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BEST PRACTICE IN PORTFOLIO MANAGEMENT: SOCIALLY RESPONSIBLE INVESTING COMES OF AGE

Socially Responsible Investing (SRI) has for decades remained on the fringe of strategic money management, routinely battling the perception that prioritizing an ethical or social focus requires sacrificing significant returns. The recent freefall of markets and business morality, however, has triggered a greater awareness of correlations between company performance, integrity and transparency – an interdependence that highlights the nature and high potential of an evolved form of SRI.

While 40 years ago, the nascent industry was content to label investments in black and white via negative screening, the current environment makes clear that SRI is a complex web of research and individual preferences. Global issues such as corporate fraud, opacity in the financial sector and delays in addressing climate change spotlight the importance of sound, forward-looking business practices. Simply put, good management with a moral compass and a long term view reduces investor liability – a key component to growing capital.

With these realities in play, SRI is on the cusp of its next iteration. The screening approach of old is steadily transforming into a concept based more on opportunity than avoidance. Decisions that are founded on research examining ethical management, industry disruption and fundamental company strength are proving to be both financially and socially rewarding.

Gradual acceptance of this transition is reflected by an influx of mainstream funds into SRI. As one indicator, a recent article in the Wall Street Journal noted a jump in SRI among retirement plans: “more workers are trying to align their personal values and their retirement savings by opting for socially responsible investments in their 401(k) plans...many younger workers and

mainstream investors are demanding them as options in their retirement accounts -- especially so-called green funds.”ⁱ

To further advance the practice, the industry must embrace its shifting role. Investors must understand and communicate more about their priorities, and advisors must tailor their work accordingly through individualized portfolio construction – an approach that requires diligent research, constancy, and a willingness to emphasize individual needs over the allure of mass produced mutual fund alternatives.

Stretching the roots of SRI

A focus on substantive investment opportunities is a significant shift from the earlier days of SRI. The practice was originally driven by religious communities looking to avoid “sinful” industries such as tobacco and military manufacturing, and anti-war activists supported that outlook as part of the protest against U.S. involvement in Vietnam.

The 1980s provided a new dimension and increased following as anti-apartheid sentiment led to divestment from South Africa. A youth movement, legislative action, and the staggering amount of money at stake brought into focus the power of avoiding certain industries.

Investment firms took their cue to capitalize on the momentum. The potential of attracting the large inflows of capital spurred on by divestment was clear, and it validated the idea that a service could be established to cater to socially-minded clients.

The foothold gained during this time period endured beyond any one specific social issue. According to a 1995 Dow Jones article, “Despite predictions that the end of apartheid in South Africa would lead to the demise of socially responsible investing, three out of four U.S. money managers who handled investments for clients opposing apartheid continue to manage responsibly invested portfolios.”ⁱⁱ

The seeds of modern SRI were further nurtured by a team of accidental participants focused on employee advocacy. In 1984, Milton Moskowitz and Robert Levering published their first analysis of *The 100 Best Companies to Work for in America* to highlight ethical management best practices. The list was compiled without regard to strong financial performance, but it led SRI enthusiasts to wonder if a connection between ethics and success could be sourced from the work.

Indeed, a study conducted in 2009 followed the 100 Best Companies list from 1984-2005 and determined that “the portfolio outperformed industry- and characteristics-matched benchmarks, and...the Best Companies also exhibited significantly more positive earnings surprises and stronger earnings announcement returns.”ⁱⁱⁱ

This close correlation between performance and ethics issued a powerful message against the general perception that SRI necessitated eliminating the most promising investments. The idea

began to form that companies that behave ethically can be profitable, which unleashed a new wave of SRI. By identifying the elements of a strong company and sustainable performance, the practice moved a theoretical step from simple avoidance and towards productive investing.

