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SRI TO ESG: FROM PROTEST TO PROCESS

BY D.J. SHAUGHNESSY, CFA, VICE PRESIDENT

In November 1962, the United Nations General Assembly passed a non-binding resolution that called for economic and other sanctions on South Africa in protest of apartheid. However, it wasn't until 1986 that the US Congress passed the *Comprehensive Anti-Apartheid Act*, which banned new US investment in South Africa and severely limited trade. The actions of Congress in 1986 were compelled by a groundswell of opposition to apartheid that had been building for two decades. During that time, the drumbeat for divestment and sanctions was growing louder in the halls of universities and unions. Endowments and pension plans were the first to adopt the campaign to divest companies doing business in South Africa. While the ultimate efficacy of divestment is open to debate, the result of the broader anti-apartheid movement itself is undeniable: the playbook for change had been rewritten. The catalyst for quick, decisive action was to lobby business, not Congress.

Similar campaigns for divestment have been replayed in response to crises in Sudan and Burma (Myanmar), as well as across a broad array of issues including tobacco, child labor, equal opportunity employment, and carbon emissions. Socially Responsible Investing (SRI) became the generic label for screening and excluding companies from consideration. For institutional and individual investors with strong beliefs and a well-defined mission, avoiding companies that operate counter to that mission is a logical and reasoned choice. However, with an ever-expanding list of SRI issues, investing in a broadly defined SRI portfolio meant excluding a growing portion of the investable universe, potentially damaging performance. While the true impact on performance is difficult to measure, the popular perception was that investors were faced with the choice of doing good or doing well.

The SRI movement has clearly advanced despite the obstacles. According to a 2012 report from *The Forum for Sustainable and Responsible Investment*, the amount of managed assets adhering to SRI strategies increased 486% from 1995 – 2012. However, the impact of this movement has been more evolutionary than revolutionary. Above and beyond any specific issue, perhaps the greatest impact has been on the demand for transparency. In turn, the increase in transparency has opened the door to the next generation of SRI: Environmental, Social and Governance, or ESG investing.

What is ESG investing?

In short, ESG investing goes beyond the financial statements by systematically incorporating other measureable factors in the analysis. These factors include issues related to the environment such as pollution and carbon emissions, social issues like equal opportunity employment and safety, and governance concerns like executive compensation and shareholder rights. The manner in which these issues are evaluated is what differentiates ESG from the traditional SRI. In an ESG framework, the objective is to quantitatively evaluate companies relative to their peers. For example, if one were to analyze energy exploration and production companies, a framework can be created that ranks companies on various ESG criteria:

- Does management have a good safety record along with policies that minimize the environmental impact?
- Where does the company operate: in lower-risk, onshore regions with a strong regulatory presence or in higher-risk offshore areas with greater biodiversity impact?
- To what extent does management monitor and report these issues to shareholders?

All of these factors will have an impact on the sustainability of the business, and in most cases, the profitability of the company. While many of these issues have been considered to a degree in the past, the focus of ESG is to assign a score to measure these concerns and incorporate this analysis into the investment decision. In this manner, investors are not removing companies from the investable universe at the start. Rather, the analysis incorporates the relevant ESG factors as part of a stock selection process, with emphasis placed on those companies who score higher on specific issues.

What is driving ESG investing?

In every marketplace, the forces of supply and demand will tend to converge. The investment management industry is no different. Both individual and institutional investors increasingly want to reflect ESG issues in their portfolios. They are demanding more accountability and transparency. At the same time, companies are sharpening their focus on ESG issues because it affects their bottom line. Companies need to adapt to the challenges of population growth, resource scarcity, as well as regulatory and environmental constraints. In order to attract shareholders, companies have an incentive to voluntarily supply this information, while third-party data providers such as MSCI, FactSet and Bloomberg are eagerly aggregating and distributing ESG data.

Finally, investment management firms have an incentive to integrate ESG factors into their research process, even if their clients don't explicitly demand this analysis. There is a growing body of industry and academic research, including studies from Goldman Sachs and Harvard Business School, that suggests companies that score higher in ESG ratings tend to outperform their peers, both in terms of stock performance and financial measures. In effect, the ESG approach shifts the focus away from excluding companies that do "bad," to including companies that do "good." In today's investment management world, being a thoughtful fiduciary now includes having a solid understanding of a company's ESG issues as well as its management strength, financial results and strategic plan.

Grounded in protest and the desire to create change, the SRI movement raised the bar for corporate accountability and transparency through a policy of exclusion. The evolution of this movement to actively include the measurement of these environmental, social and governance issues in the investment process is gaining recognition and acceptance. By focusing on process rather than protest, investment managers can strive to bridge the gap between stockholders and stakeholders, between doing good and doing well.

2014 MARKET DIARY		
	6/30/14	**YTD Change***
Dow Jones Industrials	16,826.60	2.67 %
NASDAQ	4,408.18	6.19 %
S&P 500	1,960.23	7.12 %
Russell 2000	1,192.96	3.18 %
10-Year Treasury Bond Yield	2.53 %	- 50 b.p.