

# **SOCIALLY RESPONSIBLE INVESTING**

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## FOREWORD

This study was undertaken in response to Senate Concurrent Resolution No. 13, S.D. 2, adopted during the Regular Session of 2001. The Resolution resolved that the Legislature "encourages the Chief Investment Officer, administrator, and trustees of the State Employees' Retirement System to apply the principles of SRI [socially responsible investing] in their investment practices and decisions, and encourages other investment counselors and money managers to also apply SRI to their investment portfolios." Apart from its endorsement of "the principles of SRI," the Legislature separately requested the Bureau to "conduct research on SRI by examining the laws and practices in other states, and current reports and studies in the field." This study responds to the Legislature's request of the Bureau to shed light on "the principles of SRI," particularly in light of public policy.

Ms. Jean Mardfin was responsible for Chapter 3 dealing with the issue of fiduciary standards.

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December, 2001

## EXECUTIVE SUMMARY

"Socially responsible investing" (SRI) is a method of investing that is best known for screening stocks for their social or environmental characteristics, as opposed to their financial performance. Thus, an SRI investor can avoid buying – and supporting – companies that are felt to harm whatever social values held dear by the investor. Or, the investor can get rid of those already owned – a process known as divesting.

Much less known is another SRI strategy called "shareholder advocacy" or "shareholder activism." This strategy involves leveraging equity in a company to influence its social behavior. An SRI investor may own many shares, or buy only a nominal amount just to be able to introduce shareholder resolutions aimed at changing a company's social or environmental policies and actions.

A third SRI strategy is community investing, in which often lower-than-market returns are offered to make funds available to help the "poorest of the poor" in areas such as affordable housing, small business, and community development. This segment of SRI is relatively minuscule.

These three strategies have evolved and are often treated as one. However, although the rationale underlying the three strategies share certain commonalities, they are in no way a prepackaged whole which must be embraced as one indivisible unit. For example, an SRI investor may choose only to screen and divest stocks without engaging in shareholder advocacy or community investing. That is, if an SRI investor uses any one strategy, he or she is not obligated to engage in any of the other two strategies.

Engaging in SRI, in any of its three expressions, is beyond reproach for any *individual* investor. In fact, it is an individual right to choose that is not subject to any other person's criticism or control – including the government's.

However, the appropriateness of *institutional* investors engaging in SRI is debatable. Social screening of stocks for ownership is, above all, a political act. Mandating institutions, particularly public or quasi-public retirement trust funds, to adopt SRI strategies would be a radical act. Such a mandate would not only usurp trust fund boards' right to independent action, but would also confer upon them perhaps unintended public policy-making powers that not even legislative nor executive branches may wield.

With respect to public retirement trust fund boards, the question of fiduciary duty and responsibility also arises. Money in such trust funds must be used for the ultimate benefit of beneficiaries. Although there are some indications suggesting SRI investment strategies cause no significant harm (nor outperform non-SRI investment significantly), the evidence is far from conclusive.

Accordingly, the Bureau recommends that the Legislature refrain from mandating the Employees' Retirement System or any other public institution to adopt either social screening or shareholder advocacy as investment strategies. As community investing is already practiced in some form by the ERS, there appears no need to legislatively mandate the ERS to do so.

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# Chapter 1

## INTRODUCTION

S.C.R. No. 13, S.D. 2: This Resolution (Appendix A) directs the Legislative Reference Bureau to conduct research on socially responsible investing by examining the laws and practices in other states, and current reports and studies in the field.

Definition of Socially Responsible Investing: The concept represented by the term "socially responsible investing" has also been described as "social investing," "socially aware investing," "ethical investing," "mission-based investing," and "double-bottom line investing."<sup>1</sup> According to Domini Social Investments, socially responsible investing "refers to the incorporation of social and environmental criteria into the investment decision-making process ... that ... cuts across asset class and investment style."<sup>2</sup>

According to the Social Investment Forum, the following is a general description of socially responsible investing (SRI):<sup>3</sup>

Integrating personal values and societal concerns with investment decisions is called Socially Responsible Investing (SRI). SRI considers both the investor's financial needs and an investment's impact on society. With SRI, [one] can put [one's] money to work to build a better tomorrow while earning competitive returns today.

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1. Social Investment Forum, 1999 Report on Socially Responsible Investing Trends in the United States, SIF Industry Research Program, November 4, 1999, p. 6, (hereafter "1999 SIF Report") posted at <http://www.socialinvest.org/areas/research/trends/1999-Trends.htm>, and S.C.R. No. 13, S.D. 2, 2001.
  2. David P. Wieder, managing principal and chief executive officer, Domini Social Investments, in remarks delivered at Hawaii Double Bottom Line Investment Summit, 'Aha Ho'opuka Pono, State Capitol Auditorium, Honolulu, Hawaii on February 25, 2001.
  3. Social Investment Forum, "Introduction to Socially Responsible Investing" posted <http://www.socialinvest.org/Areas/SRIGuide/Default.htm> The Social Investment Forum describes itself as follows:  
The Social Investment Forum is a national nonprofit membership association dedicated to promoting the concept, practice and growth of socially and environmentally responsible investing. The Forum's membership includes over 500 social investment practitioners and institutions, including financial advisers, analysts, portfolio managers, banks, mutual funds, researchers, foundations, community development organizations and public educators. Membership is open to any organization or practitioner involved in the social investment field. The Forum provides cutting-edge research on trends in social investing, publishes the nation's most comprehensive annual directory of practitioners in the field, and publishes a Mutual Fund Performance Chart which provides monthly performance data on socially screened funds. The Forum's web site, [www.socialinvest.org](http://www.socialinvest.org), links interested parties to member sites and dozens of other resources.

SRI is a method of investing that allows investors to<sup>4</sup>

...consciously put their money to work in ways designed to achieve their financial goals while working to build a better, more just and sustainable economy. Social investment requires investment managers to overlay a qualitative analysis of corporate policies, practices and impacts on to the traditional quantitative analysis of profit potential.

However, as discussed in Chapter 2, SRI is more complex than this. As a concept, SRI is a moving target and continues to evolve, giving rise to several controversial issues.

Focus of the Study: SRI is an approach to investing that can be adopted by *individuals*. On the other hand, it can also be used by both private and public *institutions*. *Private* individual and institutional investors are free to research the issue and act accordingly. Government does not and should not interfere with their freedom to make certain financial and social investing decisions.

However, the focus of public policy is on *institutional* investment by *public* entities, especially those with fiduciary responsibilities. The relevant public policy issues revolve around fiduciary and legal aspects of public institutional SRI investing and to what extent, if any, government should get involved.

There is a need to distinguish between *private* (both individual and institutional) investing and *public* institutional investing. S.C.R. No. 13, S.D. 2 expresses the Legislature's wish

...to encourage our State's financial institutions, financial advisors, banks, trust companies, trustees of our State's funded and landed trusts, trustees of the State of Hawaii Employee's Retirement System, and all other individuals and entities handling and managing financial investments, to become more familiar with the principles of SRI and to apply those principles to their financial advice and decisions...[and] to foster and encourage wider discussion, understanding, acceptance, and practice of SRI in the community.

Government is clearly acting within its limits by encouraging greater education for private and public entities. Even encouraging acceptance and actual practice of SRI – beyond mere familiarity with it – is still within bounds. Mere encouragement creates no legal mandate. However, when government *mandates* public institutions to adopt certain SRI principles or strategies, the situation becomes more complex.

Thus, this study focuses on SRI as an investing approach not so much with regard to individual or institutional investing in the *private* sector, but as it relates to *public* institutional investing. The study also addresses the issue of a potential governmental *mandate* for public institutions to adopt SRI principles or strategies, rather than merely recommending them. It must also be noted that most of the literature in the field focuses on equity investments (ownership of stock securities in companies). However, institutional investors typically diversify by investing across asset classes that include not only equity, but money market, bonds, and other

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4. 1999 SIF Report, p. 6.

instruments. (See chapter 2 for the Investment Company Institute's four categories of mutual funds.) Throughout the study, the term "entity" refers to public institutional entities, including those with fiduciary responsibilities, like a public employees retirement system, that handle and manage financial investments.

Organization of the Study: Chapter 2 reviews SRI's background and examines the concept of SRI. Chapter 3 examines the role and responsibility of fiduciaries of public investment entities with respect to SRI investing. Chapter 4 deals with reports and studies dealing with the effectiveness or performance of SRI as an investment and social strategy and reviews laws and practices in other states with regard to SRI. Chapter 5 presents findings and recommendations.

## Chapter 2

### CONCEPT OF SOCIALLY RESPONSIBLE INVESTING

#### I. BACKGROUND

##### Historical Beginnings

Depending on how broad one's definition is of socially responsible investing ("SRI"), its history could stretch back to biblical times. According to the Social Investing Forum:<sup>1</sup>

The origins of ethical investing date back many hundreds of years. In early biblical times, Jewish laws laid down many directives on how to invest ethically. In the mid-1700s, the founder of Methodism, John Wesley, emphasized the fact that the use of money was the second most important subject of New Testament teachings. As Quakers settled North America, they refused to invest in weapons and slavery. For hundreds of years, many religious investors whose traditions embrace peace and nonviolence have actively avoided investing in enterprises that profit from products designed to kill fellow human beings. Many avoid the "sin" stocks – those companies in the alcohol, tobacco and gaming industries.

The modern roots of social investing can be traced to the impassioned political climate of the 1960s. During that decade, a series of social and environmental movements from civil rights and women's rights, to the anti-war and environmental movements served to escalate awareness around issues of social responsibility. These concerns also broadened to include management and labor issues, and anti-nuclear sentiment. In the late 1970s, the concept of social investing began attracting a considerably larger group of American investors due, in large part, to concerns about the racist system of [a]partheid in South Africa.

Concerned U.S. investors joined international efforts to put economic pressure on South Africa to end [a]partheid. A growing number of investors throughout the 1970s and 1980s used both screening and shareholder advocacy to press for change in South Africa. Both individual and institutional investors refused to invest in companies who did business in South Africa, and sponsored shareholder resolutions asking companies to withdraw from South Africa.

On September 14, 1993, Nelson Mandela appeared before the United Nations Special Committee on Apartheid and stated: 'The international community should now end all economic sanctions against South Africa'.

This version of the beginnings of SRI is essentially corroborated by Good Money, Inc., a social investing firm that conducts research and advocates for socially responsible investing.<sup>2</sup> According to this source:<sup>3</sup>

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1. Social Investment Forum, "1999 Report on Socially Responsible Investing Trends in the United States", Nov. 4, 1999, p. 7 (hereafter "1999 Trends"). <http://www.socialinvest.org/areas/research/trends/1999-Trends.htm>

Until the mid 1980s, SRI [*socially responsible investing*] was considered to be nothing more than what Fortune Magazine sarcastically called 'feel-good investing' or what would be labelled today as 'politically correct' behavior. The movement needed to get over two credibility hurdles – one social/political and the other economic.

Wall Street 'wisdom' had long preached that making social judgements in the investment process would have no effect on corporations, especially large ones. The second bit of wisdom was the belief that making social judgements would limit return to investors. The first hurdle was successfully negotiated as a result of the South African divestiture movement of the late 80s....

In addition, years of accumulating research began to demonstrate that corporations with good social records on the whole outperformed corporations with bad social records. In turn, socially [screened] portfolios, no matter what the social issue, rewarded investors better than unscreened portfolios.... As a result, SRI took off in the U.S. in the 1980s.

The earliest social investing screen, and the most basic, is the "sin screen" used by churches and universities for over a hundred years.<sup>4</sup> That is, companies that were involved with tobacco, alcohol, and gambling were screened out. After the Vietnam War,<sup>5</sup>

...a number of corporate horror stories (including Hooker Chemicals and the controversy concerning Love Canal, Firestone Tire & Rubber's exploding 500-radial tires, A. H. Robins and the Dalkon Shield, and General Public Utilities and Three Mile Island) added fuel to the movement.

Aside from the boycott of investment in South Africa, as of 1995, legislation in six states provided for some sort of use of state pension investment strategy to oppose religious discrimination in Northern Ireland. To avoid being boycotted, companies needed to adhere to the so-called "MacBride Principles." (See section "Social Values, Screens, and Indices," below.) Other states restricted investment in Iran, Cuba, or companies which complied with the Arab League's boycott of Israel.<sup>6</sup>

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2. Good Money, Inc. was initially incorporated in 1982 by Ritchie and Peter Lowry as the Center for Economic Revitalization. In 1986, the Center was reorganized as Good Money Publications, Inc. "to more accurately reflect its mission as a for-profit, educational and publishing company for the social investment community ... [and] to reflect the broadening mission as a multi-media information provider for socially and environmentally concerned consumers, investors and business people.  
<http://www.goodmoney.com/history.htm>.

3. Good Money, Inc., "A Brief History of Socially Responsible Investing"  
<http://www.goodmoney.com/infoabout.htm>

4. Good Money website: <http://www.goodmoney.com/qna.htm>

5. *Ibid.*

6. Carol V. Calhoun, Calhoun Law Group, P.C., "The Issues Institutional Investors Face in Doing Social Investing," presented at the Making a Profit While Making a Difference Conference sponsored by Capital  
*(Footnote continued on next page.)*

## II. ASPECTS OF SOCIALLY RESPONSIBLE INVESTING

### Three Major Aspects of SRI

The popular perception of socially responsible investing appears to differ from how the SRI community defines itself. Most likely, the cause for this is that the average individual is not fully informed on the various aspects of SRI.

Right or wrong, a lay person's thinking about SRI is usually limited to two general themes.<sup>7</sup> The first is, SRI is "politically correct" or "conscience" investing. That is, an investor decides that there is more to investing than just making money. The investor wants to make money but does not want to create or contribute to social harm by doing so. This can be done by pulling money out of companies the investor finds engaging in objectionable activities. This is called divestiture. For example, news stories that a shoemaker allegedly exploited cheap foreign labor may provoke investors into selling off shares in that company. On the other hand, most such investors would probably not actively search out socially beneficial companies in which to make new investments. Taking this further step would likely require a greater degree of commitment. In other words, if an investor does anything, it would probably be to divest rather than to make positive new investments in socially screened companies.

