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Good Vibes

Socially responsible investing is gaining fans…and clout

By ROBIN GOLDWYN BLUMENTHAL

CORRUPTION CAN MAKE STRANGE bedfellows. For years, "socially responsible" investors were derided by many Wall Streeters as muddle-headed leftists or hopeless do-gooders. But the tidal wave of disclosures about wrongdoing in Corporate America's executive suites and boardrooms has won this group important allies, including pension funds, unions and individual investors concerned about corporate governance. That's put a surprising amount of cash -- and clout -- in the socially responsible investment proponents' corner. Thank you, Enron, Sunbeam, Tyco and, maybe, Martha Stewart.

The big impetus is practical, not ideological. As stock prices were obliterated by blowups, bankruptcies and scandals linked to bad behavior by greedy executives, oblivious auditors and clueless directors, many investors discovered that corporate ethics -- or the lack thereof -- can be important to their personal financial health. That's elevated the level of scrutiny from shareholders. "Corporate irresponsibility did for social investing what Watergate did for politics," says Cliff Feigenbaum, co-author of the book *Investing with Your Values; Making Money and Making a Difference*.

Comments Barbara Krumsiek, CEO of the Calvert Group, which runs 30 socially responsible funds with $8.7 billion under management: "The new conventional wisdom is going to be that it doesn't just matter how a company's stock price moves, but it matters, too, how it conducts its business." While outfits like Calvert historically have concentrated on avoiding securities linked to tobacco, alcohol, gambling, environmentally harmful or other "sinful" pursuits, the Bethesda, Md.-based investment firm now focuses just as much on staying away from companies, such as **Qwest Communications**, WorldCom and **Rite Aid,** that melted down because of questionable accounting or ethics.

Despite the bear market, assets in all socially screened portfolios surged 36%, to $2.03 trillion, in 2001, from $1.49 trillion in 1999, according to the latest available data from the Social Investment Forum, an industry group that tracks such investments every two years. Portfolios that either use a social screen, or do shareholder advocacy or community investing totaled $2.34 trillion in 2001, nearly 12% of the $19.9 trillion in total assets under management in the U.S. as of that year. The Forum defines socially responsible portfolios as those that work for some form of investing in local communities or that employ at least one screen to keep out what it views as socially unacceptable industries.

Randy Jones

In 2002, socially responsible mutual funds had a net inflow of $1.5 billion, while U.S. diversified equity funds had a nearly $10.5 billion outflow, according to Lipper, the fund-tracking unit of Reuters. In this year's first quarter, such funds pulled in a net $185.3 million, compared with a net outflow of $13.2 billion for all diversified U.S. equity funds.

Given the trend, it's no surprise that asset managers from State Street to Gabelli to Smith Barney to Vanguard offer a socially responsible investment (a/k/a SRI) option and that 14 indexes around the world serve as templates for this type of investing. The best-known, the Domini 400 Social Index, screens large-cap companies from the S&P 500 against nearly 100 social and environmental criteria. It was formulated in 1990 by KLD Research Analytics and social investing doyenne Amy Domini, the head of Domini Social Investments, a New York concern that oversees about $1.3 billion in investments.

