Doing well while doing good: The case for positive screening in SRI investing

By: Britton C. Smith, CFA, Portfolio Manager I Santa Barbara Asset Management EcoLogic Equity Strategy

Socially Responsible Investment (SRI)[1] is a multi-trillion dollar,[2,3] premium priced[4] asset class growing at many times the rate of the overall market. Wider adoption of SRI is constrained by the perception (real or imagined) of negative relative performance. Investors believe they are faced with a choice between doing good ethically and doing well financially. This perception is a.o. due to the pervasive use of negative screening. By utilizing positive screening, SRI managers can not only rid themselves of the negative alpha stigma, but also can be more effective in maximizing their ethical goals.

Doing well

If the SRI market has such attractive characteristics, then why is it viewed through lenses ranging from suspicion to outright disdain? First, the investment management industry is guided by fiduciary law, which (until this decade in Europe and still currently in the US) requires asset managers to maximize returns, period. There is no legally recognized value for investing ethically. In fact, if doing so leads to consistent underperformance, there is potential negative legal exposure.[5] Second, despite recent meta-studies suggesting neutral to positive association of

1 The practice of incorporating ethics into investment decisions goes by many names. In Europe, it is generally referred to as socially responsible investing (SRI). In the US, we also used to call it SRI, but now we generally refer to it as environmental, social, and governance investing (ESG) in order to distinguish the supposedly more modern incarnation from its predecessor. To illustrate its continued evolution, there are a growing number who refer to it as sustainable investing (SI). For purposes of this writing, I will use «SRI« to describe all iterations.

2 Eurosif, 2008 European SRI Study

3 Social Investment Forum, 2007 Report on Socially Responsible Investing Trends in the United States

4 Robeco and Booz & Co, Responsible Investing: a Paradigm Shift from Niche to Mainstream

5 Momentum is building in this area to redefine fiduciary responsibility to, at a minimum, allow inclusion of SRI criteria in making allocation decisions, beginning with passage of the UK's SRI pension fund regulations in 2000 (soon thereafter followed by many European countries), the Freshfields Report in 2005, and the launch of the UN Principles for Responsible Investment in 2006.

6 Orlitzky, Schmidt and Rynes (2003), Corporate Social and Financial Performance: A Meta-analysis

7 UNEP FI Asset Management Group and Mercer (2007), Demystifying Responsible Investment Performance: A Review of Key Academic and Broker Research on ESG Factors

SRI and performance,[6,7] in practice the findings have yet to materialize. Aggregate SRI industry performance data are not available. However, in a 2008 European survey,[8] 46% of wealth managers and 39% of high net worth investors cited performance concerns as the reason for not demanding sustainable investments. A search on the Social Investment Forum's mutual fund performance web site revealed that 69% of large cap equity managers underperformed the Russell 1000 benchmark over the last five years.[9] Negative relative performance, real or perceived, remains an obstacle.

Why then does theoretic research suggest that SRI investing should lead to outperformance, when observation argues against that thesis? In a recent study by Statman and Glushkov, the authors argue that it is because most practitioners of SRI are not properly diversified.[10] The majority of SRI investing is accomplished, at least in part, through negative screening. This is the practice of boycotting investment in companies or industries that engage in business deemed unethical. In the case of an environmentally focused fund, this might mean avoiding investments in resource extraction or energy production industries. The broader the ethical net one tries to cast, the more areas will not be eligible for investment.

Another search of the large cap equity funds on the Social Investment Forum website shows that 94% of strategies have an outright «no investment« policy on at least one industry. 89% of strategies allow no investment in alcohol, 94% in tobacco, 83% in gambling, 61% in defense/weapons, and 50% in none of the four.[9] Eurosif estimates about 60% of all SRI AUM is managed with strategies including some form of exclusion.[2] This means that for most SRI investors, their universe is constrained before any security analysis begins. Modern Portfolio Theory dictates that restricting your investment universe is disadvantageous for beating the market. Imagine a conventional portfolio manager claiming to offer long term outperformance without being able to invest in energy, utilities or materials – not impossible, but very difficult.

Another example of the pitfalls of negative screening is thematic funds. These funds take negative screening to an extreme, reducing the investment universe from companies that are not egregiously unethical to include only those that are shining examples of ethical behavior. Take, for example, the goal of limiting carbon emissions. Traditional negative screening would preclude investment in carbon-intensive industries. A thematic fund might limit its investment universe exclusively to clean energy companies. While this might be effective in incentivizing low carbon-intensity behavior, the attractiveness of alternative energy is dependent on the marginal cost of energy production. As a result, the fund will have an even higher beta than the energy sector. This may be useful as a small allocation of a larger portfolio or for those who try to time the market, but would hardly serve as a substitute for a conventionally managed portfolio.

Positive screening can alleviate these diversification constraints. It entails ranking your entire investment universe on a measure of your ethical criteria, comparing companies within their peer group, and selecting investments from those that meet a minimum threshold. Positive screening relies on gathering comparable data across the entire investment universe. Until recently, this would have been extraordinarily labor-intensive, but in the past few years, a number of data providers have begun to offer such data. For example, you might rank the entire S&P 500 based on intensity of carbon emissions per dollar of revenue. Then, you could limit your universe to companies that are among the top half for this measure in their peer group. This allows SRI managers to select from industries that would traditionally be excluded from their universe. By ranking the companies and choosing from those that act most according to the desired ethical goal, managers can demonstrate that they are indeed investing to incentivize an underlying ethic.