Ethics underscored

Theory met practice when the junk bond market collapsed in the early 1990s and loose threads began to connect unethical practices and underperformance – or, in this case, widespread losses amidst scandal that was typified by the downfall of Drexel Burnham Lambert. As the New York Times reported in 1990s, “With Drexel's bonds, smaller companies that never before could have obtained financing were able to make bids for some of America's largest corporations...[Its bankruptcy] marked the demise of a firm that seemed to symbolize the fast-money era on Wall Street.”^{iv}

The event sparked an economic tumble that reflects elements of today’s much more pronounced global market volatility. It was an early indicator of the importance of solid moral ground and brought additional attention to the notion of social responsibility.

By the end of the decade, attempts were being made to construct models and measurements around the impact of socially responsible behavior on performance. Sloan Management Review, for example, had this to say about conducting audits to gauge a company’s ethical operating environment:

The premise behind social responsibility audits is that responsibility pays off handsomely in profitability and productivity. This premise can, in fact, be calculated in monetary terms by incorporating costs buried in overhead, turnover rates, insurance costs, regulatory costs, and in other non-value-added expenses...Companies that do not pollute are not fined and do not pay the associated legal fees; that is a cost savings. Companies that treat their employees with respect...avoid the costs of absenteeism, turnover, and other forms of lost productivity.^v

The desire to actively encourage companies to integrate social awareness into business was a shift from merely avoiding ethically questionable companies. It was the start of a new period of discovery and disruption for SRI, and it called for closer examination of sectors and enterprises that acknowledged the need for moral direction.

Since that realization, the lines around sin stocks have blurred. Once “safe” investments such as financial services are now avoided, while previously reviled industries like nuclear power are beginning to get a second look in some social investment circles. Fannie Mae serves as prime case study for the deceptive appeal of financial stocks. Heralded as one of the most socially responsible companies by Business Ethics Magazine from 2000-2004, the lender was in fact built on a model of irresponsible management that would soon cripple the housing industry. The company was at that time lauded for financing over \$240 billion in home mortgages for 1.6

million minority first-time home buyers,^{vi} yet little thought was given to how leverage was employed to achieve this feat. In truth, those mortgages were sitting on the weakest of foundations: the product was among the most socially irresponsible in modern financial history.

The end result came in 2008 with Fannie Mae's bankruptcy and a ripple effect that will be felt for years (if not decades) to come. It served as a stark reminder that identifying social responsibility requires a long look under the hood of every enterprise; investors cannot be satisfied by outward-facing initiatives that lack fundamental strength.

At the same time, some previously avoided industries are being revealed as positive forces with the potential to improve quality of living. Nuclear energy is gaining some recognition as a possible long-term solution for cleaner power in an era of global warming, and genetically modified crop producers that are viewed by some as ethically unsound are being considered as a tool to ease famine in fast-growing developing nations.

By widening its breadth of options in this manner and steering away from black and white decisions, SRI is decreasing its dependence on simplistic screening and graduating to a more complex investment mosaic.

Even so, the struggle persists to advance the practice. In 2007, the New York Times wrote that "although socially responsible investments have grown substantially over the last 10 years, they still represent a small part of the world of investments under professional management: 9.4 percent..."^{vii}

Of course the world has changed since 2007. The financial markets crumbled, a greater emphasis has been placed on climate change, and corporate "greening" has become a national – if not global – mandate. These events have conspired to elevate awareness of and investment in SRI, giving rise to the next iteration of best practices.

Model management, model returns

The consistent through-line across the decades is the difficulty of shedding screening habits that originally defined SRI to incorporate the full scope of investment principles alongside an ethical assessment of managements and operations. The current environment, however, creates the ideal playing field to bring that into vogue. The days of avoidance are giving way to individualization; examining a company's social impact, its balance sheet fundamentals, and the potential to capitalize on industry disruption are becoming the real foundation for investment.

An investor's obligation to understand the landscape of each industry and where the opportunities lie is a critical element of success that fell out of favor during the heady bull market days. Well-positioned, socially responsible companies are identifiable within the context of a sizable ideological shift, as more leaders accept their role in shaping a better world. Climate change, for example, is a nearly all-encompassing issue that did not exist 15 years ago but will have a tremendous impact on investments going forward.

