

# Socially Responsible (ESG) Investing

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## 1 Socially Responsible Investing (SRI)

What is it?

*“Socially responsible investing (SRI), or social investment, also known as sustainable, socially conscious, “green” or ethical investing, is any investment strategy which seeks to consider both financial return and social/environmental good to bring about social change regarded as positive by proponents.*

*Recently, it has also become known as “sustainable investing” or “responsible investing”. There is also a subset of SRI known as “impact investing”, devoted to the conscious creation of social impact through investment.*

*In general, socially responsible investors encourage corporate practices that they believe promote environmental stewardship, consumer protection, human rights, and racial or gender diversity. Some SRIs avoid businesses perceived to have negative social effects such as alcohol, tobacco, fast food, gambling, pornography, weapons, contraception/abortifacients/abortion, fossil fuel production or the military. The areas of concern recognized by the SRI practitioners are sometimes summarized under the heading of ESG issues: environment, social justice, and corporate governance.”*

(Wikipedia)

## 2 Introduction

*Socially Responsible Investing, or Sustainable and Responsible Investing has moved from a niche investment strategy to the mainstream. With a wide definition, SRI is any investment strategy which pursues additional goals to a pure financial one. Typically, the additional goal is a social objective, for example environmental protection.*

Issues related to SRI has become central to any financial investor.

To understand where it is coming from, let us discuss a related concept, *Corporate Social Responsibility*.

### 3 Corporate Social Responsibility

Business sphere. Where do corporations fit in society?

Purpose: Provide economic services (goods, utility) to citizens.

#### 3.1 Corporate governance

Many competing choices for how corporations are organized.

- cooperative governance
- partnerships
- employee-run.
- state-run
- Capitalist model: Equity-owned, management-run.

Why is the capitalist model the most common?

The capitalist model: Residual claimant are the owners of *capital*.

Most corporations: Combining labour and capital in provision of services. So why are the providers of capital (investors/financiers) the ones ending up with decision-making power?

One possibility: The most important component gets decision power.

- Expect labour-intensive firms with little physical capital to be partnerships or employee-run.
- Capital-intensive firms those where more likely to see the capitalist model.

However, not the whole story. Asymmetry here, capital easier to withhold. Lack of capital often more critical, bankruptcy can bring company down overnight. (Thomas Cook recent example).

Critical for providers of capital: information allowing the understanding of the risks involved. So, even labour-intensive firms may optimally be run using a capitalist model.

#### 3.2 Separation of ownership and control

Modern companies large, complex organization.

Structure with employees (managers) running the firm on behalf of the owners.

How to ensure that management runs the firm in the interest of owners?

Governance structures, stick (supervision) and carrot (align interests of management and owners).

- Corporate board - supervise corporation on behalf of owners.
- Remuneration of management - e.g. stock options - incentivise management to maximize stock values.
- Financial structure as a governance mechanism.
  - Equity owners run the corporation when firm is doing well.
  - Debt holders can take control and protect values when firm in trouble
- External threat – Corporate takeover market.

#### 3.3 What is Business' Social Responsibility

Economic institutions based on two key principles:

- Creation of Value
- Accountability

Key for accountability:

- Does the firm take into account the consequences of its decisions for its stakeholders? Does the firm “internalize” these consequences in decision?

Example: Pollution. Would be part of the firm's decision if there was an environmental tax (e.g. CO2 pricing). But what if there is no such tax?

Generally: To what extent do firms’ internalize *externalities*

Very hard to perfectly operationalize this notion of accountability.

Corporate Social Responsibility a “fuzzy” notion.

For example, the EU defines the social responsibility of business as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis.”

A key word here is “voluntary”, this is not imposed on corporations, it goes beyond legal obligations.

To make more concrete, three (not mutually exclusive) views of corporate social responsibility

- Is the enterprise *sustainable* in the long term?
- Does the enterprise show the *ethical behaviour* expected by its stakeholders?
- Corporate Philanthropy

### Long term sustainability.

- Well known discussion: Short termism in corporate decisions. <sup>1</sup> Are corporate decisions made to maximize next quarter earnings? Or are they maximizing the present value of *all* future cashflows?
- Broader notion of sustainability. For example – climate.

**Ethical behaviour.** Desire among stakeholders to be (or be seen as) “good people”. Taken on by the corporation (delegated philanthropy).

Challenges to delegated philanthropy

- Free Riding. Are we prepared to make individual sacrifices to limit global warming?
- Limited information. Is it possible for stakeholders to verify that claimed socially responsible policies really are so (Greenwashing)?  
Proliferation of ESG/CSR rating agencies to provide verification services.
- Weighing objectives. How to aggregate the various dimensions?