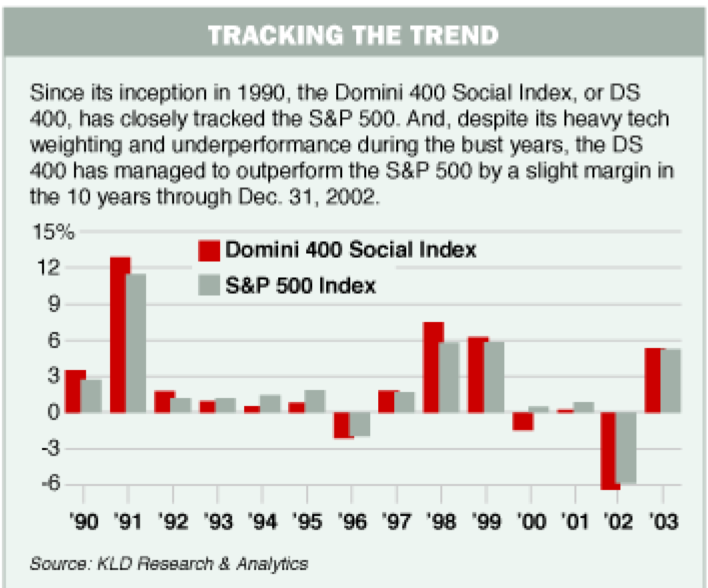
Although the more than 200 socially responsible mutual funds had about $153 billion in assets as of 2001, that's just a fraction of the $6 trillion currently invested in U.S. mutual funds. But assets in separately managed SRI accounts for institutions and individuals surged to $1.87 trillion in 2001, from $1.34 trillion in 1999. And the trend appears to be continuing.

"Where 10 or 12 years ago, institutional investors were very careful to say, 'We pay attention to corporate governance but not social investing,' now there's no distinction," says Peter Kinder, president of KLD Research Analytics. "The trend is strongly toward incorporating the issues that social investors have been concerned about for 30 years into mainstream securities analysis," says Kinder. This, he maintains, is a way of "looking at the entities that are supposed to be making money for you in a nuanced way -- the way Benjamin Graham said you should look at railroads in the 1930s."

In addition, social investing's reliance on "independent" research -- or at least research that doesn't bear the tarnish of Wall Street's big investment banks and their potential conflicts of interest, is in tune with the times. And, in an effort to try to bring more transparency and, perhaps, support for corporate reform, activists such as Domini and California State Treasurer Philip Angelides spearheaded a proposal, approved this year by the SEC, to get mutual funds to disclose their proxy votes. An oft-repeated criticism of funds is that because many of their parent companies earn fees for running 401(k) and other pension plans for corporations, the funds tend to vote in line with what managements want. The rule takes effect next year.

MOREOVER, DESPITE HAVING A smaller investable universe and thus increased risk, as well as higher fees for the research, many SRI funds have rewarded their shareholders quite nicely.

In fact, the Domini 400 index had a total return of 9.99% in the decade ended Dec. 31, 2002, versus 9.35% for the S&P 500, although its performance in the past couple of years has been somewhat lackluster because of its relatively heavy weighting in tech stocks.



Some portfolio chiefs argue that using social or environmental research helps them make better decisions, by red-flagging potentially costly dangers, such as asbestos liability. "If you can find factors that definitely have an impact on enterprise value that are not recognized by the market, you should outperform," says Diane Keefe, who manages four-year-old **Pax World High Yield** Fund, a $54 million bond fund that's up 10% this year, slightly lagging behind its peers because of its emphasis on higher-quality issues. Its three-year return outperformed its peers by 2%, according to Morningstar. Though Keefe primarily uses financial analysis to pick bonds she thinks are due for an upgrade, her mandate, like that of all Pax World funds, is to find companies whose products and services improve the quality of life. Among Keefe's current favorite issuers: **Dean Foods**, **Saks** and Telecorp PCS, an affiliate of AT&T Wireless.

Jonathan Naimon, president and co-founder of Light Green Advisors, considers environmental performance a good indicator for risk -- market, operational and reputational -- and stock-market performance. "Companies that meet our ecometric screening are better managed and have fewer long-term liabilities than their peers," says Naimon, a former head of the environmental program at the Investor Research Responsibility Center, an independent social-research outfit. "Environmental accounting is a proxy for a company's overall accounting," adds the money manager, whose Eco Performance Portfolio of 80 stocks, including **Boise Cascade**, **Placer Dome** and **Calpine**, was up 3.46% in the 12 months through June 30, versus 0.25% for the S&P.

Indeed, attention to environmental and corporate-governance concerns helped some social investors get out of stocks such as Enron early, or avoid them altogether.

