate social expectations, regulatory changes and shifts in market demands. This has been reflected in recent changes to UK pensions legislation and listing requirements for the London Stock Exchange, which demonstrate that the social, ethical and environmental dimensions of corporate performance are now deemed to be of substantive importance for financial analysis and investment. Legislation on pensions is under active discussion in Germany, and major pension funds in the Netherlands, the US and Canada are showing increasing interest in the environmental and social impacts of their investment strategies.

More generally, the globalisation of capital is generating shareholder demands for more information on company performance to answer corporate governance concerns, and reporting on corporate responsibility is becoming an essential element of this. Research following the Asian financial crash, for example, highlighted a strong correlation between those companies that came through the crisis and those with strong corporate governance and corporate responsibility programs. Major international programs on corporate governance by the World Bank/OECD and the commonwealth are also stressing the responsibilities of business to a range of stakeholders.

The success of SRI is breeding new challenges. Expectations are rising in government and society about the leverage that SRI can bring to remove some of the major obstacles to sustainable development. Pressure from SRI fund managers is increasingly seen as one of the main drivers for increased corporate disclosure of social and environmental performance, at a time when government exhortation is still failing to produce results.

official said recently that “one of the big issues for the future is how to find a way to get these SRI funds to flow South”.

The new agenda: Smart SRI
A new agenda for SRI is therefore coming into view. SRI funds have largely proved their point: it is possible to combine ethical values with financial returns. The movement has evolved and matured from the original “ethical” focus on negative screening, through the early 1990s emphasis on green technologies to the current socially responsible investment model, stressing “best in class” and engagement. But SRI will need to get smarter and tougher in the years ahead if the gains that have been made are to be sustained.

Indeed, there is no guarantee of future expansion. The prospects are illustrated in Figure 3. One scenario would be for SRI to decline — going the way of “green consumerism” — if investors grow cynical of the quality and integrity of SRI fund managers. It could also simply have reached a plateau and stagnate, unable to rise to the changed expectations that lie ahead.

But a new era of growth and influence could be ahead if SRI fund managers successfully tackle a number of critical issues.

Global challenges require global solutions
Global challenges require global solutions — and SRI fund managers will need to take a progressively global approach if they are to take advantage of both investment opportunities and make lasting contributions to social and environmental conditions.

From ‘SRI growth’ to ‘SRI value’
SRI fund managers will need to become strategic in their approach to investing in the “industries of the future”. The world economy has entered a slowdown which could evolve into recession. SRI has expanded on the back of the boom in new-economy stocks and fund managers will need to refocus attention from “SRI growth” to “SRI value”. The “industries of the future” investment tilt can be defined into three different growth clusters:

- privatised utilities with key environmental linkages (such as water and transport);
- new technological innovations (notably telecoms and information technology); and
- environmental solutions (such as renewable energy and waste management).

These clusters have very different driving forces — and very different challenges. Thus, while the technology sector has seen rapid...
growth, it has generally lagged in corporate social responsibility, and the privatised utilities have suffered from major regulatory design flaws, leading to serious performance and reputation problems, notably in rail and bus. One of the exciting themes for the future will be to understand whether the political need for climate solutions will be sufficient to drive continued growth in new and renewable energy sources through a slowdown and beyond.

**Strengthening the analytical foundations**

SRI fund managers will need to become more comprehensive and rigorous in their assessment of corporate performance on sustainable development: simply being an “industry of the future” or operating in a “benign” sector is no longer adequate. The greater availability of independent research and rating agencies, along with the growing SRI literacy of individual and institutional investors, is raising the bar for fund managers. One response is to develop a rating system for each company based on its strategic approach to corporate responsibility, as well as its specific social, economic and environment performance. The rating will cover core performance criteria for all companies and sector benchmarks.

And to deliver on sustainable development, SRI will have to become more assertive in its expectations of industry champions about their contribution to the resolution of major structural issues (eg, Glaxo and access to health, BP and climate change, Rio Tinto and human rights).

**A more systematic approach to engagement**

SRI fund managers will need to become more systematic in the use of their shareholder influence to achieve change in corporate practice and policy frameworks. This will require careful identification of key business risks and opportunities in individual sectors.

To maximise the impact of the shareholder role in corporate governance, it will be necessary to focus on corporate strategy, vision, policies, systems and management structures, and develop approaches suited to differing corporate governance contexts around the world. SRI shareholders will have to develop ways to work in partnership with each other, and with NGOs, research institutes, government and others.

**From ‘trust me’ to ‘show me’**

SRI fund managers will need to become more transparent to their stakeholders, like the corporations they assess, moving from a “trust me” to a “show me” world. To stay ahead of potential pressures for the introduction of “soft law” standards, managers should be prepared to report publicly in more detail on their assessments of their holdings. In addition, the market and social reputation of SRI funds will be increasingly linked to the progress made on corporate responsibility by parent companies as a whole.

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### The green side of security analysis

The close attention being focused on socially responsible, or “green”, investment promises a significant shift in the investment scene, and a significant new workload for fund managers and analysts trying to determine true company values and optimum portfolio weightings.

Some may be watching the famously optimistic behaviour of investors who are easily attracted by “popular” securities. As proponents of green investment promote “nice” companies on the basis of superior business conduct and reported good returns, enthusiastic investors are likely to open their chequebooks. The process is infectious: popular companies, for a time at least, tend to become more popular.

This does wonders for share prices — but not necessarily for the value embedded in those companies (and it is impossible here not to be reminded of the travails of high-tech stocks). The brows of many accountants are furrowed over this question, for the activities of green companies may require a new kind of financial control and reporting.

Academic studies have shown that in many companies accountants play a relatively small role in the control of environmental costs. For example, managers, rather than accountants,

**The potential long-term bottom-line effects of such investment are immense, and accountants understandably see a role for themselves in planning strategies to deal with the environmental consequences of production.**

are likely to make decisions about spending on, say, rectifying pollution caused by manufacturing processes. Yet the potential long-term bottom-line effects of such investment are immense, and accountants understandably see a role for themselves in planning strategies to deal with the environmental consequences of production.

In a recent issue of Australian Accounting Review, Professor Lee Parker of the University of Adelaide identified five groups of environmental costs, the imperfect measurement of which has implications for company value. These costs range from the highly visible “front-of-pipe” outlays and “end-of-pipe” costs such as clean-up and disposal, to compliance costs, voluntary “beyond-compliance” costs and contingent costs which may include possible legal claims and losses from consumer reactions.

Some of these costs are difficult to measure or anticipate, and yet information about them could be vitally important to the long-term worth of a company. Parker says that “cost is arguably the language of business, and is a potentially powerful management motivator, offering the prospect of advancing the incorporation of environmental variables into mainstream management thinking and decision-making”. Green-sector investors may need to listen carefully to what the accountants are saying.