**Corporate Philanthropy** Use of corporate profits for philanthropy.

Controversial

- Is this not just marketing? (Greenwashing)
- Are managers choosing the “right” philanthropy?  
Corporate giving means tax reduction.  
Prioritizing of where tax revenues go not considered by managers choice of what to support.
- (Friedman, 1970): Give the shareholders the money and let them decide what to do with it.

**Readings** This discussion follows (Tirole, 2017, Ch 7).

See also: *What are companies for? Big business is beginning to accept broader social responsibilities*, *The Economist*, Aug 22nd 2019

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<sup>1</sup>See (Stein, 2003).

## 4 Socially Responsible Investment/ESG investing

To return to the concept of SRI/ESG investing, it is now easier to see where it fits.

Equity investments are portfolios of stocks.

Equity investors:

- Have a menu of equities (corporations) to invest in.
- The Corporate Social Responsibility of the potential investments is used in investment decisions. The theory behind SRI is therefore the same as theory behind CSR.

SRI questions

- How large is it these days?
- Methods of SRI
- Exclusions from considerations – what are the criteria?
- Implementing SRI – constructing indices.
- The potential benefits of SRI:
  - It may help identifying high performing stocks (in the returns sense)
  - It may help removing low performance stocks (future problems not priced in).
- The costs of SRI

### 4.1 Institutional background

Ethical investing is not a new concept. Arguably, the Christian view on *usury* and the Islamic negative view on *interest* are early examples of ethical investment. The Pax World Fund was the first modern SRI mutual fund, and was founded in 1971 (Renneboog, ter Horst, and Zhang, 2007). The fund avoided investing in weapon contractors.<sup>2</sup>

### 4.2 Aggregate figures - current state of SRI

The growth in the SRI industry started in the early 1990s. Let us look at some recent numbers. Table 1 shows estimates of the total assets in funds with some kind of SRI. The estimate is a total of more than 30 trillion dollars invested in SRI related funds.

Region	2016	2018
Europe	\$ 12,040	\$ 14,075
United States	\$ 8,723	\$ 11,995
Japan	\$ 474	\$ 2,180
Canada	\$ 1,086	\$ 1,699
Australia/New Zealand	\$ 516	\$ 734
<b>TOTAL</b>	<b>\$ 22,890</b>	<b>\$ 30,683</b>

Note: Asset values are expressed in billions of US dollars. All 2016 assets are converted to US dollars at the exchange rates as of year-end 2015. All 2018 assets are converted to US dollars at the exchange rates at the time of reporting.

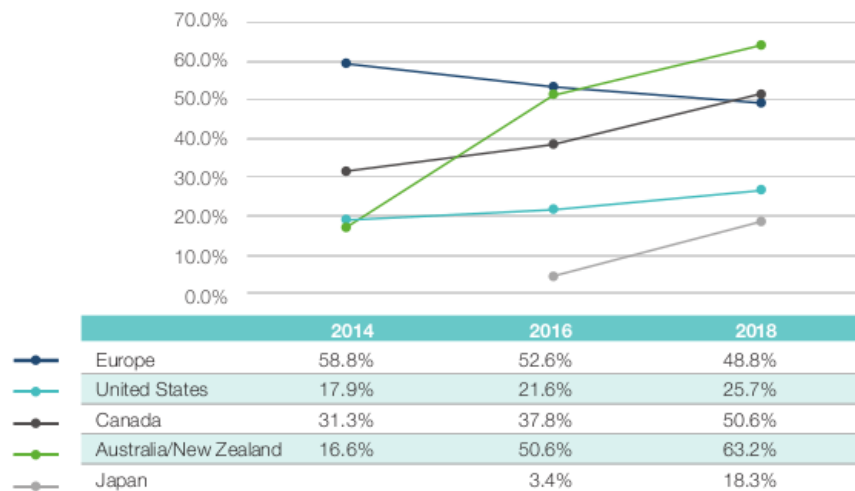
Source: Global Sustainable Investment Alliance (2018).

Table 1: Snapshot of global sustainable investing assets 2016–2018

In addition to the absolute numbers, it is instructive to look at how large SRI related investments are relative to the total assets under management. Figure 1 show estimates of SRI related funds relative to

<sup>2</sup>Make love not war - a saying in the flower child generation.

total funds under management in recent years. Europe is the geographical area with the largest fraction of funds under management under the SRI umbrella.