SRI (divesting or making new, screened investments) is seen as a concern only for those who have already attained a certain level of wealth. Those who rank day-to-day living expenses high in their hierarchy of needs, and who have no surplus funds to invest, are not viewed as facing an SRI dilemma. SRI has commonly been criticized as a conscience-salving yuppie activity.

The second theme, in a lay person's view, is that SRI is an individual activity. Integral to this idea is that the individual has the right to choose how to invest. That is, no one can or should force any individual to invest one way or another. Given that each individual has the right and freedom to choose how to invest, each person is also unique. It is true that many investors share certain traits. Nonetheless, each individual investor possesses a unique combination of personal beliefs and experiences that shape how each person makes investment decisions. Just as no one would deny any individual the right to invest in a socially responsible way, no individual should be forced to adopt any SRI strategy.

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Missions Company, May 12, 2000, Employee Benefits Legal Resource Site:  
<http://benefitsattorney.com/cmhc.html> (hereafter "Calhoun".)

7. Statements referring to "lay person," "average lay person," "popular" view, " etc. are based on informal interviews with staff of the Bureau, a relatively sophisticated group with broad experience and whose jobs require them to be knowledgeable. Statements ascribed to the "average" lay person thus err on the side of caution given that the real "average lay person" would know even less about SRI.

On the other hand, according to the SRI community, SRI has developed over time to reflect at least three distinct aspects. According to one source, SRI consists of the following:<sup>8</sup>

- Portfolio screening for certain social and environmental values
- Shareholder advocacy
- Community investing

Anecdotally, the average lay person's view generally encompasses only the first aspect. In informal discussions, staff at the Bureau – who have broad experience and are fairly knowledgeable – did not identify shareholder advocacy, either personal or institutional, as an aspect of SRI. The same was true for community investing.

Others in the field have mapped out more elements of SRI than the three above. For example, another approach views SRI as having five elements, below:<sup>9</sup>

***Economically targeted investments.*** These are investments chosen to foster specific social goals, such as economic development and/or home ownership in a particular state or area.

***Shareholder activism.*** This involves using the ownership rights associated with equity holdings to influence the behavior of individual firms. Often, fiduciaries have intended shareholder activism to increase the value of shares owned by changing management practices. The only instance in which shareholder activism becomes social investing is when it is used to foster other goals. For example, a number of states have passed laws addressing the "MacBride Principles," a set of policies aimed at ending religious discrimination in Northern Ireland.

***Preferences for certain investment managers*** (e.g., a preference for minority- or female-owned investment firms). This practice does not directly affect what investments a fund makes. Rather, it affects investment performance only insofar as the chosen managers choose different investments than other investment managers might choose.

***Socially screened investments.*** For example, many church pension funds will limit new investments in companies that produce products in conflict with the particular denomination's beliefs. This screening commonly involves companies that produce tobacco products, alcoholic beverages, pornography, or which conduct gambling operations, but could also extend to restrictions on investing in the defense industry or even certain food producers (e.g., meat or caffeinated products) in the case of churches that promote certain dietary restrictions.

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8. Social Investing Forum. The SIF is a national nonprofit membership association dedicated to promoting the concept and practice of socially responsible investing. It is made up of over 600 financial professionals and institutions. Membership is open to any organization or practitioner who wishes to participate in the socially responsible investing field. Website is: <http://www.socialinvest.org/>.

9. Calhoun, p. 2.

**Divestiture.** At first, this involved selling stocks in companies that invested in South Africa, a practice that changes in the South African political situation have eliminated in recent years. However, it has also been proposed in other areas, although it is not, at least as yet, in common use.

For the purposes of this study, SRI is examined in its three aspects. This is justified because divestiture and manager preference can be treated as a part of active portfolio screening. That is, screening includes identifying certain stocks to buy, avoid, or divest. Shareholder "advocacy" and "activism" are interchangeable. "Community," "economically-targeted," and "alternative" investment are sufficiently similar. The remainder of this chapter deals with the three aspects of SRI.

## 1. Portfolio Screening

The first aspect of social investing involves portfolio screening, which is:<sup>10</sup>

...the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on social and/or environmental criteria. Generally, social investors seek to own profitable companies that make positive contributions to society. 'Buy lists' include enterprises with outstanding employer-employee relations, excellent environmental practices: products that are safe and useful, and respect for human rights around the world. Conversely, they avoid investing in companies whose products and business practices are harmful.

Kendall provides an example of how The Calvert Group, Ltd., an investment firm, handles social screening.

These money managers at Calvert, however, work hand in hand with a team of social research analysts that verify the company's competency to make sure they suit Calvert's standards. Nikki Daruwala, a social research analyst on Calvert's team, explains their social screening process. 'We have different criteria for different funds. In our most stringent fund, Social Investment Fund Managed Growth Portfolio, we have five different areas on which to screen. The analysts investigate environmental impact, product safety, human rights standards, labor relations and community relations.'

It seems to be a pretty straightforward procedure to select equity securities for a socially responsible fund. Check the balance sheet, investigate their work policies and nose through their environmental record. But what about government bond funds? How do portfolio managers sort through all the red tape and paperwork and the thousands of available bonds from which to choose? Surprisingly, it's not as difficult as it might seem.

Daruwala, who handles fixed-income securities for the Calvert Group, says it's a different process altogether. 'Bond selection is very project specific.' For example, if the bond is for industrial development, the analysts have to investigate from several different miens. Daruwala explains that environmental impact needs to be scrutinized, labor issues

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10. Ibid., p. 6.



need to be examined and the final product itself must be certified. 'Environmental reports have to be filed with the government on every project. We also talk to the labor unions and the building trades to see if the contractor has had labor issues. If it's a facility being constructed — like a nursing home or hospital — we can check to see if there have been any industry violations. In many ways, it's an easier process. There's a lot of public documentation because government projects have more openness and there's more accountability. You have to know where to look for the information; if you know where to look, the access and information are plentiful. If you don't know where to look, then you're limited.'

**Five General Screening Methods:** Given the different aspects of social investing, the question arises as to how a pension fund or other investing "entity" (see chapter 1, "Focus of the Study") actually goes about investing in a socially responsible way. There are roughly five general methods with which an investing entity can screen holdings for its portfolio. These are:<sup>11</sup>

- All-or-nothing – an absolute approach to investment
- Proportionate impact – a relative approach to investment
- Indirect or secondary impact – screening out companies that generate indirect or secondary harm
- Best-of-industry – choice of the best companies in pre-selected industries or best companies exhibiting pre-selected values
- Potential impact – screening out companies that potentially but have not actually caused harm

*First – All-or-Nothing:* First, the investing entity must decide how extreme and absolute its investment policy will be. Will the entity invest only in companies that are *completely* free of *all* possible harmful social and environmental practices? Or can there be some balance? For example, a pharmaceutical company may make a life-saving drug but may also produce toxic waste byproducts in its manufacturing process. Or the company could charge prices too high for patients in emerging countries. Or it could use animals in its product testing. Another company may be a pioneer in equal opportunity employment and family-friendly practices such as providing for free employee child care, but may also be a defense contractor. Would the investing entity be willing to discount any of the company's negative values? Would any one negative value or practice disqualify the company?

In other words, an investing entity must decide whether or not to use an *absolute value screen*. This *all-or-nothing* screen rejects any company that fails any social screen used by the entity. One example of the use of an absolute screen is the total boycott of firms that did business with South Africa over apartheid.

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11. Good Money website: <http://www.goodmoney.com/srihowto.htm>

Currently, Philip Morris Companies, Inc. would be screened out for its tobacco and alcohol products (its Miller Brewing Company also makes beer). The packaged and processed foods and beverages made by its wholly-owned subsidiary Kraft Foods, Inc. would not be an offsetting factor. Another example would be the Boeing Company, best known for its passenger airplanes. However, Boeing is also a defense contractor.<sup>12</sup> Although not everyone considers national defense antisocial or harmful, almost all social screens reject military or defense contractors. On the basis of this first method, the Boeing Company would be screened out.

*Second – Proportionate Impact:* Second, if an investing entity declines to use an absolute screen, it must then decide its position on the issue of *proportionate impact*. In reality, very few companies are entirely faultless. Accordingly, an entity weighs the proportionate impact of a company's negative practices. That is, since most companies do *some* damage, *how much* damage will the entity accept, balanced against its merits?

For example, an agricultural commodities firm may boast an excellent record in environmental reporting. It may also invest heavily in developing community labor skills, especially in emerging nations. The company may further be a leading-edge advocate against global warming. However, it develops and distributes biotechnology trait food grains to help alleviate starvation in many overpopulated emerging countries. However, many social screens oppose bioengineered food products. The company may also produce herbicides to help control weeds and insects, leading to higher crop yields. Its herbicides production would also hurt its environmental rating.

In fact, in one instance, Bristol-Myers Squibb Company failed a screen for donating its infant formula to hospitals, a practice said to discourage breast feeding. (Squibb is a producer and distributor of consumer medicines, pharmaceuticals, nutritionals, medical devices, and beauty care products. It also makes Pravchol, a cholesterol lowering drug, and Excedrin, etc.)<sup>13</sup>

The question then is, to what degree are "negatives" mitigated or outweighed, if at all, by "positives"? Does the good arising from bioengineered rice that relieves hunger outweigh the harm caused by herbicides and any doubt over potential harm from bioengineered products?

Another example<sup>14</sup> is an energy company that, in drilling geothermal fields, causes hundreds of small earthquakes daily. The company recognizes its responsibility and tries to mitigate this by recycling used water back underground. However, the drilling also releases

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12. Boeing's military aircraft and missiles segment is involved in the research, development, production, modification and support of military aircraft, including fighter, transport, and attack aircraft, helicopters, and missiles. In addition, Boeing's space and communications segment is involved in the research, development, production, modification and support of space systems, missile defense systems, satellites and satellite-launching vehicles, rocket engines, and information and battle management systems.

13. Roger Lowenstein, "The Virtuous Investor: 'Socially responsible' funds have a surprisingly good recent record – but will it last?" *Unconventional Wisdom* in *SmartMoney* magazine, May 2001, p. 60.

14. Good Money website.

gases such as hydrogen sulfide that can be harmful to plants, animals, and humans. However, these negative effects are mitigated by the location of the geothermal fields entirely in desolate areas populated essentially only by rattlesnakes. In addition, the company's emissions, in proportion to those caused by other forms of energy exploration and use, are insignificant.

Thus, under this approach, an entity must evaluate the *proportionate impact* of harm caused by a company. These examples only hint at the many ways in which an entity must measure the proportionate impact of "negative" activities against a company's "positive" values.

*Third – Indirect or Secondary Harm:* Third, an investing entity may further wish to screen otherwise unblemished companies for *indirect* harm that may arise from their operating relationships with others. The primary company under consideration for investment causes no *direct* or *primary* harm. Instead, its business operations either require or allow other companies to engage in *indirect* or *secondary* harmful practices.

For example, a clothing retailer may be a model of environmental awareness. However, it may earn a low rating on an *indirect/secondary harm* screen if its purchasers buy footwear from a company that uses emerging country sweatshop labor. In another example, many investors rejected Southland Corporation because its 7-Eleven stores sold Playboy and Penthouse magazines. SRI investors similarly excluded the Holiday Inn hotel chain (Bass Hotels and Resorts, Inc.), said to be the nation's largest distributor of in-room satellite TV adult movies.

In yet another example, Burger King (Diageo) buys beef globally. However, raising beef in other countries has required clearing rainforests for cattle range land, destroying the native flora and fauna and contributing to the greenhouse effect. Although selling beef in hamburgers is not a negative social value (yet), buying beef from companies that contribute to global environmental destruction is. McDonald's Corporation, on the other hand, buys beef only from the American southwest.<sup>15</sup>

On the other hand, a social screen that recognizes indirect harm but does not penalize a company for it is the *exclusionary* nuclear power screen used by Kinder, Lydenberg, Domini & Co., Inc. (KLD). Companies that derive identifiable revenues from the design of nuclear power plants are subject to exclusion by the KLD screen. But this does not include companies providing construction or maintenance services for nuclear power plants.<sup>16</sup> On the other hand, KLD does penalize secondary companies that cause indirect harm under its *qualitative* environmental screen. Of course, a company causing direct harm by selling coal or oil would score low in KLD's ratings – it contributes to negative climate changes. However, secondary companies that derive substantial revenues *indirectly* from the combustion of coal or oil and its derivative fuel products also cause concern. Companies scoring low on this KLD screen would

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15. Good Money website.

16. Kinder, Lydenberg, Domini & Co., Inc. "2001 Social Rating Criteria": <http://www.kld.com/research/ratings.html> (hereafter "KLD website").

include electric utilities, transportation companies with fleets of vehicles, auto and truck manufacturers, and other transportation equipment companies.<sup>17</sup>

***Fourth – Best-of-Industry:*** A fourth method an investing entity may consider is an approach that focuses on the "best-of-industry" companies. This approach allows zeroing in on certain selected values. For example, an entity may pre-select a specific social *value* and then look for companies in *any industry* with the best records. Alternatively, it could pre-select a specific *industry* and search for companies with the best *social* records.

To illustrate, suppose an entity has chosen to invest in the retailing industry for purely financial reasons. It then chooses an issue area such as hiring of women and minorities. The next step is to find companies with the best records in this area. If the choice of industry group is not important, the entity first chooses a social value. For example, implementing environmental management systems or handling corporate environmental reporting may be especially important to the entity. It then searches for companies in *any* industry that has performed the best with regard to these environmental tasks. (See section on "Social Grading Criteria", below for an idea of what social values populate current screens.)