Doing good

Proponents of negative screening will argue that allocating capital to unethical companies works against their goal of incentivizing ethical behavior. I suggest that by engaging in negative screening, SRI investors are actually ignoring their greatest opportunity. By avoiding investment in specific industries, SRI investors have no influence on the very behavior they are trying to change. Assume again your goal is to minimize global carbon emissions. In 2006, global CO_2 emissions were 28.4 billions metric tons.[11] Last year, the seven integrated oil and gas companies in the S&P 500 accounted for 15% of that amount.[12] Traditional negative

8 Eurosif, 2008 High Net Worth Individuals & Sustainable Investment
9 http://www.socialinvest.org/resources/mfpc/, as of 6/30/09
10 Statman and Glushkov, The Wages of Social Responsibility, Financial Analysts Journal, Volume 65, Number 4

11 US Department of Energy, Carbon Dioxide Information Analysis Center
12 Risk Metrics Group, Carbon Beta Ratings and Emissions data. Total emissions defined as the sum of direct carbon emissions (sources owned or controlled by the company), electricity indirect carbon emissions (from the generation of purchased electricity), and other indirect carbon emissions (consequence of the activities of the company, excluding sources owned or controlled).

screening would without doubt preclude an investment in this industry.

As a proponent of positive screening, I view this as a vast wasted opportunity. Consider the following illustration of the scope of this lost opportunity. First, I construct a simple positive screen based on carbon intensity (calculated as total carbon emissions normalized by revenue). Next, I choose a threshold required to pass the screen. For this example, I use the industry mean carbon intensity of 3.77 – meaning that in order to pass the positive screen, a company must score below 3.77. Finally, I compare individual company results to the threshold and limit the universe to those companies that pass the screen. The results are shown in Table 1.

Table 1 | Carbon intensity of the integrated oil and gas industry

Company	2008 Rev (USDb)	Carbon Emissions (million metric tons CO2e)	Carbon Intensity (CO2/$)
Chevron	273	1,105	4.05
ConocoPhillips	246	862	3.50
Exxon Mobil	477	1,812	3.80
Hess	41	145	3.53
Marathon	79	316	4.03
Murphy	28	104	3.77
Occidental	24	59	2.40
		Median	3.77

Source: Yahoo Finance, Risk Metrics Group Carbon Beta Ratings and Emissions data

With a carbon intensity of 3.80, Exxon Mobil just misses the cut. However, if they were to reduce their emissions by just 1%, they would pass the screen. If Exxon could be convinced to reduce their CO2 impact by 1%, it would be the equivalent of taking over 11 million cars off of US highways.[13] It would also be the equivalent of replacing 5 coal burning power plants with over 8,000 1-megawatt windmills,[14,15] (eat your heart out T. Boone Pickens).

Now imagine that you are the CIO of all SRI investments globally, having USD6 trillion of capital to allocate[2,3]. A 1% allocation of your fund would be USD60b, 17% of Exxon's market capitalization or almost equal to their last four years of capital expenditures.[16] You think they might listen? How about if you threatened to offer that USD60b to PetroChina to do the same thing?

Further, positive screening sets a dynamic upward-moving hurdle. Rewarding companies to act ethically incentivizes ethical behavior. If this generates alpha, other companies will also behave ethically. If the example of ethical behavior generates enough alpha to become widely apparent, then all competitors will mimic it, and that behavior no longer differentiates among competitors. The field of play is again level, but at a higher ethical plane.

Thirty years ago, active recycling was an abstract concept to most to large multi-national companies. Today, I would be very surprised if any company in the S&P 500 does not have a company wide recycling plan. Returning to our hypothetical goal of reducing in carbon emissions, before a company can become more carbon-efficient they must first measure their carbon output.

Currently only 222 companies in the S&P 500 conduct an annual inventory of greenhouse gas (GHG) emissions from operations and publicly report the results[12]. Measuring and reporting carbon emissions is, therefore, a differentiating factor. A simple, positive SRI screen might limit the investment universe to those companies that meet this criterion. If demonstrating carbon emission reduction leads to a competitive advantage, then eventually all companies will inventory and report GHG emissions, and the differentiation of this characteristic ceases. While your ultimate ethical goal may not yet be achieved, the entire investment universe is further along on that path, society having realized the benefit of this evolution. All companies must now differentiate on new, more stringent criteria.

The bar is continually raised as this iteration continues.

Conclusion

The goal of SRI investing is to incentivize ethical behavior. The more capital invested under SRI mandates, the greater the incentive. To be effective in gathering a larger share of the investment capital, SRI strategies need to generate performance comparable to mainstream strategies. SRI managers need to rid themselves of the notion that trading performance for the ethical high ground is acceptable. Research suggests that there is indeed alpha to be captured from SRI, but concentration inherent in negative screening negates the oppor-

13 Estimate based on data from Environmental Defense, Global Warming on the Road: The Climate Impact of America's Automobiles.

14 Estimate based on data from the US Energy Information Administration

15 Wikipedia: Since wind speed is not constant, a wind farm's annual energy production is never as much as the sum of the generator nameplate ratings multiplied by the total hours in a year. The ratio of actual productivity in a year to this theoretical maximum is called the capacity factor. Typical capacity factors are 20–40%, with values at the upper end of the range in particularly favorable sites. For example, a 1MW turbine with a capacity factor of 35% will produce $1 \times 0.35 \times 24 \times 365 = 3{,}066$ MWh, averaging to 0.35 MW.

16 Thomson Baseline 8/9/09

tunity. Utilizing positive screening as an integrated step within security analysis allows for better diversification. Additionally, engaging in, rather than ignoring, unethical industries maximizes the ethical impact of SRI.

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