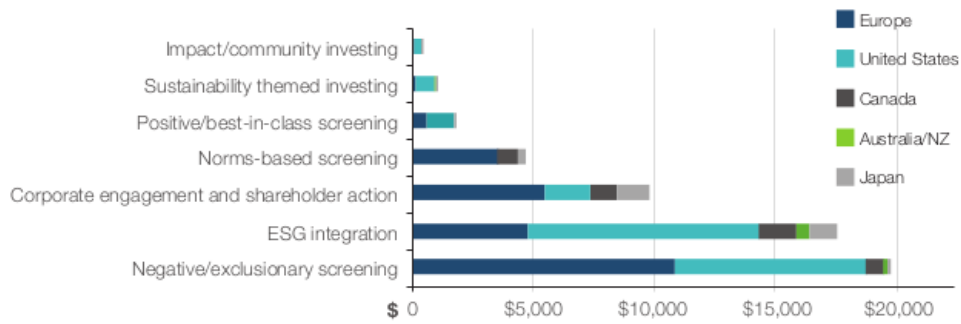
Source: Global Sustainable Investment Alliance (2018).

Figure 1: Proportion of sustainable investing relative to total managed assets 2014–2018

However, SRI a concept with many connotations. To inform about the degree to which funds are SRI, consider a classification from Global Sustainable Investment Alliance (2018), where the methods of SRI are grouped as:

1. Negative/exclusionary screening
2. Positive/best-in-class screening
3. Norms-based screening
4. ESG integration
5. Sustainability themed investing
6. Impact/community investing
7. Corporate engagement and shareholder action

Figure 2 shows the distribution of assets along these strategies. Clearly, the biggest chunk of SRI relies on negative screening, which is the “first generation” SRI. More advanced SRI are much smaller fractions.



Note: Asset values are expressed in billions of US dollars.

Source: Global Sustainable Investment Alliance (2018).

Figure 2: Sustainable investing assets by strategy and region 2018

### 4.3 The methods of SRI

Lets look more detailed at the methods of SRI, summarized in figure 3.

1. **NEGATIVE/EXCLUSIONARY SCREENING:** the exclusion from a fund or portfolio of certain sectors, companies or practices based on specific ESG criteria
2. **POSITIVE/BEST-IN-CLASS SCREENING:** investment in sectors, companies or projects selected for positive ESG performance relative to industry peers
3. **NORMS-BASED SCREENING:** screening of investments against minimum standards of business practice based on international norms, such as those issued by the OECD, ILO, UN and UNICEF
4. **ESG INTEGRATION:** the systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis
5. **SUSTAINABILITY THEMED INVESTING:** investment in themes or assets specifically related to sustainability (for example clean energy, green technology or sustainable agriculture)
6. **IMPACT/COMMUNITY INVESTING:** targeted investments aimed at solving social or environmental problems, and including community investing, where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose
7. **CORPORATE ENGAGEMENT AND SHAREHOLDER ACTION:** the use of shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines

Source: Global Sustainable Investment Alliance (2018)

Figure 3: The methods of SRI

## 4.4 Screens

Some examples of screens

**Tobacco** Avoid manufacturers of tobacco products

**Alcohol** Avoid firms that produce, market, or otherwise promote the consumption of alcoholic beverages

**Gambling** Avoid casinos and suppliers of gambling equipment

**Defense / Weapons** Avoid firms producing weapons for domestic or foreign militaries, or firearms for personal use

**Nuclear Power** Avoid manufacturers of nuclear reactors or related equipment and companies that operate nuclear power plants

**Irresponsible Foreign Operations** Avoid firms with investments in government-controlled or private firms located in oppressive regimes such as Burma or China, or firms which mistreat the indigenous peoples of developing countries

**Pornography / Adult Entertainment** Avoid publishers of pornographic magazines; production studios that produce offensive video and audio tapes; companies that are major sponsors of graphic sex and violence on television

**Abortion / Birth Control** Avoid providers of abortion; manufacturers of abortion drugs and birth control products; insurance companies that pay for elective abortions (where not mandated by law); companies that provide financial support to Planned Parenthood

**Labor Relations and Workplace Conditions** Seek firms with strong union relationships, employee empowerment, and/or employee profit sharing.

Avoid firms exploiting their workforce and sweatshops

**Environment** Seek firms with proactive involvement in recycling, waste reduction, and environmental cleanup. Avoid firms producing toxic products, and contributing to global warming.

**Corporate Governance** Seek companies demonstrating "best practices" related to board independence and elections, auditor independence, executive compensation, expensing of options, voting rights and/or other governance issues.

