POWER OF POSITIVE SCREENING: PURSUING STRENGTH OF SOCIAL AND FINANCIAL RETURNS

Market volatility and sweeping changes to mainstream views of investing are catalyzing acceptance of tactics that combine fundamentals with a progressive outlook on social issues. Positive screening brings balanced companies to the fore of the investment landscape: this practice isolates sound equities that demonstrate strength of balance sheet, dependability of management, and a commitment to act as part of a global community focused on positive change. Such companies limit their risks, open opportunities, and position themselves for success in a market that rewards transparency and social contributions that are tied to the bottom line.

Investors are realizing that viewing portfolios through a social lens does not mean sacrificing returns. That may be one reason that inflows to this type of equity have skyrocketed in recent years. US SIF’s 2012 report on sustainable investing highlighted that entering 2012, the overall total of SRI assets in the U.S. was $3.74 trillion, a 22 percent increase over 2009 totals.1

Europe is seeing a similar influx, with 2010 seeing “an increase of 35% over the figure for 2008, even while [high net worth] individuals’ total assets under management shrunk during that two-year period because of the global economic crisis,” noted the Wall Street Journal. “The trend…is here to stay. By 2013, Eurosif predicts the share of HNWI assets allocated to [social] investing will have risen to 15% or just below €1.2 trillion.”2

This shift is worlds away from the historic view of social investing, which in decades past was often dismissed as a nearly philanthropic effort. Investors were seen as giving their money to causes, rather than investing for social and financial gain. However, as the world has responded to disappointing outcomes – the credit crisis, investment schemes, the ever-growing wage gap – capital has more consistently sought higher ethical ground.
Investments have always yielded both a financial and social impact – the challenge of positive screening is ensuring that one is not lost in favor of the other. Portfolio strength is developed on themes, opportunities in the marketplace, and underlying quality, and it is (and always has been) critical to have a full understanding of the composition of and rationale behind each investment. Such due diligence requires investigating elements such as:

- **Disruption opportunities.** Economies are made up of shifting plates of industry, and those who identify undervalued areas poised for significant momentum – and individual companies that are positioned to benefit – will see enduring upside that thrives when the general investing population weakens.

- **Quality of Demand.** Stability and sustainability of demand are critical factors that drive opportunities. Investors must also understand the value of functional demand as it relates to supply. In the last decade, as an example, the demand for commodities as investment products brought many outside buyers into the commodities markets, driving prices well above the rational price suggested by the functional supply and demand fundamentals in the global economy. This mispricing left investors vulnerable.

- **Debt/asset ratios.** A low debt/asset ratio is a fundamental sign of a strong balance sheet, and in a deleveraging environment it is a critical component to sustainability. There is a true competitive advantage to having actual liquidity at hand; it provides management with the flexibility to keep their options open, to pursue opportunities that may benefit shareholders, and to grow market share when overleveraged competitors are weakened by a lack of accessible capital.

- **Dividend growth.** Management that gives back to its investors with consistent increases in dividend returns demonstrates a long-term commitment to the enterprise, and invites shareholders to remain dedicated.

- **Social positioning.** Companies that lead with ethical business practice set a standard that leads to competitive advantage. Fair treatment of employees, the environment, suppliers, customers, and shareholders is rewarded by the market and influences vendors and partners. Just as important, those that provide solutions to environmental or social concerns are tying their business to market needs that have the potential to spike as the global picture changes.

**Evolution of SRI**

Using positive screening to identify substantive investment opportunities is a significant leap from the early days of SRI, during which negative screening was the thrust of the strategy. 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.”

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.”

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.”

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.

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 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. Business Ethics Magazine rated Fannie as the most socially responsible company in 2004 – at the height of the lender’s struggles, as the company 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, 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 sectors are being reconsidered for their potential to improve quality of living in a world facing new challenges. Nuclear energy is gaining 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 may be crucial to easing famine in fast-growing developing nations.

Moving to the Positive Screen

The consistent through-line across the decades is the difficulty of shedding negative screening habits to incorporate the full scope of investment principles alongside an ethical assessment of managements and operations. 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.
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 and require forward thinking companies to spearhead profitable solutions. This paves the way for positive screening, as both investors and companies are more actively considering social issues on par with financial elements in making decisions.

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.

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. Market conditions, however, now highlight the correlation between company performance, integrity and transparency – an interdependence that makes smart SRI nearly indistinguishable from smart mainstream investing.

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 – and in our ever-progressing world, opportunities abound to grow capital while promoting positive social change.
About the Authors

Charlton Reynders, III, Chairman and CEO of Reynders, McVeigh Capital Management, brings more than 20 years of experience in investment management and social venture investing to Reynders, McVeigh Capital Management. 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.

In this vein, Chat has for decades produced award-winning, socially oriented IMAX films with an emphasis on climate change. Chat’s focus on this area led him to his role as a Director on the Board of the One World One Ocean Foundation, an organization committed to increasing awareness of the delicate state of today’s oceans. He also sits on the advisory boards of Project Adventure and the MacGillivray Freeman Educational Foundation.

Chat served as a senior officer and director of new business at Lowell, Blake & Associates. He oversaw growth in assets under management at that firm from just over $200 million to nearly $700 million, and worked as a senior equity strategist to lead key institutional relationships, advising on more than $1 billion in outside assets. He previously served as Executive Director of The Whale Conservation Institute, the nation’s leading independent cetacean research center, which was founded under a grant from the MacArthur 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. With 26 years of experience in the industry, he was one of three original employees at Trillium Asset Management. His research there was a key factor in the growth of assets from startup to $700 million.


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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