As noted in a 2009 Reynders, McVeigh Insight paper, *Investment Opportunities in the Climate Change Economy*, carbon cap and trade legislation pending in the U.S. will create seismic shifts in business. “Low carbon players will gain a 10 to 50 percent cost advantage, with complex interactions...opening up clear growth opportunities for prescient investors. According to a report by the Natural Resources Defense Council (NRDC), ‘Global investment in new renewable energy installations totaled \$100 billion in 2007, up from \$15 billion in 2000 [and] renewable energy resources are spread across the United States.’”^{viii}

Additional issues such as energy and shortages of food and potable water capture the growing appeal of tailored SRI portfolios. These are challenges that effect the global population as a whole, while the externalities of the problems are historically left unaddressed by investors when the cost is borne by invisible political forces. But today’s communities are enthusiastically embracing involvement for the sake of future generations. This marks the current incarnation of SRI, as both companies and investors actively consider environmental and social issues on par with financial elements in making decisions.

The evolution is manifesting in the mainstream. Investment Adviser magazine wrote in June 2009 that “as ethical funds have evolved, they have begun to utilize 'softer' screening techniques that allow for more flexibility in terms of investment options. The perception that the choice is between an investment strategy that satisfies the conscience and [one that achieves] growth is gradually being broken down.”^{ix}

The next stage – which is already upon the market in some corners – is the full integration of investment research that blends strength of balance sheet, market position in the face of industry disruption, and social impact. This state of maturity calls into play the passion that launched SRI and the investment sensibilities that can propel long term portfolio performance.

The final iteration of SRI will materialize when it is recognized as the overarching approach to investing. There will be no socially oriented ventures or portfolios, only sound investment strategy that considers the full spectrum of relevant information. The theory holds true in practice: profitable investments take into account a company’s management approach as part of a global community that is focused on positive change. Such corporate direction limits risks, opens opportunities, and supports evolved SRI as a best practice in modern portfolio management.

About the Authors

Charlton Reynders, III, Chairman and CEO of Reynders, McVeigh Capital Management, has more than 15 years of experience in investment management and social venture investing. His passion for forward thinking investment strategy rooted in fundamentals has provided a guidepost for his success to date.

In addition to his leadership in the traditional investment management world, Chat has structured and funded public/private partnerships that have brought more than \$150 million in revenues to leading cultural institutions around the world – projects that have won numerous awards. In this vein, he has for decades produced socially-oriented IMAX films including *Dolphins*, which was produced in conjunction with the National Wildlife Federation and garnered an Academy Award nomination in 2000, and *Coral Reef Adventure*, which received the largest grant in the history of the Informal Science Division of the National Science Foundation. He currently sits on the Advisory Boards of Project Adventure and the MacGillivray Freeman Educational Foundation.

Patrick McVeigh, President and Chief Investment Officer of Reynders, McVeigh Capital Management, is widely recognized as a pioneer in bringing traditional investment management together with socially responsible investing. He was one of three original employees at Trillium Asset Management; his research was key to asset growth from startup to \$700 million.

A voice of reason and leadership within the socially responsible investing realm, Patrick has served as Managing Editor of *Investing for a Better World*, authored numerous articles on ethics and ecology, and contributed chapters to *The Social Investment Almanac* (New York: Henry Holt, 1992) and *Working Capital: The Power of Labor's Pensions* (Cornell University Press, 2001).

Since 1995, Patrick has been project manager for a series of groundbreaking studies conducted by the Social Investment Forum, tracking the growth of socially responsible investing and its implications in the investment markets. He also served on the boards of SEED: The Haitian Community Loan Fund, directing approximately \$1 million to peasant cooperatives in Haiti to create businesses; the Social Investment Forum; and the San Jose Food Co-operative.

Endnotes

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