**Business Practice** Avoid firms with antitrust violations, consumer fraud, and marketing scandals. Seek companies committed to sustainability through investments in R&D, quality assurance, product safety

**Employment Diversity** Seek firms pursuing an active policy related to the employment of minorities, women, gays/lesbians, and/or disabled persons who ought to be represented amongst senior management

**Human Rights** Seek firms promoting human rights standards. Avoid firms which are complicit in human rights violations.

**Animal Testing** Seek firms promoting the respectful treatment of animals. Avoid firms with animal testing and firms producing hunting/trapping equipment or using animals in end products.

**Renewable Energy** Seek firms producing power derived from renewable energy sources.

**Biotechnology** Seek firms that support sustainable agriculture, biodiversity, local farmers, and industrial applications of biotechnology. Avoid firms involved in the promotion or development of genetic engineering for agricultural applications.

**Community Involvement** Seek firms with proactive investments in the local community by sponsoring charitable donations, employee volunteerism, and/or housing and educational programs



**Shareholder activism** The SRI funds that attempt to influence company actions through direct dialogue with management and/or voting at Annual General Meetings

**Non-married** Avoid insurance companies that give coverage to non-married couples

Source: Renneboog et al. (2007)

## 5 Measurement of ESG

Investment strategies need to be implemented using quantitative criteria.

A key development in SRI is therefore development of indices that *quantify* ESG concepts, and which are then used to rank companies along ESG dimensions.

Numerous index providers supplying (selling) such indices.

Production:

- Choose dimensions of ESG to measure
- Select observable criteria that can be used to quantify (ranking)
- Weight resulting ranking.

Example: Figure 4 Show the groups of criteria that go into MSCI Intangible Value Assessment (IVA) measurement.

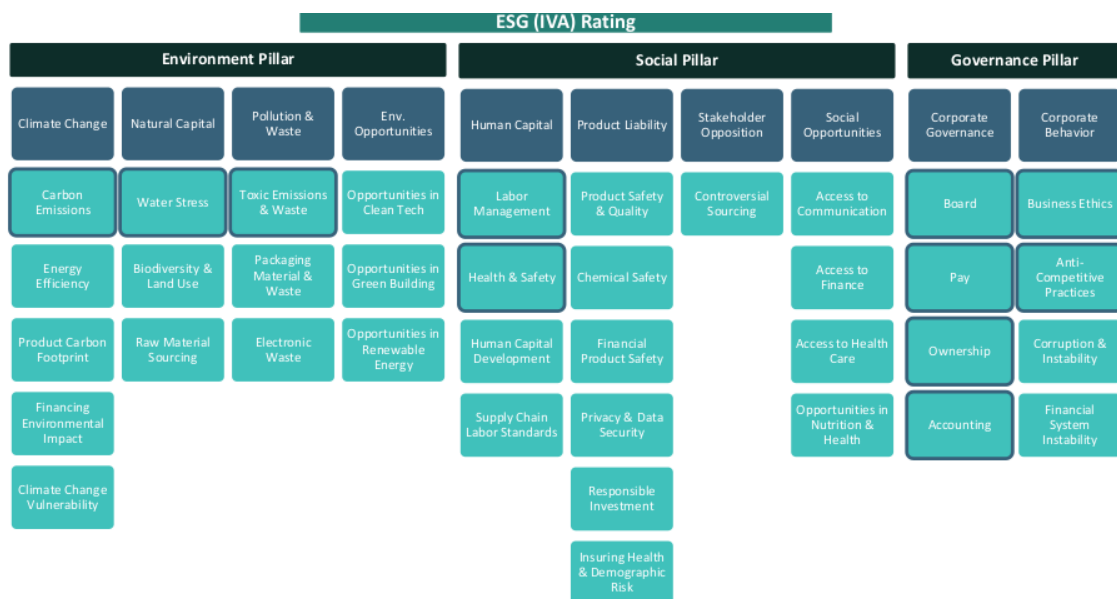


Figure 4: MSCI EVI methodology

## 6 Costs of SRI?

What is the cost of SRI?

- Direct:
  - Costs of subscribing to ESG information services.
  - Extra investment officers dealing with SRI/ESG.
  - Additional Transaction costs from SRI motivated trades
- Indirect:
  - Reduction in investment universe → Diversification cost.
  - Restrictions on portfolio remove potential high return stocks?

## 7 Socially responsible investing – Summary

Background: Corporate Social Responsibility (CSR)

SRI: As an equity investor, look at CSR of potential stocks in portfolio

Typical actions

- Interactions with corporations (voting)
- Exclusion

Costs

- Direct: Data, manpower, time
- Indirect:
  - Reduction in investment universe
  - Missing high return stocks?

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