***Fifth – Potential Harm:*** Fifth, an investing entity may finally consider screening companies for their *potential* rather than *actual* transgressions. New England Electric Systems has had a good and safe record for operating nuclear power plants. However, barring outright exclusionary screens for nuclear power, the inherent potential environmental risks in operating nuclear plants may disqualify this company from investment under this approach.

***Certain Potential Problems:*** After choosing an investing approach, any entity faces certain generic problems. *First* is the issue of fiduciary duty and whether that allows public or quasi-public entities that control investable funds to use non-financial criteria in managing moneys for beneficiaries. Not all public or quasi-public entities have a fiduciary duty or beneficiaries, however. For example, the Hawaii Health Systems Corporation has no "members" or beneficiaries per se to which it owes a fiduciary duty. This is not to say that the Corporation is free to invest irresponsibly or in a way detrimental to its public purpose of providing health care. Nonetheless, the Corporation does have the power to invest<sup>18</sup>

...any funds not required for immediate disbursement in property or in securities that meet the standards for investment established in chapter 88 as provided by the corporation board; provided the investment assists the corporation in carrying out its public purposes; selling from time to time securities thus purchased and held, and depositing any securities in any bank or financial institution within or without the State...

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17. KLD website: <http://www.kld.com/research/ratings.html>.

18. Hawaii Revised Statutes, section 323F-7(26)(A).

The investment standards cited are those established for the pension and retirement systems of the State's public employees.<sup>19</sup>

On the other hand, the Employees Retirement System of the State of Hawaii (ERS) does have a fiduciary responsibility to manage the moneys in its portfolio. The ERS is governed by an eight-member board of trustees. However, the Governor appoints only three of the eight, all of whom must be state residents but not state employees. Furthermore, one of these three must be "a responsible officer of a bank authorized to do business within the State."<sup>20</sup> A fourth trustee is required by law to be the State's Director of Finance, as member *ex officio*.<sup>21</sup> The remaining four trustees must be ERS members and are elected by other ERS members and retirants. Two of these four must be "general employees, one of whom shall be a teacher, and one of whom shall be a retirant."<sup>22</sup>

The need to resolve any conflict between an entity's fiduciary duty and SRI investing is discussed separately in chapter 3.

*Second*, the nature of an entity, how it is governed, how it is constituted, and the political environment in which it operates, all may affect how it handles SRI investing. It may face external or internal pressures from a variety of sources. The case of Florida's tobacco divestiture and rescission of that divestiture, below, serves as an illustration. *Third*, with the passage of time, an entity must also ensure that its value screens continue to reflect any policy changes and that its investments are consistent with newly adopted values. *Lastly*, it must choose among a myriad of values, screens, principles, etc. that it feels are appropriate.

*The Nature and Composition of an Entity:* A variety of factors may affect how an investing entity approaches SRI investing. A decision to adopt an SRI strategy typically rests with an entity's board of trustees or similar governing body. However, if the entity is a pension or trust fund, it may need to consider the input of its beneficiaries. If it is a public pension fund, its activities are most likely governed or further restricted by state laws. How the body is constituted – in terms of board membership and its powers and duties – likely reflects the political environment in which the entity operates.

A public pension board may have operated without SRI for whatever reasons – because of prior success without it, fiduciary duty, or disagreement over SRI effectiveness. If that board were inclined to continue doing so, adoption of a new SRI strategy would need to win the board's vote. Similarly, a board that is already using SRI strategies would face the same pressures trying to reverse its policy. Here, a board's composition becomes important. If the board is perceived

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19. Hawaii Revised Statutes, section 88-119.

20. Hawaii Revised Statutes, section 88-24((3).

21. Hawaii Revised Statutes, section 88-24(1).

22. Hawaii Revised Statutes, section 88-24(2).

to fairly represent pensioners, policy changes would not be as problematic. Florida's public employees pension fund serves as an illustration of this scenario.<sup>23</sup>

Florida's \$100 billion pension fund is governed by three members of the board: the Florida governor, the state comptroller, and the insurance commissioner. In May 1997, while Florida was engaged in lawsuits against tobacco companies, they voted two-to-one to divest the fund of some \$835 million in tobacco stocks. Then-governor Lawton Chiles and then-insurance commissioner William Nelson voted to divest. Florida's comptroller, Robert Milligan, opposed it, saying that it was politically popular but financially foolish. Consultants to the state also advised against divestiture, saying that the outlook for tobacco stocks was positive, despite ongoing lawsuits.<sup>24</sup>

Clearly, both internal and external pressures played a part. In the end, Florida's policy change was accomplished purely as an executive act – carried out by two individuals – that affected some 750,000 current and retired Florida public employees. In other words, the pension fund members themselves, as beneficiaries, relied solely on a legally constituted board to make a lawful decision to divest.

The makeup of Florida's public pension board, and how it operates in that state's political environment, clearly made a difference in how a decision regarding an SRI policy was made. The irony is that on June 13, 2001 the Florida board reversed its divestiture decision.<sup>25</sup> (Florida is the second state, after Maryland, to have reversed its decision to divest tobacco stocks.) Again, external and internal pressures to alter investment policy were clearly factors. At one point last year, the Dow Jones index had risen only about 3.6% while the share prices of Philip Morris and R. J. Reynolds nearly doubled. With a slight change in membership (new governor Jeb Bush and new insurance commissioner Tom Gallagher), the board was able to reverse a significant investment policy decision.

The further irony is that, prior to the decision to reverse, Florida had no idea how much it had lost or gained over the years by selling its tobacco stocks.<sup>26</sup> Only at the time the decision

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23. Decision to divest taken from Diane Rado, "Florida rethinks tobacco policy: as lawsuits are settled and tobacco stocks soar, top officials say they are open to putting tobacco back into the portfolio" in St. Petersburg Times, May 16, 2001.

24. Bush, Milligan, and Gallagher are all Republicans. However, Tom Herndon, executive director of the State Board of Administration that administers the pension fund and chief of staff to former Governor Chiles, is a Democrat and also opposed the original decision to divest. Herndon's deputy executive director, Coleman Stipanovich, who headed a council of investment advisers in 1997, also opposed divestiture.

25. Decision to reinvest taken from Alisa Ulferts, "Ban on tobacco stocks reversed: the three-member board overseeing Florida's employee pension fund votes to reinvest in the profitable industry, ending a ban that began four years ago," in St. Petersburg Times, June 13, 2001.

26. Rado article, quoting Elizabeth Mozley, investment communications manager, Florida Board of Administration, "We've never really done a full-scale, here are the numbers, here are the stocks, this is what happened. We basically divested and went on."

was reversed in June 2001 did Florida determine that the pension fund had lost \$300 million because of the tobacco divestiture four years earlier.<sup>27</sup>

With a board structure like Florida's, the decision process is technically simple. A board may even conduct policy discussions. However, unless legally required to factor in direct pension fund member input, such a board may unilaterally implement policy changes. The perception of possible inequity is amplified the smaller and less representative a board is. Larger boards and those with more diverse representation – like Hawaii's ERS board of trustees – lessen the impact, but only to a degree. A more prudent approach would include positive safeguards such as increasing the board's voting margin say, from a simple majority to two-thirds, in order to ratify certain investment policy changes.

In any case, regardless of a board's structure and safeguards, its decision-making could be rendered moot. For example, a legislature could attempt to redefine a board's composition or "pack" the membership. A more extreme move would be to legislatively mandate certain policy actions – such as adopting or abrogating SRI strategies – that would otherwise be the decision and responsibility of investing entities. Unquestionably, one policy goal is to preserve the integrity of the primary purpose of entities such as pension funds. Adopting SRI not only means using a different investing strategy, it is a public policy decision in itself.

*SRI as Economic and Political Activity:* The argument is made that the reason for engaging in SRI is that it is the right thing to do. In addition, advocates have recently cited SRI investment results to show that using social screening does no harm. Various studies appear to show either that results from SRI investing do not differ significantly from non-SRI investing or that they are even slightly better. One reason often cited is that socially conscious companies, who use employee- and environment-friendly practices, are more immune to lawsuits and thus reduce risk to shareholders and enhance *financial* return. However, there are other reasons SRI is advocated. For example, boycotting shoemakers that use cheaper foreign labor, who may or may not be working under "sweatshop" conditions, helps protect local jobs. Furthermore, in terms of *social* value, hardly anyone can disagree with opposing sweatshop labor. However, the *economic* and *political* returns are often left unspoken.

However much the social merits of SRI are promoted, it must be realized that SRI, at its core, is *political* in nature. SRI exists to leverage investors' money to influence policy decisions of companies. Investors can at the same time reaffirm their values by actively screening their investments. And at least before the erstwhile bull market ended, SRI investors as a whole did fairly well financially with their screened investments.

Certainly, *individual* investors should be free to express their political or social opinions by screening investments, introducing shareholder resolutions, etc. Whether or not *institutional* investors ought to assume the role of policy-making is open to legitimate debate, purely as a political issue and regardless of financial return. Institutional investors can wield enormous leverage when they engage in the same practice.<sup>28</sup> Those in elected or appointed policy-making

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27. Ulferts article, quoting Tom Herndon, executive director, Florida Board of Administration.

(Footnote continued on next page.)

positions may often agree with the social policy goals of SRI-minded institutional investors. However, disagreements are bound to arise. Accordingly, whether institutional investors should be encouraged to exercise policy-making powers, through shareholder advocacy, should be carefully thought through.

*Changing Values:* As the Florida case illustrates, values change. *First*, investing entities need to recognize this and adapt to changing values. It is possible that decisions to adopt new or drop old values may take on as high a profile as the original decision to implement a fundamental investment policy change. Thus, they may face the same pressures.

*Second*, in order to ensure that investments consistently adhere to whatever values a board espouses at any given time, a board or its delegates need to continually monitor those investments. Although an entity's values may change, the more likely scenario is that companies either favored or eschewed by a board may change its practices over time.

For example, perhaps Bristol-Myers Squibb will stop distributing infant formula gratis at hospitals. (See discussion of this company under "Second – Proportionate Impact" above.) Nestle S.A. is another maker of infant formula. In 1977, a worldwide boycott was launched against Nestle S.A. for predatory marketing of infant formula in developing countries. It was charged that untrained women dressed as nurses would give just enough free infant formula to new mothers until their breast milk dried up, thus gaining new customers. As a side effect, because mothers often used unsanitary water to mix formula; babies fell ill or died.<sup>29</sup>

Predatory marketing certainly seems a legitimate reason for an SRI investor to eschew Nestle. But what should an investor do knowing that human immunodeficiency virus type 1 (HIV-1) is transmitted through breast-feeding – and that transmission is higher in mothers who breast-feed than those who use infant formula? This is of special significance for the developing counties in Africa where AIDS is epidemic. In a recent article in the Journal of the American Medical Association, a researcher found that:<sup>30</sup>

Studies have led to estimates of [HIV-1] transmission risk during acute maternal infection of 29% (95% CI 16%-42%) and for women with established infection of 14% (95% CI 7%-22%).... Of the 401 infants [of HIV sero-positive mothers] in the study analysis 92 were HIV-1 infected, 61 of these were in the breastfeeding group and 31 in the formula group. At 24 months the cumulative probability of HIV-1 infection was significantly higher for infants in the breastfeeding group than the formula feeding group.... However

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- 28. Interview of August 27, 2001 with Michael Picker, co-principal of Lincoln Crow Strategic Communications. Mr. Picker said that it has been estimated that institutional investors own about 60% to 70% of all U.S. stocks and that the 25 largest pension funds own about 30% of the 25 largest corporations.
  - 29. Breastfeeding.com: [http://www.breastfeeding.com/advocacy/advocacy\\_boycott.html](http://www.breastfeeding.com/advocacy/advocacy_boycott.html).
  - 30. Nduati R, et al., "Effect of Breastfeeding and Formula Feeding on Transmission of HIV-1: A Randomised Clinical Trial" summary, in Journal of the American Medical Association, March, 2000-Vol 283, No. 9 p 1167.



the HIV-1 free survival at 2 years was significantly lower in the breastfeeding group than in the formula feeding group (58% vs 70% respectively;  $P = 0.02$ ).

An investing entity will need to monitor ongoing company practices and unfolding developments that affect their SRI investment decisions. It is highly unlikely that a board would have the time to actively carry out this task. It would probably rely on its portfolio managers, but the decision to cut or add companies ultimately should rest with the board. In reality, investing entities may delegate the work to consultants or managers who are guided by one or more of the many social values "indices" maintained by specialized research firms. For example, the firm Kinder, Lydenberg, Domini & Co., Inc. created the Domini 400 Social Index and supports SRI institutional investors with research. But can an investing entity be sure that changes to a social index are consistent with its own values? There is room for some doubt given that one of the largest ones, the Calvert Social Index, does not divulge why a company is not included or is deleted from its index. (*See "Calvert Social Index" below.*)

An investing entity that adopts a social screening strategy makes a fundamental change to investment policy. This is not a casual decision and should not be made lightly or without serious commitment. Any such decision must be informed. Assuming that an entity has chosen to use social screening to support its values, it is only logical for it to ensure that its investments continue to reflect those values in a changing world. Although the entity will probably delegate the research role of "values police" it must still retain responsibility for final choices of investments.

*Which Values:* At first blush, this question appears fatuous. After all, everyone should be virtuous, stand for life, liberty, and the pursuit of happiness. We all reject evil, pollution, discrimination, death, and pestilence. However, upon deeper reflection, the answer gets murkier as one navigates a complex and confusing landscape studded with real-life inconsistencies and contradictions.

These complexities are best viewed through two underlying and interrelated issues. *First*, there seem to be no limit to the numbers and types of values investors might espouse, giving rise to all sorts of problems both philosophical and structural. *Second*, given that an investing entity has decided to engage in SRI investing, in an ever-changing world, it will always be difficult to reach and sustain a legitimate consensus on values in a way that truly reflects the entity's will. This is especially true if the entity is a fiduciary and works for beneficiaries whose individual and collective social views may differ from that of the governing board.