Joan Bavaria, president of 20-year-old Trillium Asset Management, which has $650 million under management, recalls a meeting with Enron executives two years before the energy trader blew up. Alarms went off, she says, when "they cautioned us about not asking too many questions about how they did business in foreign lands." Though she didn't sell the stock immediately, "we didn't stay around for two minutes when we heard there were possible indictments." She dumped the shares at $30, well before they became worthless.

Dan Boone, who runs the Calvert Social Investment Fund Equity Portfolio, thinks there's "a huge overlap" in the universes of high-quality companies and socially screened investments. Combining fundamental analysis from his firm, Atlanta Capital Management, an investment-management firm with $6.9 billion under management based in Atlanta that is subadviser to Calvert Social Equity, and a social-research screen from Calvert helped him "avoid all the bankruptcies and all the really significant blowups." One of the biggest was Tyco, which Atlanta Capital had picked up in 1994 at $5 a share. After it failed Calvert's social screen, the large-cap growth-fund manager sold his position from May 2000 through that December at an average price of about 56 and change.

Other companies that Boone happily avoided were Global Crossing, WorldCom, Adelphia Communications and HealthSouth. Though HealthSouth seemed sound both socially and fundamentally, he says he passed on it, in part because he had doubts about the quality of its management.

Table: Costs and Rewards[1]

Right now, Boone favors health-care concerns such as **Pfizer** and **Medtronic**, and natural-gas names such as **EOG Resources** and **Questar**. He has been significantly overweight tech for the past nine months, picking up **Cisco**, a cash-rich leader in Internet-equipment manufacturing whose stock has been severely pummeled. He also likes computer maker **Dell** and advertising giant **Omnicom**. While Boone strongly objected to options awards at Dell, he finds that Chairman Michael Dell's ownership of 300 million shares "aligns his economic interests with mine." Omnicom's top officers, he observes, recently decided to give up bonuses, in "sharp contrast" with what happened at its major competitor, **Interpublic**.

One way to judge economic alignment is through attention to a company's corporate governance practices. A recent paper published in the Quarterly Journal of Economics reinforces an argument often made by investor Warren Buffett: Corporate governance affects shareholder value. The authors, researchers from Harvard and the Wharton School, constructed a "governance index" to gauge the level of shareholder rights at about 1,500 companies, from September 1990 to December 1999. They found that those with the strongest shareholder rights produced returns 8.5% higher than those with the weakest.

"We were completely shocked" by the results, says Andrew Metrick, one of the authors, an associate professor of finance at the Wharton School. Among the governance issues they tracked were the companies' willingness to provide golden parachutes for departing executives or to create poison pills to thwart takeovers that might result in the ouster of existing management.

Metrick cautions that it's difficult to determine whether "good" governance rules are symptomatic of good companies, or whether the changes made by these companies during the 1990s actually caused their outsized returns. But Metrick, who has received indications of interest from hedge-fund managers who might consider using his methodology in selecting stocks, says categorically: "If I had a billion dollars I would form an activist fund and buy the bad guys and pressure them to change. Then, I would have the good guys."

THAT'S PRECISELY THE STRATEGY that was employed in the Lens fund by long-time shareholder activist Robert Monks and Nell Minow, who founded the Corporate Library, a research firm that now rates companies based on corporate governance. "There is such a thing as governance risk, though few people know how to measure it," Minow says. The Lens fund, a concentrated portfolio with a three-to-five-year investment horizon that targeted undervalued companies such as **Sears** and sought to improve performance through shareholder activism, largely outpaced the S&P 500 from the fund's founding in 1992 until it was closed in 2000.

Minow says the "singlemost important theme we heard from bad companies was that they didn't want to hear bad news." Other telltale signs: a lot of noncore assets and somnolent boards. Monks, who's now affiliated with Milberg Weiss, the class-action law firm, says that "the cancer today that's really destroying the public trust is [excessive] executive compensation." He contends outlandish pay packages indicate that managers are more interested in lining their pockets than doing what's best for their companies.