*A Plethora of Values:* Mainstream America has become increasingly interested in investing in general over the last decade. Although there are other ways to invest than through mutual funds, their increasing numbers are a good indicator of the rising interest in investing in mainstream America. Reflecting this trend, interest in SRI investing has also increased. The number of mutual funds in the United States has skyrocketed in the last decade. Correspondingly, the number of SRI mutual funds has expanded to the point of constituting a sub-industry. It is unclear whether this expansion is demand- or supply-driven.

In any case, SRI funds have been created to appeal to almost any set of values one can imagine. As a former analyst for Morningstar commented in a 1997 article, "Having launched

funds targeting every conceivable investment strategy in the past few years, which fund marketers could resist tailoring funds to tap the social conscience of the fifty something Baby Boomer?"<sup>31</sup> For example, the Amana Funds cater to investors adhering to Islamic beliefs (no financial stocks because of Islamic aversion to usury). The Noah Funds and the Timothy Plan are funds that invest based on the Bible.<sup>32</sup> Just recently, a press release announced the introduction of the Ave Maria Catholic Values Fund. The fund is offered by Schwartz Investment Counsel, Inc., whose CEO said:<sup>33</sup>

With 60 million Catholics in the U.S. and more than \$1 trillion currently invested in socially responsible portfolios, investors who are seeking a sound equity investment vehicle while still adhering to their core religious beliefs now have a unique opportunity.

The fund claims that it seeks out seasoned companies, with healthy profits, strong balance sheets, proprietary products and enduring business franchises. Thereafter, it screens out companies involved with abortion or anti-family policies. The Ave Maria fund makes a point of publicizing the use of only these two screens. This SRI fund thus implies<sup>34</sup> that social screening hinders investment performance because with only two screens, it is

...less cumbersome than the broader array of 'sin stocks' many socially responsible funds refrain from purchasing. This affords the fund manager a greater universe of stocks from which to select.

Apparently, in the view of at least one SRI fund, most SRI investing is not so much about the "I" as it is about the "SR" component. The Ave Maria fund's portfolio manager and senior vice president further stated that other SRI funds often relegate financial return to a secondary role in favor of social responsibility:<sup>35</sup>

Unlike other socially responsible mutual funds where investment performance is often secondary to the social criteria, we have created a fund that places equal emphasis on the performance of the underlying stocks as well as on following the Fund's Catholic values

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31. Jon Hale, "Socially Responsible Investing," in Morningstar.com: <http://news.morningstar.com/news/MS/FundFocus/SRI/sri1.html>.

32. The Timothy Plan is a family- and biblically-based mutual fund family: <http://www.timothyplan.com/>. The Noah funds is another biblically-based series of funds whose website greets visitors with "Hallelujah, we believe the NOAH FUND is a gift from God that could be your answer to Biblically-based investing." <http://www.noahfund.com/>.

33. PRNewswire, Detroit, 5/1/2001 8:04 a.m. EST, "Introducing: The Ave Maria Catholic Values Fund – A Mutual Fund That Blends Fundamental Value Investing With Core Values of the Catholic Church." Schwartz Investment Counsel, Inc. was founded in 1980 and manages \$500 million in assets and also manages the Schwartz Value Fund and two hedge funds.

34. Ibid.

35. Ibid., statement by Gregg D. Watkins, senior vice president and portfolio manager of the Ave Maria Catholic Values Fund.

mandate... We don't think investors should have to sacrifice performance for their principles.

Language from the prospectus of another SRI mutual fund seems to acknowledge that the use of social criteria may detract from financial returns. In Trillium's Advocacy Fund, five principal risks of investing in the fund are listed. Two of these were:<sup>36</sup>

- The Fund's social criteria eliminate some stocks that might have higher returns than the stocks from which the Adviser is able to choose.
- Changes in company social policies cause the sale of stocks that subsequently perform well.

According to the Social Investment Forum (SIF), at the end of 1998 Wiesenberger<sup>37</sup> tracked 183 socially screened open-end mutual funds offered by over 40 different fund families. The number of screened mutual funds increased from 55 in 1995 to 139 in 1997, to 175 in 1999.<sup>38</sup> The Calvert Social Index,<sup>39</sup> as of June 28, 2001, encompassed 629 individual companies selected for being socially responsible. (*See more detailed discussion of the Calvert Social Index in "Social Values, Screens, and Indices" below.*)

The number of SRI mutual funds pales in comparison to the total number of U.S. mutual funds. According to the Investment Company Institute (ICI),<sup>40</sup> the national association of the American investment company industry:<sup>41</sup>

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36. Trillium Asset Management's the Advocacy Fund, prospectus dated August 15, 2000: [http://clientdata.forum-financial.com/trillium/Trillium\\_prospectus\\_final\\_for\\_web.pdf](http://clientdata.forum-financial.com/trillium/Trillium_prospectus_final_for_web.pdf).

37. Social Investment Forum, "Socially Screened Mutual Fund Statistical Summary (as of 12/31/98)": [http://www.socialinvest.org/areas/research/other/FundStats\\_12-31-98.htm](http://www.socialinvest.org/areas/research/other/FundStats_12-31-98.htm). Wiesenberger the nation's first mutual fund tracking service, has provided mutual fund data to financial professionals for more than 55 years. It is the leading provider of customized retirement, marketing and sales, and research software to both distributors and sponsors, including financial planning companies, broker/dealer firms, banks, mutual fund and insurance companies. Wiesenberger is a division of Thomson Financial Services, a leading provider of information services and work solutions to the worldwide financial community.

38. 1999 Trends, p. 8.

39. According to the Calvert Group, Ltd., "The Calvert Social Index is a broad-based, rigorously constructed benchmark for measuring the performance of large, US-based socially responsible companies." [http://www.calvert.com/invwcal\\_calvertindex.asp?letter=All](http://www.calvert.com/invwcal_calvertindex.asp?letter=All).

40. Investment Company Institute website: [http://www.ici.org/about\\_ici.html](http://www.ici.org/about_ici.html). The ICI is the national association of the American investment company industry. Founded in 1940, its membership includes 8,414 mutual funds, 489 closed-end funds, and eight sponsors of unit investment trusts. Its mutual fund members represent more than 83 million individual shareholders and manage approximately \$7 trillion. The Institute represents its members and their shareholders in matters of legislation, regulation, taxation, public information, economic and policy research, business operations, and statistics. The ICI seeks to enhance public understanding of the investment company business, to serve the public interest by encouraging adherence to the highest ethical standards by all segments of the industry, and to promote the interests of fund shareholders.

(Footnote continued on next page.)

The increased demand for mutual funds in the 1990s led to the creation of a large number of new mutual funds. The number of funds rose from around 2,900 at the beginning of the decade to about 8,200 by year-end 2000. Equity funds accounted for more than half of the new funds.

Information in Table 2A is derived from a 2001 ICI publication.<sup>42</sup> (As of mid-2001, there were at least 8,414 mutual funds that were listed as ICI members.)

From 1990 to 2000, total mutual fund assets increased 541% while net new cash inflows rose 782%.

| <b>Table 2A</b>                               |                           |                     |              |                         |
|---|---------------------------|---------------------|--------------|-------------------------|
| <b>NUMBER OF U.S. MUTUAL FUNDS, 1900-2000</b> |                           |                     |              |                         |
| <b>Year</b>                                   | <b>Equity/Hybrid/Bond</b> | <b>Money Market</b> | <b>Total</b> | <b>Percent Increase</b> |
| 1990  | 2,340                     | 741                 | 3,081        | N/A                     |
| 1991  | 2,585                     | 820                 | 3,405        | 10.5%                   |
| 1992  | 2,962                     | 864                 | 3,826        | 12.4%                   |
| 1993  | 3,618                     | 920                 | 4,538        | 18.6%                   |
| 1994  | 4,367                     | 963                 | 5,330        | 17.5%                   |
| 1995  | 4,731                     | 997                 | 5,728        | 7.5%                    |
| 1996  | 5,266                     | 988                 | 6,254        | 9.2%                    |
| 1997  | 5,671                     | 1,013               | 6,684        | 6.9%                    |
| 1998  | 6,288                     | 1,026               | 7,314        | 9.4%                    |
| 1999  | 6,746                     | 1,045               | 7,791        | 6.5%                    |
| 2000  | 7,130                     | 1,041               | 8,171        | 4.9%                    |

The amount of money invested in mutual funds has also increased dramatically in the last decade or so – certainly in part because of the longest running bull-market in United States history. According to the ICI (Table 2B):<sup>43</sup>

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41. ICI, Mutual Fund Fact Book 2001 Edition, p. 39, ("ICI 2001"): [http://www.ici.org/pdf/01fb\\_ch3.pdf](http://www.ici.org/pdf/01fb_ch3.pdf).

42. Ibid., p. 40.

43. Sean Collins, "Mutual Funds Assets and Flows in 2000" in Perspective, Investment Company Institute, v. 7, n. 2, February 2001, p. 2: <http://www.ici.org/pdf/per07-02.pdf>. Except for percentage change, data is derived from ICI.

| <b>Table 2B</b>                 |                     |              |                                |
|---------------------------------|---------------------|--------------|--------------------------------|
| U.S. MUTUAL FUNDS: 1985 TO 2000 |                     |              |                                |
| (\$ billions)                   | Net New Cash Inflow | Total Assets | Percent Change in Total Assets |
| 1985                            | 68                  | 495          | N/A                            |
| 1986                            | 164                 | 716          | 44.6%                          |
| 1987                            | 40                  | 770          | 7.5%                           |
| 1988                            | -23                 | 810          | 5.2%                           |
| 1989                            | 73                  | 982          | 21.2%                          |
| 1990                            | 44                  | 1,065        | 8.5%                           |
| 1991                            | 112                 | 1,393        | 30.8%                          |
| 1992                            | 155                 | 1,643        | 17.9%                          |
| 1993                            | 228                 | 2,070        | 25.9%                          |
| 1994                            | 84                  | 2,155        | 4.1%                           |
| 1995                            | 212                 | 2,811        | 30.4%                          |
| 1996                            | 321                 | 3,526        | 25.4%                          |
| 1997                            | 374                 | 4,468        | 26.7%                          |
| 1998                            | 477                 | 5,525        | 23.7%                          |
| 1999                            | 363                 | 6,846        | 23.9%                          |
| 2000                            | 388                 | 6,967        | 1.8%                           |

*"Total Assets" includes capital appreciation as well as net new cash inflows. Thus, for 1988, although there was a net new cash outflow of \$23 billion, total assets still increased \$40 billion from 1987 to 1988.*

SRI-related assets have also grown dramatically. According to the SIF, social investment grew to \$2.16 trillion in 1999 from \$40 billion in 1984.<sup>44</sup> This money was managed by major investing institutions including pension funds, mutual fund families, foundations, religious organizations, and community development financial institutions. The \$2.16 trillion accounted for about 13%, up from 9% in 1997, of the total \$16.3 trillion in investment assets under management in the United States. SRI-related assets grew at twice the rate of all asset growth under professional management in the United States, rising from \$1.185 trillion to \$2.16 trillion from 1997 to 1999, an 82% increase. During the same period, the broad market grew 42%.<sup>45</sup>

44. 1999 Trends, pp. 3, 5.

45. *Ibid.*, p. 3. The 13% and 42% figures are cited from the 1999 Nelson's Directory of Investment Managers.

Also according to the SIF:<sup>46</sup>

...total assets under management in screened portfolios for socially concerned investors rose 183 percent, from \$529 billion to \$1,497 billion. Assets in socially screened mutual funds grew by 60 percent to \$154 billion, and assets in screened separate accounts [privately managed and screened for both individual and institutional clients] grew 210 per cent to \$1,343 billion.

In screened mutual funds, assets grew from \$12 billion in 1995 to \$96 billion in 1997, and to \$154 billion in 1999. Similarly, assets in separate accounts rose from \$150 billion in 1995 to \$433 billion in 1997, reaching \$1,343 billion in 1999.<sup>47</sup>

The number of different values, many of which are embodied in various value screens, that determine which screened companies are listed in various social indices, is extremely large. Therefore, this topic is treated separately in the section "Social Values, Screens, and Indices" below.

*Difficulty in Reaching and Sustaining a Consensus:* The plethora of values is, in itself, a problem. Another problem is the difficulty in reaching easy consensus. Usually, the number of beneficiaries is far greater than that of board members. Therefore, it is likely that the universe of values of the former will reflect a far greater spectrum than that of the latter. A board's decisions will always be vulnerable to the activist influence of individual members or beneficiaries.

For example, a board may agree to invest in companies that adhere to the MacBride Principles, a corporate code of conduct consisting of nine fair employment and affirmative action principles. These principles apply only to companies doing business in Northern Ireland and are aimed at counteracting anti-Catholic discrimination. (See section "Social Values and Screens" below.) Non-Catholic individual members may not object to the issue per se. However, they may question the lack of a similar policy for companies doing business in say, Japan, where women in the labor force are discriminated against. Or, some individuals may want to favor companies that reflect a Buddhist philosophy.

Would both a board and its members agree on birth control/abortion and alcohol issues? Even assuming agreement on use of alcohol and birth control/abortion screens, would they give equal weight to both issues? In Norway, about half of all first-born children are to single mothers. Consequently, on the marriage of Crown Prince Haakon of Norway to commoner Mette-Marit Tjesson Hoiby, Norwegians "barely raised an eyebrow over [future princess] Hoiby's having a [four-year-old] child."<sup>48</sup> However, citizens of the same country take "a dim

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46. *Ibid.*, pp. 3, 8.

47. *Ibid.*, p. 8.

48. Associated Press (Oslo, Norway) "Norway's future princess confesses to wild past," in Honolulu Advertiser, August 22, 2001. The two wed on August 25, 2001.

view of drug abuse, and public support for the [Norwegian] monarchy has been declining."<sup>49</sup> Who is to say that the same disparity of opinion does not also exist elsewhere, including Hawaii?