John Adams, who runs $140 million in SRI accounts at Smith Barney, says in nearly all of the blowups of the past few years, "you've seen management provided very generous incentives to have phenomenal earnings growth." Focusing on such issues has helped big pension managers such as the California Public Employees' Retirement System, or Calpers, with $125 billion under management, to effect change and increase shareholder value at companies. "We don't have a choice to exit the market," says State Treasurer Angelides, a Calpers trustee.

A study by Wilshire Associates conducted in 1994 found that stock prices of companies that Calpers targeted for governance reform trailed the S&P 500 by an average 66% in the five years prior to Calpers' engagement, but outstripped the benchmark by 41% in the five years after it.

One peril that confronts socially responsible investors is that companies' practices often look a lot better on paper than they do in reality. Naimon of Light Green Advisors says that though some steel makers have signed codes of conduct that social investors like, they continue to make their products the old-fashioned way, by burning coke. **Nucor**, however, uses electric arc furnaces that Naimon views as more environmentally friendly. "If you can find a way to make money off it, we triple-weight it as a factor" in scoring considerations.

In addition, defining just what is socially responsible is far from an exact science. Kim Gluck, a member of a team that manages $1.7 billion in core and SRI large-cap money at State Street Global Advisers, says that, in selecting stocks, "we're looking for companies with some kind of competitive advantage we think would last for a long time." Some of her top picks: **Citigroup**, **General Electric** and **Wal-Mart**, not names that some would expect to find in a socially responsible portfolio.

Indeed, KLD deleted Wal-Mart from its Domini 400 index in May 2001, and the Domini Social Equity Fund sold its shares in the retailer, citing "sweatshop conditions" at overseas factories. But "people don't have to buy into my exact value system," Amy Domini says, noting that she holds at least one issue that other socially responsible investors might find questionable: **McDonald's**, which got a top rating in a stakeholder analysis of fast-food chains.

Jerome Dodson, founder and president of Parnassus Investments, which has $880 million under management, is among those who find McDonald's (and Coca-Cola) inimical to the socially responsible cause, simply because "we don't like the impact of the product" on the environment and on consumers' health. Dodson, who is very bearish right now, with nearly 70% in cash, has trounced the S&P 500 in the past five years, with the Equity Income Fund putting up nearly 10% returns.

Even a name such as **ExxonMobil** -- infamous for the Exxon Valdez oil spill in Alaska a decade-and-a-half ago -- shows up on some SRI outfits' radar screens. State Street's Gluck tells clients that "there is beauty in owning some of these companies" because every year "you get to vote proxies" and potentially effect change.

Indeed, 2003 is shaping up as a bang-up year for proxy voting. One of the biggest issues is expensing of stock options, says Carol Bowie, director of governance research at IRRC, which set the standard for social research. This year, IRRC has tallied more than 1,053 shareholder proposals -- 771 of them on governance -- among the 2,000 companies it examines, up from 802 proposals last year, 529 of them on governance.

Accustomed to shareholders' ignoring proxy material, many companies are seeing record-breaking voting, including an 80% vote at **Avon** mandating the annual election of directors. "It means that some of the really large institutional investors are willing to vote against management because they think it's in the long-term interest of shareholder value," says Steve Lippman, senior social research analyst at Trillium.

Few of these efforts bear immediate fruit -- witness dissident shareholders' recent unsuccessful effort to oust the management of **El Paso Corp.** -- but they do put pressure on companies to eventually reform some of their practices. Just last week, Wal-Mart, which had been prodded by activists including the Pride Foundation, decided to expand its anti-bias policy to explicitly include gays and lesbians.

Some managers obviously are paying attention. Chief Executive Jim Rogers of **Cinergy**, a major electric utility based in Cincinnati, dedicated its annual report to corporate governance. And hoping to hear new points of view, Cinergy's board invited more than 15 CEOs from other companies and regulators to speak about how they approach the power industry.

"Historically, boardrooms have been very polite places," Rogers says. "My job is to create an environment where even really smart people feel comfortable asking the tough questions." That approach could be paying off. Cinergy stock recently hit a 52-week high of $38.75.