How should a board react to individual members' demands to promote human rights by blacklisting companies that do business in countries with poor human rights records? A huge number of multinationals do business in the People's Republic of China. Neither Bosnia nor Russia has good records. India mistreats Muslims and Pakistan abuses Hindus. Should a board boycott companies that want to open up the Socialist Republic of Viet Nam and the Democratic People's Republic of Korea (North Korea)? How should a board respond to demands to invest in the Meyers Pride Value fund, which favors companies said to be tolerant toward lesbians and gays? Christian Scientist-leaning beneficiaries may lobby to eschew pharmaceuticals and biotechnology companies, which is what the American Trust Allegiance fund does.<sup>50</sup> The point is, arriving at a consensus of values could be an extraordinarily complex task.

Furthermore, some values are disputable. Not many are absolute or unequivocal. Even if some values can be painted in absolute black and white, how they play out in terms of a company's actions often poses conflicting choices for an investing entity. Using Hawaii as an example, the following illustrate that differences of opinion can arise for many reasons. Although Hawaii is multicultural and multiethnic, acceptance of fast food, and especially the hamburger appears universal here. However, would individuals such as beneficiaries of the ERS support a decision to boycott shares of Diageo (Burger King) for contributing to global rainforest depletion by buying cattle that graze overseas? (See "Third – Indirect or Secondary Harm" above.) Would McDonalds' use of beef flavoring in its french fry oil, which is offensive to Hindus and vegetarians, be sufficient for beneficiaries to agree to divest shares? Investors who apply the Citizens Funds animal issues screen may well reject McDonalds for inhumane treatment of animals because its products encourage "meat production" (or Colgate-Palmolive Company for animal testing). Amana Funds offers funds that cater to Islamic values. Thus, they avoid companies involved with pork, alcohol, and pornography. However, their funds also steer clear of all financial stocks because of the Islamic aversion to usury – and banks and insurers earn interest.<sup>51</sup>

SRI social screening is only a tool. On the one hand, liberal social values are often used in screening. For example, a company that promotes non-discrimination in sexual orientation would get high marks. However, at times the opposite is true when conservative values are used to screen companies. Depending on who wields power, SRI can be a double-edged sword. Just as liberal investing entities may reject a weapons manufacturer, conservative entities may reject the Walt Disney Co. for depiction of sex and violence.<sup>52</sup> The Texas State Board of Education

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49. AP story, August 22, 2001.

50. Lowenstein, p. 59.

51. Dawn Smith, "Putting Your Money Where Your Heart Is," in SmartMoney.com, April 20, 2001: <http://www.smartmoney.com/fundscreen/index.cfm?story=200104201>.

52. Lowenstein, p. 59.

voted in 1997 to divest the \$17.65 billion Texas Permanent School Fund of 1.2 million shares of Disney stock. Allegedly, the divestiture was made because of objections to Disney's depiction of sex and violence as well as its extension of health benefits to employees' gay and lesbian partners.<sup>53</sup>

Hawaii residents, including many retirees, enjoy regular jaunts to Las Vegas – indicating some acceptance of gambling. How likely would ERS beneficiaries agree with a decision to avoid or divest gambling stocks?

Individuals who control their own personal portfolios may invest as they see fit. Individuals should be at liberty to use any investment criteria, financial or non-financial, including using SRI strategies. There should be no restrictions on how individual investors express their own personal opinions through investments. However, when public institutions, such as boards of fiduciary trusts, do this – especially if mandated by legislatures – investment decisions based on non-financial criteria become problematic.

Purely cultural differences could also cause disagreement. For example, on a Dateline NBC show aired in December 2000<sup>54</sup>, consumers were shocked to discover that some Chinese-made toy animals used real dog or cat fur. The Humane Society of the United States went "undercover" posing as customers at two Chinese factories. They filmed toy makers telling them the fur was not "fake". To the Chinese manufacturer, it did not appear important whether the fur on the toys were real or not. In China, there is no law against exporting cat or dog pelts – just as there is no U.S. federal law against importing them into the United States. However, to an American audience, this was proof of barbarity. Viewers were urged to boycott distribution outlets such as Hallmark Cards and Ben Franklin stores.

The undercover video also showed an importer's willingness to purposely mislabel the items as "rabbit" fur to avoid American outrage. At this point, the breadth of the cultural chasm becomes abundantly clear. The obvious value being violated here is the killing of a pet.<sup>55</sup> It appears that cats and dogs occupy a relatively higher place in American than in Chinese culture as cherished pets. This is not to say that the average Chinese citizen does not like cats or dogs as pets. The closer reality is that, in a historical environment where physical survival has always ranked fairly high in a people's hierarchy of needs, keeping any kind of pet necessarily ranked much lower. (The nobility kept pet dogs whereas the lower classes sometimes ate them.)

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53. Peter Marcus, "Bye, bye Mickey: Texas board washes its hands of Disney stock – and opens Pandora's Box" in Plan Sponsor, September 1998, published by Asset International Inc.: <http://www.assetpub.com/archive/ps/98-08pssept/sept98PS52.html>.

54. MSNBC: <http://www.msnbc.com/news/346373.asp?cp1=1#BODY>.

55. The Humane Society's chief investigator, Rick Swain, charges that the cats and dogs were "killed in the most inhumane manner you can imagine." However, no evidence of this is offered or presented by the Humane Society or by NBC in the show.



The further irony is that killing rabbits in America seems to be at least tacitly more acceptable. The manufacture of rabbit-lined gloves and coat collars does not spark undercover television exposés. Yet, rabbits are also favored pets, especially during Easter time. They are fixtures in many grade school classrooms throughout the country. Rabbits even have pedigrees and are bred for shows and competitions. However, perhaps even within the relatively homogeneous culture of American petdom, domesticated rabbits occupy a lower rank as "members" of the family. Perhaps as a result, certain things can be done to them that are not acceptable for higher-ranking pets such as dogs and cats. This may be due in part to the shorter and more fragile history of rabbits as pets. Colonial settlers kept cats and hunted with their dogs for rabbit stew. (The colonials kept dogs and cats as pets but ate rabbits.)

Rabbit's feet are also used as lucky charms. The ancient European Celts believed that spirits inhabited rabbits' bodies. The Celts also held the rabbit to be sacred because of their prodigious reproductive prowess. They believed that the spirits intended rabbits to be revered as symbols of procreation, health, and prosperity. Since the rabbit itself was considered to be lucky, it followed that any of its body parts would also be considered lucky. Eventually, people selected the rabbit's foot to tote around for good luck, because of its capacity to dry quickly, its small size, and the fact that it made a great key chain.<sup>56</sup> No charges of barbarism or moral outrage have surfaced over this. A Chinese toy manufacturer would likely have no qualms over exporting rabbit's foot key chains. But it would also probably fail to see any difference between affixing rabbits' feet or cats' paws to key chains.

A final, not so trivial, example is nuclear power generation. This seems to be on most industry value screens. Generating toxic nuclear waste obviously creates harm. The effects of radioactive contamination can be extreme. A core meltdown would be catastrophic. Yet, nuclear energy has caused far fewer deaths and incalculably less pollution than the use of fossil fuels.<sup>57</sup> However, emerging countries denied the use of nuclear energy would most likely burn fossil fuels. This would add to global air pollution – hardly an intended result of social investing.

Without abundant energy, developing countries would be at a serious and unfair disadvantage. Lack of energy would hinder economic development needed to raise standards of living to those of developed countries. This is a classic North-South conflict. By excluding nuclear power companies, investing entities are in fact picking sides in global politics.

Nuclear power generation is imbued with geopolitical ramifications and ambiguity. People in developed nations oppose nuclear power, treating it as an absolute value. However, from the perspective of developing countries, it is relative. In fact, to them nuclear energy generation is a positive value. They only aspire to achieve what the developed countries have already gotten. The developed countries – having been first in the pool – have already muddied it and oppose any further despoiling by latecomers. In other words, investing entities that

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56. Uselessknowledge.com: <http://www.uselessknowledge.com/explain/rabbits.shtml>.

57. Lowenstein, p. 60.

eschew nuclear energy companies are engaging in more than good conscience investing, they are engaging in geopolitics.

To sum up, boards of investing entities must deal with the legitimacy of their investing decisions. Board decisions may not always fully represent members' views. Members unquestionably outnumber board membership and likely hold values that are more diverse. In addition, investing entities must appreciate that their SRI activities are clearly political, not just socially redeeming. SRI strategies not only satisfy culturally conditioned consciences, but also consciously attempt to force change, often political in nature, at all levels – international, national, and local. A further step in SRI's role in making policy changes is embodied in the more activist aspect of shareholder advocacy.

## 2. Shareholder Advocacy

**Definition and Concept:** According to the SIF, social advocacy:<sup>58</sup>

...describes investor efforts to submit and vote corporate proxy resolutions as a means of influencing company behavior. This strategy was successful in pressuring corporations to pull out of South Africa. It has also been instrumental in reporting minority hiring practices and improving environmental practices through adoption of the CERES principles (an environmental code of conduct).

The Calvert Group, Ltd., a leading provider of social investing mutual funds, describes shareholder advocacy as follows:<sup>59</sup>

Shareholder activism combines ongoing dialogue with companies, proxy voting and shareholder resolutions in an effort to encourage companies to address key issues such as the environment, workplace diversity and human rights. Dialogues aim at learning about the company management's successes and challenges while helping them improve on issues of concern. Calvert, as a shareholder through portfolio investments, is guaranteed an opportunity each year to express your views on issues of corporate governance and social responsibility at annual stockholder meetings through proxy voting.

In addition to proxy voting, "ongoing dialogue" involves correspondence and in-person meetings with corporate managers. Institutions can also actively lobby on policy matters, testifying at congressional hearings, legislatures, and county and municipal councils, and participating in SRI conferences. Often, these ancillary activities generate sufficient pressure to persuade companies to take action without the actual filing of a shareholder resolution.

KLD uses the term "shareholder activism" rather than "shareholder advocacy." On the nature of shareholder activism, KLD states that:<sup>60</sup>

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58. Council on Economic Priority website: <http://www.socialinvest.org/areas/sriguide/shareholder.htm> (hereafter "CEP website)."

59. Calvert Group website: [http://www.calvert.com/sri\\_648.html](http://www.calvert.com/sri_648.html) (hereafter "Calvert website").

(Footnote continued on next page.)

A shareholder action is a concerted effort by shareholders to affect a corporate practice and public opinion about it.... Changing corporate policy requires the same techniques as changing government policy. (*Emphasis added.*)

Under the rubric of "shareholder activism," KLD distinguishes between social activists and "corporate governance activists." The latter are more interested in affecting corporate governance, which usually has nothing to do with social policies.<sup>61</sup>

Until about 1990, "shareholder activists" referred to investors who raised social issues – such as, military weapons production or South Africa – often by placing resolutions on the proxy ballot for a company's annual meeting.... Since 1990, the term "shareholder activists" has come to include a broad swath of institutional shareholders who have focused on "corporate governance," a term whose precise meaning refers to the structures created by legal documents for the operation of a corporation. The term has come to include financial performance, board composition and terms, corporate operations, and executive compensation issues. The Council of Institutional Investors and the California Public Employees Retirement System (CalPERS) are among the leaders in raising corporate governance issues. Some social-issue activists have recognized a commonality of interests with the corporate-governance activists, perceiving a shared focus on corporate responsibility and responsiveness. However, the corporate-governance activists have shown little interest in the societal effects of their positions or social issues generally.

That is, corporate governance concerns itself more with how a company is run in relation to the *financial* bottom line. For example, with respect to the single issue of a company's board of directors, corporate governance actions could support the following:<sup>62</sup>

- Limit outside directors' total compensation
- Disclose payments for consulting by directors
- Elect a majority of independent directors, including independent chair
- Elect independent compensation and nomination committee members
- Limit number of board memberships of directors
- Eliminate pension plans for directors
- Limit tenure of directors
- Oppose mandatory retirement age for directors
- Separate positions of board chair and chief executive officer

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60. KLD website: <http://www.kld.com/resources/sa.html>.

61. Ibid.

62. Based on corporate governance proxy voting guidelines of Trillium Asset Management: [http://www.trilliuminvest.com/pages/activism/activism\\_voting\\_corp.asp](http://www.trilliuminvest.com/pages/activism/activism_voting_corp.asp).

- Support but do not require ownership of stock by directors

Further corporate governance actions regarding the single issue of compensation could include the following:<sup>63</sup>

- Limit CEO compensation
- Offer effective and fair stock option plans
- Seek shareholder approval for repricing underwater stock options<sup>64</sup>
- Grant stock options to senior management based on performance
- Oppose elimination of stock options and executive bonuses
- Oppose linking executive compensation to dividends paid to shareholders
- Cap executive pay to a certain multiple of lowest-paid employee
- Disclose executive pay above certain level
- Freeze executive pay during downsizing
- Disclose and limit executive severance packages
- Create management incentive plans

On the other hand, corporate *social* responsibility has to do with the company's *social* bottom line. Thus, a company's practices with regard to health and safety, the environment, labor and human rights issues, etc. are the purview of "corporate social responsibility." In terms of SRI, it is the latter that is of importance.

***The "Average" Person's View:*** As mentioned above, informal unscientific discussions were held with staff at the Bureau about SRI. The purpose for this in-house exercise was to get a feel for how much an "average" person knew about SRI. The Bureau staff who were queried have, individually and collectively, many years of legislative and research experience. As knowledge workers, their jobs require keeping abreast of current events. However, none identified shareholder advocacy, either individual or institutional, as an aspect of SRI. Almost all knew about screening of companies by various social values. Almost all cited the apartheid issue and divestiture of companies doing business with South Africa. All were able to identify most of the most commonly used screens. (*See "Social Values, Screens, and Indices" below.*)

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63. Based on Trillium Asset Management's corporate governance guidelines.

64. A stock option is a right to buy a company's stock at a certain price within a specific period of time, usually given to an employee as an incentive. The point is to allow the employee to pay much less than the market price for shares of the company stock. For example, if an employee exercises an option to buy 100 shares at \$10 and the market price is \$50, he pays \$40 less for each share and makes a \$4,000 profit if he then sells them at \$50. However, when the market price of those shares fall below the option price, they are said to be "underwater." Under normal circumstances, no one would exercise underwater stock options for a loss.

However, after extensive discussions, none could name – on his or her own initiative – shareholder advocacy either as a term or a concept, or identify it as part of SRI. As individuals, most did not recognize the term after it was introduced in discussions and only a few could correctly define the concept. (*In general, this reflects the finding of Rivoli (1995)<sup>65</sup> that it is institutions – religious groups, educational institutions, and public pension funds – not individuals, that tend to engage in shareholder advocacy, via both formal resolutions and informal discussions with management.*) However, after having the definition and concept explained to them, along with examples, most felt that shareholder advocacy went beyond what they considered socially responsible investing.

In fact, most felt that *institutional* shareholder advocacy was inappropriate, especially when funds are held in trust such as in a pension fund. Some felt that shareholder advocacy with regard to *corporate* governance insofar as it affects financial return is justified. However, most viewed shareholder advocacy in terms of *social* responsibility as inappropriate, except for a very small minority. The overriding opinion among staff queried was that SRI was an *individual* affair. It was each individual's right to choose to invest socially, to decide on values, and to choose whether or not to participate in shareholder advocacy. Most would be uncomfortable with a pension fund engaging in shareholder advocacy, particularly if they could not influence the board's decisions and if they disagreed with the board's values. Differences in financial return – either better or worse – did not affect their opinion on shareholder advocacy.

Before discussions were initiated, it was anticipated that most, if not all in-house staff, would be able to adequately define SRI or to understand its components. The results were unexpected. These informal in-house discussions hint at several things. First, even for people with relatively higher levels of sophistication and knowledge, the entire concept of SRI as it is defined in the field, is not very well known. Second, some aspects of SRI such as shareholder advocacy are perceived to be political in nature, which conflicts with the view that SRI should be an individual right, not an institutional prerogative. Third, SRI is an evolving concept, its definition expanding over time.

For example, the concept of corporate governance is not new. (*See "Definition and Concept" above.*) Shareholders -- individual and corporate – have long used shareholder resolutions, threatened or in fact, to pressure companies to adopt corporate governance practices that affect financial returns. However, the use of "corporate social responsibility" to effect changes in social policies is relatively new. It has evolved from and is an extension of the "corporate governance" tactic.

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65. Pietra Rivoli, "Ethical Aspects of Investor Behavior," in *Journal of Business Ethics*, 14 (1995) pp. 265-277, as cited in Brian R. Bruce, ed., *The Investment Research Guide to Socially Responsible Investing*. Investment Research Forums, Inc. 1998, p. 104.

The most recent SRI development is the expansion into community investment. A recent publication on community investing<sup>66</sup> commented that the recent growth in the SRI industry has been a direct result of marketplace demand. That is, a significant number of investors have clamored for a values-aligned method of investing. The authors claim that market demand has led from

...negative sin stock screens; to issues like apartheid and tobacco; to workplace, environmental, and other affirmative screens. It has led to an increasingly active shareholder dialogue process: where shareholders encourage the companies whose securities they own to improve their social and environmental practices. Many in the industry believe that an increasing number of investors are now looking beyond quantifiable financial returns and are seeking to optimize the *social* returns on their investments. Community investing clearly fills this need for high-impact investments.

***Assets Involving Shareholder Advocacy*** According to the SIF, almost a trillion dollars is controlled by investors who play an active role in shareholder advocacy on social responsibility issues.<sup>67</sup>

Over 120 institutions and mutual fund families have leveraged assets valued at \$922 billion in the form of shareholder resolutions. These institutional investors used the power of their ownership positions in corporate America to sponsor or co-sponsor proxy resolutions on social issues. They also voted their proxies on the basis of formal policies embodying socially responsible goals and actively worked with companies to encourage more responsible levels of corporate citizenship.

Of the \$922 billion, \$265 billion in assets were in portfolios that used both screening and shareholder advocacy. This is the fastest-growing component of SRI, growing 215% from \$84 billion in 1997 to \$265 billion in 1999. The remaining \$657 billion were in portfolios that used shareholder advocacy only.

***Shareholder Advocacy Actions:*** As shareholders, investing entities may exploit the power of their voting shares to shape corporate policies that may or may not affect operations or profits, or both. KLD explains what boards of investing entities can do to influence corporate policy, and the effects of their actions:<sup>68</sup>

The investment decision-making process may factor in shareholder activism, the use of the franchise (the right to vote) conferred by stock ownership to raise issues of social concern with corporate management, and proxy voting generally.

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66. Cindy Mitlo & David Berge, "Increasing Investment in Communities: A Community Investment Guide for Investment Professionals and Institutions," Social Investment Forum, SIF Industry Research Program, September 15, 2000, p. 4.

67. 1999 Trends, pp. 4, 7.

68. KLD website: <http://www.kld.com/resources/sa.html>.

Each year, between 60 and 120 "social issue" resolutions appear on proxy ballots. Deciding how to vote on these issues presents a board with an opportunity to define the institution's stance on issues ranging from equal employment to the environment.

A board could adopt a general proxy voting policy that reflects the institution's core philosophy. For instance, a foundation concerned with social welfare issues might adopt a policy on executive and board compensation packages. One focusing on environmental matters may decide to vote for resolutions asking for a corporate policy favoring disclosure of ecological risks....

Shareholder activism is a process of initiative, negotiation, and compromise. It is commonly tied to proxy resolutions.... But shareholder activists usually file resolutions when they have failed to reach an agreement with management through other means.

Shareholder actions often begin with an attempt to engage management in a dialog on a specific issue. Sometimes they end at this stage, because it is in the interests of both sides to reach an accommodation. If one is not reached, the shareholders [sic] activists may file a resolution to be voted on by all shareholders at the annual meeting.

A proxy resolution is the proverbial 'stick' that makes palatable the 'carrot' of discussion. Even after a resolution is filed, compromise may occur, and the resolution may be withdrawn. If it is not, the issue goes to a vote, which shareholder activists almost never win. But, that does not mean they 'lost.'

The vote gives shareholders opportunities to educate their peers on their issue, as well as the public. In response to shareholder votes, companies may eventually change their practices; they may take the point. Or, the votes may mobilize internal constituencies at the corporation to press for change. Thus, while shareholder resolutions rarely pass, they bear fruit.

For example, as of an August 21, 2001 posting on its website, Shareholder Action Network<sup>69</sup> reported filing a resolution at Sara Lee Corp. to report on the impacts of genetically engineered foods. The resolution is to be voted upon in October 2001. The resolution directs Sara Lee's board to "... identify the risks, financial costs and benefits, including environmental impacts of the continued use of genetically engineered crops, organisms, or products thereof from all food products sold under the company's brand names or private labels."<sup>70</sup> The resolution cites the existence of scientific concern that genetically engineered agricultural products may be harmful to humans, animals, or the environment. The report further urges Sara Lee to:<sup>71</sup>

- 1) identify the scope of the Company's products that are derived from GE [*genetically engineered*] ingredients;
- 2) identify sources of alternative non-GE food ingredients;

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69. Shareholder Action Network is a project of the Social Investment Forum:  
<http://www.shareholderaction.org/>.

70. Shareholder Action Network: <http://www.shareholderaction.org/article.cgi?type=3&id=11>.

71. Ibid.

- 3) outline a contingency plan for sourcing non-GE ingredients should circumstances so require; and
- 4) cite evidence of long-term safety testing that demonstrates that GE crops, organisms, or products thereof are actually safe for humans, animals, and the environment.

Other examples reported by Shareholder Action Network include:

- (1) Filing of a resolution with ExxonMobil to diversify its energy mix by investing in more renewable energy technologies;
- (2) Filing of a resolution with Wal-Mart Stores, Inc. to ensure that it does not purchase from suppliers who manufacture items using forced labor, convict labor, or child labor, or who fail to comply with fundamental workplace rights protecting their employees' wages, benefits, working conditions, freedom of association, collective bargaining and other rights; and
- (3) Withdrawal of a resolution on predatory lending filed with Citigroup Inc. following a commitment to improve its practices and commitments to continued stakeholder dialogue.

According to the Interfaith Center on Corporate Responsibility (ICCR), (*not to be confused with IRRC, below*) in 1999 socially concerned investors filed approximately 220 resolutions with more than 150 major U.S. companies. Those who filed included religious shareholders, foundations, mutual funds, social investment managers, pension funds, and others. The breakdown appears in Table 2C.<sup>72</sup>

| <b>Table 2C</b>                              |                           |
|--|---------------------------|
| <b>CATEGORIES OF SHAREHOLDER RESOLUTIONS</b> |                           |
| <b>1999 Shareholder Issues</b>               | <b>No. of Resolutions</b> |
| Environment                                  | 54                        |
| Global Corporate Accountability              | 41                        |
| Equality                                     | 38                        |
| Corporate Governance/Executive Compensation  | 30                        |
| International Health and Tobacco             | 31                        |
| Global Finance                               | 14                        |
| Militarism and Violence                      | 12                        |

According to the Investor Responsibility Research Center (IRRC), there was a substantial increase in shareholder resolutions for the 2000 proxy season. Out of 108 socially-oriented

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72. 1999 Trends, p. 13, citing Interfaith Center on Corporate Responsibility (ICCR) data.



proposals, over 90% exceeded the 3% of the vote required to submit again in 2001.<sup>73</sup> The IRRC further reported that the highest performing resolutions call on companies to diversify their boards of directors. At American Power Conversion, the vote was 30.1% in favor. The second highest level of support went to resolutions calling on companies to implement the MacBride Principles in Northern Ireland. According to the IRRC:<sup>74</sup>

Resolutions on genetically modified organisms (GMOs) were hot this year, filed with 21 companies (2000 was the first year for GMO resolutions). They commonly called on companies – such as Monsanto, Coca-Cola, McDonald's, Campbell's, Heinz, General Mills, and Kellogg – to stop sales of products with GM ingredients pending further safety tests. [Votes garnered an average of 4%.]

Among other environmental shareholder resolutions, 'Report on global warming emissions & misinformation' was the most popular, with 11 resolutions. Companies included Alleghany Energy (8.87%), Chevron (8.7%), and Eastman Chemical (7%). Shareholders withdrew resolutions from Duke Energy, Cinergy, Goodyear and Texaco when they agreed to enter into discussion.

'Endorse CERES principles' was also popular, gathering about 9.9% of the vote at Aetna, Allstate, Dana, and Whirlpool. Niagara Mohawk shareholders voted in favor by 18.7%; at Lilly, the resolution received only 4.7%. Resolutions at Alcoa and Hasbro were withdrawn pending discussion.

BP Amoco (13.5%), Chevron (7.1%) and ExxonMobil (5.4%) were asked to 'Cancel Drilling in Arctic National Wildlife Refuge.'

Other shareholder resolutions reported by the IRRC include:<sup>75</sup>

- "Criteria for underwriting 3 Gorges Dam": Morgan Stanley (6.1%) and Citigroup (withdrawn)
- "Reduce radioactive emissions": Ameren (13.3%)
- "Drilling on indigenous land": Occidental Petroleum (6.1%)
- "Expand energy conservation": Pinnacle West (5.3%)
- "Phase out chlorine-bleached paper": Procter & Gamble and TYCO International (3.2%)
- "Phase out PVC medical products": Cardinal Health (vote still to be updated)
- "Report on environmental impact & plans": Enron (8.8%)
- "Adopt non-toxic chemical policy": Chevron (6.7%)
- "Promote renewable resources": ExxonMobil (6.2%)

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73. Investor Responsibility Research Center website: <http://www.shareholderaction.org/victory.cgi?id=2>.

74. Ibid.

75. Ibid.

- "Reduce Fuel consumption": Ford and GM (both withdrawn)
- "PCB Education/Disclose costs of delay in PCB clean-up": General Electric (8.99%)
- "Phase out old growth wood sales": Home Depot (withdrawn)

The SIF reported shareholder successes in 1999 that include the following:<sup>76</sup>

- After 12% of shareholders asked The Home Depot, Inc. to stop selling old-growth wood, the company announced an environmental wood purchasing policy that would eliminate its practice of buying three species of old-growth timber from endangered forests by 2002.
- After a year of dialog with shareholders over a resolution, Baxter International, Inc. agreed to look for alternatives to phase out polyvinyl chloride (PVC) materials in its intravenous products. (During manufacture and incineration, PVCs release toxic dioxin.)
- After years of shareholder encouragement, R. J. Reynolds Tobacco Holdings, Inc. agreed to separate its tobacco business from its food business.
- Upon the withdrawal of a resolution co-filed by Trillium Asset Management<sup>77</sup> and the Pride Foundation<sup>78</sup>, McDonald's Corporation agreed to implement a sexual orientation non-discrimination policy.
- After pressure from government agencies and shareholders, the General Electric Company agreed in 1999 to spend \$150 to \$250 million to clean up a stretch of the Housatonic River in Massachusetts of polychlorinated biphenyls (PCBs).

Issues planned for shareholder action in 2000 included:<sup>79</sup>

- Genetic engineering
- Carbon emissions and global warming
- Disclosure of affiliations
- MacBride Principles
- Sexual orientation and non-discrimination
- Negative images of indigenous peoples

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76. 1999 Trends, pp. 13, 14.

77. Trillium Asset Management website: <http://www.trilliuminvest.com/>. Trillium claims to be the "oldest and largest independent investment management firm dedicated solely to socially responsible investing." Trillium focuses on three major value groups: ecology, social justice, and healthy commerce.

78. Pride Foundation website: <http://www.pridefoundation.org/about/index.php3?content=mission>. The Foundation is an organization that works to "to strengthen our gay, lesbian, bisexual, and transgender (GLBT) community."

79. 1999 Trends, p. 14, figure 7.

- Drilling in the Arctic National Wildlife Refuge
- Executive pay freezes during large layoffs
- Sweatshops and vendor compliance
- Sustainable living wages
- Human rights.

The Citizens Funds reported that in the 2<sup>nd</sup> quarter of 2001, it filed a total of five resolutions, co-filed one other, and has been involved in dialogues with several more companies.<sup>80</sup> On the issue of board diversity, Citizens Funds co-filed a resolution with American Power Conversion and entered into discussions with Chiron Corporation. After discussion with BMC Software, it is considering withdrawing its resolution. With regard to genetically engineered foods, Citizens Funds co-filed a resolution with Hershey Foods Corporation. Recently, it has also filed or co-filed shareholder resolutions and engaged in direct discussions with companies regarding:<sup>81</sup>

- Corporate responsibility, vendor standards, and codes of conduct
- Workforce diversity
- Human rights
- Endorsement of CERES principles and/or the Global Reporting Initiative ("GRI")
- Global standards in manufacturing
- Discriminatory lending practices
- Doing business in Myanmar
- Supporting AFL-CIO boycotts
- Sexual orientation protection

In conjunction with an Interfaith Center on Corporate Responsibility and Calvert Group-sponsored initiative, Citizens Funds also sent letters to Liz Claiborne and J.C. Penney Company encouraging them to alter or terminate their use of the name Crazy Horse for one of their brands. This apparel line is perceived as degrading to the Native American community and to the estate of Crazy Horse.

***Shareholder Advocacy as Politics:*** Shareholder activism is an outlet for an investing board to advocate whatever social policies it may espouse. SRI is not just social screening. The evolving definition of SRI counts shareholder advocacy as one of its expressions, in addition to social screening and community investing. Examples of social policies that an investing board may advocate include those presented in the section entitled "Social Values and Screens" below.

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80. CF website: [http://www.citizensfunds.com/Live/about/approach\\_activism.asp](http://www.citizensfunds.com/Live/about/approach_activism.asp).

81. Ibid.

However, as already discussed, it is almost impossible to keep politics – at any level – out of shareholder advocacy.

Investing entities may first apply screens and then escalate to shareholder advocacy. For example at the county level, H-POWER, Honolulu's waste-to-energy plant in Leeward Oahu, would run afoul of a qualitative environment screen used by KLD. (See "*Domini 400 Social Index: Qualitative Screen, Environment, Beneficial Products and Services*" under "*Social Values, Screens, and Indices*" below.) The same screen would raise concerns over the use of deep injection wells that may upon occasion be approved by the Departments of Agriculture and Land and Natural Resources.

Certain other screens may affect the sale of county or state bond issues. It is not inconceivable that institutions, in the role of potential bond purchasers, may exercise shareholder advocacy in addition to screening. An alcohol screen may deter an institution such as the Employees Retirement System from investing in airport revenue bonds because alcohol is sold in duty-free shops at the Honolulu International Airport. The ERS could conceivably take further action via shareholder advocacy to pressure the Department of Transportation and the current in-bond merchandise vendor to prohibit the sale of duty-free alcohol at HIA.

If the University of Hawaii were to adopt a similar alcohol screen, it would be inconsistent for the University to accept advertising revenues from alcohol manufacturers. Continuing to sell alcoholic beverages on campus and at various venues during athletic competitions would also seem inappropriate. For that matter, it may wish to ban fans from bringing and consuming their own alcohol at tailgating parties. The University could emulate Maui County, which proclaimed the University's first football game on Maui a "family event" in defense of the county's ban on alcohol consumption at the game.<sup>82</sup> Taken further, the University would need to stop participating in a local radio station's "Call the Coach" show, whose venue is a local bar and grill. The status of Kapiolani Community College's award-winning culinary arts program would be in jeopardy since teaching about wines is part of the curriculum.

Along with these self-regulating measures, the University could step up its SRI commitment by opting to use shareholder advocacy. For example, it could try to persuade, say, Anheuser-Busch Inc. (a beer-maker) to stop advertising or selling alcohol at all college-level athletic events nationwide. Even if the University has no equity in Anheuser-Busch, it could purchase a limited number of shares for the sole purpose of advocating policy changes through shareholder advocacy.

On the one hand, any investing entity may engage in shareholder activism even if it does not socially screen. However, it must be clearly understood that an entity that uses social screens is not obligated by law or in any other way to engage in shareholder advocacy. Shareholder

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82. Gary T. Kubota, Honolulu Star Bulletin "No suds, no grills for Maui's UH football tailgating: Officials also say there will be no alcohol served in the stadium during the game" September 5, 2001. Maui sports commissioner Yuki Lei Sugimura made the comment about the football game as a "family game." A Maui ordinance prohibits alcohol consumption in parking lots at county parks.

advocacy is but one of three general components of SRI as defined by those in the field. SRI investing does not come prepackaged and shareholder advocacy is only one option.

On the other hand, social screening is basic to SRI. Investing by using social, non-financial criteria often defines SRI investing for an entity. Thus, an entity may restrict SRI activity to using screens. It only further *chooses* to use shareholder advocacy if the entity deems that approach appropriate. To sum up, deciding to invest in socially screened companies in no way obligates an investing entity to engage in shareholder advocacy activities.

### 3. Community Investing

***The Average Lay Person's View:*** The informal in-house discussions mentioned above also failed to identify community investing as an expression of SRI. Most were familiar with the term "community development bank" and knew of their functions. However, it was not apparent to most that SRI considers investments in such institutions as one of its components. No one was able to differentiate community development loan funds, credit unions, and venture capital funds from community development banks. No one could estimate the proportion of SRI assets occupied by community investing. (*See below.*)

For many social investors, community investing represents a further step beyond positive and negative stock screening. Participating in community investing serves several purposes. First, it allows an SRI investor to maximize the impact of – by making the biggest difference with – each SRI-invested dollar. Community investment funds normally go to those with relatively higher need. Second, community investing keeps the SRI investor in closer touch with what the investment is actually accomplishing. On another level, investments can be targeted locally to prevent the money from leaving the state, county, or municipality.

***Community Development Financial Institutions:*** According to the SIF, community investment is channeled through four main types of community development financial institutions (CDFIs). Capital from these CDFIs benefit urban and rural communities in need and focus on local development initiatives, affordable housing, and small business lending. Recipients often are unable to secure reasonably priced capital through traditional means. As of 1999, total community investment assets amounted to about \$5,415 million and the characteristics of the four types of CDFIs are as follows:<sup>83</sup>

- *Community development banks:* are located nationwide, have the greatest assets amounting to \$2,922 million and are federally insured. They provide capital to rebuild lower-income communities and offer services available at conventional banks, like savings and checking accounts.

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83. 1999 Trends, p. 15.

- *Community development loan funds*: operate in specific geographic areas, have the second largest assets at \$1,742 million, but are not federally insured. They act as intermediaries which pool investments and loans provided by individuals and institutions at below-market rates to further community development. One example is micro-enterprise development loan funds that lend to low-income individuals for business start-ups.
- *Community development credit unions*: are member-owned and controlled non-profit financial institutions serving people and communities with limited access to traditional financial institutions. They have combined assets of \$601 million and are covered under the National Credit Union Share Insurance Fund.
- *Community development venture capital funds*: make equity and equity-like investments in highly competitive small businesses that hold the promise of rapid growth. They use the tools of venture capital to create jobs, entrepreneurial capacity, and wealth to improve the livelihoods of lower-income individuals and economies of distressed communities. Investments range from \$100,000 to \$1 million in companies employing between 10 and 100 people.

SocialFunds.com, a personal finance website devoted to SRI, lists a fifth CDFI "micro finance institution" category. Also known as "microenterprise" programs, one distinguishing characteristic about this category is that they are not currently generally available to investors. SocialFunds.com describes the category as follows:<sup>84</sup>

- *Micro Finance Institutions*: are non-profit micro-loan institutions that are also unregulated and uninsured. Grameen Bank, one of the oldest and largest, is an example. Although micro-lending has gained much recognition internationally, there are a growing number of programs in the U. S. MFIs often target some of the poorest of the poor, and may offer technical assistance and employ the peer-lending model. A few MFIs accept direct uninsured investments, yielding about 0-5% return for 1 to 5 years.

The Table 2D is reproduced from a 2000 SIF publication authored by Mitlo & Berge detailing these five institution types.<sup>85</sup>

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84. SocialFunds.com at: [http://www.socialfunds.com/education/article.cgi?sfArticleId=7\\_1](http://www.socialfunds.com/education/article.cgi?sfArticleId=7_1).

85. Mitlo & Berge, "Figure 3: Community Investing At a Glance," p. 6.

**Table 2D**  
**COMMUNITY INVESTING**

| <b>Institution Type</b>                 | <b>Community Development Bank (CD Bank) Community Bank</b>  | <b>Community Development Credit Union (CDCU)</b>   | <b>Community Development Loan Fund (CDLF)</b>  | <b>Community Development Venture Capital (CDVC)</b>   | <b>Micro-enterprise Program</b>   |
|---|---|--|--|---|---|
| <b>Definition</b>                       | For-profit, government regulated depository institution devoted to developing disadvantaged communities. Often formed by holding companies, whose subsidiaries offer services including technical assistance. | Financial cooperative, typically non-profit, providing financial and lending services to disadvantaged communities. Credit unions designated "low income" by the National Credit Union Administration may accept nonmember deposits. | Typically private, non-profit, unregulated financial intermediary, providing flexible and low-cost financing to disadvantaged communities. CDLFs work intensively with individual and institutional investors to finance high-impact community development projects. | Structured as a variety of institution types, including for-profits, nonprofits, limited partnerships, and limited liability companies. CDVCs make equity investments in entrepreneurial new businesses to create jobs and wealth in disadvantaged communities. | Spearheaded by community investment institutions, government agencies, and other nonprofits. Microenterprise programs lend to sole proprietorship/ partnership/ family businesses with fewer than 5 employees, which have no access to commercial banking products and require loans of \$25,000 or less. |
| <b>Services Provided to Communities</b> | Basic financial services and loan products.   | Basic financial and credit services; promotes local community lending.   | Financial housing and economic development; offers technical assistance and some market development.   | Equity investments and debt with equity characteristics to businesses, along with extensive managerial and entrepreneurial assistance.  | Training and technical assistance, credit or access to credit, access to markets, and economic literacy development.  |
| <b>Trade Associations</b>               | Community Development Financial Institution Coalition, National Community Investment Funds (NCIF)   | National Federation of Community Development Credit Unions (NFCDCU)  | National Community Capital Association (NCCA)  | Community Development Venture Capital Alliance (CDVCA)  | Association for Enterprise Opportunity (AEO)  |
| <b>Statistics</b>                       | Only a small number of CD banks exist. Community banks exist across the country.  | Approximately 300 CUs exist in low-income areas. At year-end 1997, total assets of NFCDCU totaled almost \$400 million.  | Hundreds of loan funds exist in the U.S., varying from those with less than \$500,000 in assets to those holding tens of millions in assets.   | Approximately 45 domestic funds in various stages of development.   | At least 500 domestic programs in existence.  |
| <b>Products Available for Investors</b> | Standard banking products, including checking and savings accounts, CDs, money market accounts and IRAs.  | Generally all traditional deposit products.  | Generally unsecured term loans offering interest rates in the range of zero to four percent.   | Equity investments.   | Generally not available to investors, but products increasingly developing for investors.   |
| <b>Security</b>                         | All depositors insured up to \$100,000 by FDIC.   | Deposits up to \$100,000 generally insured.  | Not insured; investments often protected through avenues such as collateral, loan loss reserves, and a fund's net worth.   | Not insured.  | Not insured; investments currently available protected through avenues such as collateral, loan loss reserves, and a fund's net worth.  |

Table from Mitlo & Berge, "Increasing Investment in Communities: A Community Investment Guide for Investment Professionals and Institutions," *Social Investment Forum, SIF Industry Research Guide, September 14, 2000, Figure 3, "Community Investing At a Glance" p. 8.*

The same publication listed Hawaii as having a total of five such institutions as follows.<sup>86</sup>

- Hawaii Community Loan Fund (community development loan fund; micro enterprise fund)
- Hawaii Community Reinvestment Corporation (community development loan fund)
- The Immigrant Center (micro enterprise fund)
- Kekaha Federal Credit Union (community development credit union)
- Lokahi Pacific (community development loan fund)

According to SocialFunds.com, there are four primary lending sectors that community investing supports:<sup>87</sup>

**Affordable Housing** lending builds or rehabilitates housing for low-income families. Many programs also provide important and pivotal support in helping individuals secure and repay mortgages, and even offer training and empowerment programs that help support new homeowners in other areas.

**Microenterprise Development** focuses on assisting low-income people in starting their own businesses by providing very small loans, less than \$25,000. Internationally, loans can be as small as \$50. Some programs lend directly to individuals, while others use a peer-lending model that binds individuals together in a supportive group of borrowers. Many programs also offer technical assistance.

**Small Business Development** lending is more traditionally structured and supported than micro-loans. This category of lending assists low-income people in disadvantaged communities to start or increase the scope of their own businesses by providing loans generally over \$25,000.

**Community Development** lending supports non-profits and cooperatives that are working directly with disadvantaged populations and communities to develop enterprises that provide core social resources, such as health services and daycare centers. Others activities include banking services in targeted communities and critical funding to non-profits, cooperatives, and environmental programs.

These investment opportunities finance programs that enable the poor the chance to work their way out of poverty and into jobs and homes. They enable local non-profits and small businesses to maintain the critical facilities that healthy communities depend on. These investment opportunities vary widely in terms, rates, and risk.

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86. *Ibid.*, Appendix I, p. 25.

87. SocialFunds.com at: <http://www.socialfunds.com/ci/types.cgi>.



The SIF is encouraging all SRI investors involved in screening, shareholder advocacy, or both, to direct at least 1% of their portfolios to community investing. According to the SIF, community investing grew by 35% from 1997 to 1999.<sup>88</sup>

Assets held and invested locally by community development financial institutions (CDFIs) totaled \$5.4 billion, up from \$4 billion in 1997. This critically important capital is invested in community development banks, credit unions, loan funds and venture capital funds, and is focused on local development initiatives, affordable housing and small business lending in many of the neediest urban and rural areas of the country.

**Community Investing Mutual Funds:** Examples of SRI mutual funds that parallel this 1% guideline are three funds from the Calvert Group, Ltd. – the Social Investment Fund, World Values International Equity Fund, and the Calvert New Vision Small Cap Fund. These three funds carry out Calvert's "High Social Impact Investments" program, which invests in up to 1% of assets in "high social impact" companies. To date, the three funds have invested nearly \$9.1 million, \$3.9 million, and more than \$0.29 million, respectively, in high social impact programs domestically and abroad. These investments affect 88 community organizations.<sup>89</sup>

For example, Calvert invests in low-income housing organizations that create affordable housing for the disadvantaged.<sup>90</sup> Many of these local organizations also provide innovative social services to local residents. An example is a program that finances self-help housing programs in economically depressed areas such as the Mississippi Delta and the "maquiladora" region near the Texas-Mexico border. Calvert also invests in organizations involved in community development that provide jobs and skills training. Calvert further invests in microenterprise loans that provide credit to low-income individuals seeking to start or expand their small businesses, increase their income, and feed their families.

Another mutual fund that provides money for community investing is the Domini Money Market Account. This fund places investors' money (\$36 million) at the country's oldest and largest community development bank, South Shore Bank of Chicago.<sup>91</sup> Deposits are converted into "development loans" that provide financing to local entrepreneurs working to rebuild inner-city neighborhoods. The Domini Social Bond Fund invests primarily in intermediate term investment grade fixed-income securities and aims to "...invest up to 10 percent of its assets in debt instruments and other investments that directly support and promote community development."<sup>92</sup>

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88. 1999 Trends, p. 4.

89. Calvert website: [http://www.calvert.com/sri\\_650.html](http://www.calvert.com/sri_650.html).

90. *Ibid.*

91. Mitlo & Berge, p. 22.

92. *Ibid.*

Parnassus Investments, founded in 1984, offers several mutual funds that engage in community investing. The Equity Income Fund and Fixed-Income Fund may invest up to 10% of their assets in community loan funds, The California Tax-Exempt Fund looks for investments that can generate a positive social and environmental impact including bonds that finance schools, low-income housing, energy conservation, and other programs. The \$300 million Parnassus Fund may invest up to 5% of its assets in community development loan funds.<sup>93</sup>

Trillium Asset Management, which offers the SRI-based Advocacy Fund, makes available federally insured market rate certificates of deposit issued by community banks and credit unions and/or below-market rate promissory notes issued by loan funds and non-profit organizations as follows:<sup>94</sup>

**Table 2E**  
TRILLIUM ASSET MANAGEMENT  
CERTIFICATES OF DEPOSIT AND PROMISSORY NOTES

| Certificates of Deposit                  | Promissory Notes                          |
|--|---|
| Federally insured                        | Minimum two-year term                     |
| Choice of Market Rate or Below           | 0% to 3% interest rate                    |
| Choice from available options            | Minimum investment of \$5,000 per vehicle |
| Community Institution Project/Initiative | Choice from available options             |
|  | Community Institution Project/Initiative  |

*Institutional Products for Community Investing:* The creation of community investment products for institutional investors is a new development in the field of community investing. It provides liquidity and longer-term capital to community investment organizations. According to Mitlo & Berge,<sup>95</sup> there are a number of existing securities, both debt and equity, available to institutional investors that allow them to invest in affordable housing tax credits, as well as community development securities and bond issues. Within this range of existing securities, a number of structures, terms and rates are represented, with the pricing often approaching market rates. There are also a number of new community investment products for institutional investors in development. The following is taken from Mitlo & Berge:<sup>96</sup>

*Access Capital Strategies Community Investment Fund, Inc:* This fund is a closed-end mutual fund. It was designed to be a secondary market purchaser of a wide range of community development securities, including home mortgages, affordable rental housing, commercial real

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93. Ibid.

94. Trillium website: [http://www.trilliuminvest.com/pages/sri/sri\\_comminvest.asp](http://www.trilliuminvest.com/pages/sri/sri_comminvest.asp). As of August 15, 2000, Trillium Asset Management had about \$675 million in assets under management, according to its Advocacy Fund prospectus at: [http://clientdata.forum-financial.com/trillium/Trillium\\_prospectus\\_final\\_for\\_web.pdf](http://clientdata.forum-financial.com/trillium/Trillium_prospectus_final_for_web.pdf).

95. Mitlo & Berge, p. 23.

96. Ibid., pp. 23, 24.

estate, and small business loans. This fund will purchase securities backed by community investment loans, including Federal Housing Authority and Small Business Administration loans, specialized Fannie Mae and Freddie Mac securities, and customized loan packages whose credit quality has been enhanced by individual banks using the Federal Home Loan Bank Investment Program letter of credit. The Fund will only invest in private placements rated AAA or the equivalent. The target yield for Fund investments will be a minimum equal to the return on Treasury securities of comparable maturities. The Fund allows investors to direct their capital to one or more of ten targeted geographic regions in the country. It was designed especially with bank investors in mind and will offer such investors the opportunity to earn Community Reinvestment Act credit under the Investment Test banks must now meet. The Fund's target size is \$1 billion (10,000 shares of common stock at \$100,000 per share).

*Affordable Housing Tax Credits:* A number of institutions invest in affordable housing tax credits as one component of a community investment strategy. Enabled by the Tax Reform Act of 1986, the Federal Housing Tax Credits may be used to offset federal income tax liability, dollar-for-dollar, each year for a 10- to 12-year period. Those investments are used as equity in affordable housing in lower-income communities.

*Community Reinvestment Revenue Bonds:* The Community Reinvestment Fund, Inc. (CRF) is a Minnesota-based nonprofit corporation. The CRF operates a secondary market for development loans it purchases from community development lenders around the country. The CRF has periodically issued community reinvestment revenue bonds, a typical issue ranging in size from \$2 to \$7 million and structured as a senior/subordinated transaction. Senior tranches<sup>97</sup> carry market pricing and have been secured by a first lien on revenues generated from the pool of development loans purchased with the proceeds of each bond issue. Subordinated tranches have generally been purchased by socially motivated investors or retained by CRF. Thus far, CRF bonds have only been available for purchase by institutional investors in denominations of \$100,000.

*Corporation for Independent Living Tax-Exempt Bonds:* Tax-exempt bonds revenue or general obligation bonds are issued every few years by the Connecticut Development Authority or the Connecticut Housing Finance Authority to finance the development of small group homes for individuals with mental disabilities in communities throughout the state of Connecticut. The typical bond issue is under \$10 million with an AA rating, priced at a fixed rate based on a spread over U. S. treasury offerings.

*Neighborhood Housing Services of America (NHSA):* The NHSA is a private nonprofit corporation established in 1974 to create a national secondary market for housing loans originated by a network of approximately 200 nonprofit NeighborWorks partnerships that serve more than 500 communities around the country. The NHSA has historically raised investments for its secondary market by approaching institutional investors such as insurance companies and

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97. Tranches are related securities that are offered at the same time but have different risk, reward, and/or maturity. For example, a CMO (collateralized mortgage obligation) tranche might have mortgages that are 1-year, 2-year, 5-year, and 20-year maturities.

banks, denominational pension funds, foundations, Freddie Mac and Fannie Mae,<sup>98</sup> and others. It designs a private note offering to meet the interests or needs of each investor. Note offerings have ranged from a few million to close to \$100 million in size. Many of the note offerings represented partnerships between the NHSA, the local NeighborWorks organizations, the investor, and other funders who shared the risk and cost associated with the offerings. At present, the NHSA is considering expanding its range of investment vehicles to include rated securities.

*SSgA Affordable Housing Mortgage Fund LLC:* This Fund is a commingled fund open only to accredited non-ERISA institutional investors, such as endowments, foundations, and church plans. This fund is a limited liability company providing first mortgage loans for housing projects that qualify for Low Income Housing Tax Credits. The fund's investment objective is to provide a competitive risk-adjusted rate of return, as well as reasonable liquidity for its investors, by acquiring, holding, managing, and disposing of multifamily real estate loans secured by affordable apartment projects that qualify under the Low Income Housing Tax Credit provisions of the IRS Code. Fund investments can include construction loans, permanent loans, or combination construction/permanent loans. The fund is a closed-end investment fund with a scheduled termination date of December 31, 2006.

***Below-Market Rates:*** Whenever below-market rates are involved, it is clear that community investing will not generate as much return a non-SRI investment, say in a U. S. Treasury bill. For example, with a 1% return on a \$1,000 community investment, the SRI investor will sacrifice a 2% return (\$20) on a comparable 3% treasury bill. The investor could donate the extra \$20 interest from the T-bill directly to a CDFI. However, if the \$1,000 were used for community investment, the entire amount would have been used to help loan recipients.

Thus, on the one hand, community investment maximizes the use of investment dollars. However, on the other hand, the choice of an SRI community investment requires a tacit acceptance of a real lower return. Nonetheless, the loss of investment return is relatively small and community investment usually constitutes a very small percentage of an investor's portfolio. Perhaps this helps explain why the SRI investor is willing to sacrifice return – after all, not much will be lost. An SIF publication aimed at investment professionals and institutions concedes just these points.<sup>99</sup>

Concerns [*of clients*] about returns are best addressed by the fact that below market rate community investment products tend to have the highest social impact in a portfolio with both social and financial requirements. In addition, only a small portion of a client's portfolio needs to be dedicated to low return investments in order to achieve significant results. Low risk and low return community investments representing just one percent of a client's portfolio, as recommend by the Social Investment Forum, will help to meet the

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98. "Freddie Mac" is the Federal Home Loan Mortgage Corporation; "Fannie Mae" is the Federal National Mortgage Association.

99. Mitlo & Berge, p. 26.

social impact objectives of that portfolio. Indeed investors who choose to invest one percent of their total portfolios in below market community investments will experience a minimal impact on their average return.

### **Social Values, Screens, and Indices**

An investing entity wishing to engage in SRI has available to it values of almost every kind. Cultural perspectives prevalent in the United States certainly play a role that shapes which values become predominant. However, it seems that the longer an issue has been in the public eye, the greater the likelihood of its acceptance into the mainstream. For example, the most popular value screen is for tobacco companies. According to the SIF, the following shows the percentages of social investment portfolios applying various popular investment screens in 1997 and 1999:<sup>100</sup>

**Table 2F**  
POPULAR INVESTMENT SCREENS IN 1997 AND 1999

| Screens                    | 1997 | 1999 |
|----------------------------|------|------|
| Tobacco                    | 84%  | 96%  |
| Gambling                   | 72%  | 86%  |
| Alcohol                    | 68%  | 83%  |
| Weapons                    | 69%  | 81%  |
| Environment                | 37%  | 79%  |
| Human Rights               | 23%  | 43%  |
| Labor                      | 25%  | 38%  |
| Birth Control and Abortion | 50%  | 23%  |
| Animal Welfare             | 7%   | 15%  |

Several commonly cited social indices used by SRI investors, their rating criteria, and composition are discussed below.

### **Council on Economic Priorities**

The Council on Economic Priorities (CEP) gives awards to companies annually in a variety of categories for outstanding company policies and practices. The CEP describes itself and its mission as follows:<sup>101</sup>

Founded in 1969, the Council on Economic Priorities (CEP), is a public service research organization, dedicated to the accurate and impartial analysis of the social and environmental records of corporations.

100. Social Investment Forum, "1997 Report on Socially Responsible Investing Trends in the United States", Nov. 5, 1997, p. 7 (hereafter "1997 Trends" figure 3, and 1999 Trends, figure 5).

101. CEP website: <http://www.cepnyc.org/aboutus.htm>.

Based in New York, with a program in London and partners in Japan, England, France, Australia, Italy, Sweden, Canada, Germany, Belgium, India, and Switzerland, CEP is committed to making information on corporate social responsibility available to millions of consumers, investors, policy makers and businesses.

CEP focuses its research on all the factors that make up the social fiber of a company. Our work encompasses the many aspects of ethical performance including human rights, equal employment opportunity, concern for the environment, and strong involvement in the community.

The company that continues to review the social health of its policies and takes a proactive stance on substantive issues is most likely already a Corporate Conscience Award winner and/or a CEP Honor Roll Company. Such companies reflect social consciousness from the top down.

CEP takes the responsibility of highlighting the positive work of socially and environmentally responsible companies so that they can be a role model for other companies worldwide.

On June 15, 2000, the CEP recognized the winners of the 14<sup>th</sup> annual corporate conscience awards. The winners and their categories are as follows:<sup>102</sup>

**Table 2G**

**CORPORATE CONSCIENCE AWARD WINNERS AND THEIR CATEGORIES**

| <b>Corporate Conscience Award Winners</b> | <b>Category</b>           |
|---|---------------------------|
| Bristol-Myers Squibb                      | Global Ethics             |
| Carris Reels                              | Employee Empowerment      |
| Denny's                                   | Diversity                 |
| Horizon Organic Holding Corporation       | Environmental Stewardship |
| Collins Aikman Floor Coverings, Inc.      | Environmental Stewardship |
| Ricoh Corporation                         | Environmental Stewardship |

In 2000, the Council for Economic Priority publicized its 2000 corporate conscience award winners. CEP's descriptions of the award winners illustrate the types of values, expressed through a company's actions, that are examined in its screens.<sup>103</sup>

- Bristol-Myers Squibb established a \$100 million program in partnership with South Africa, Botswana, Namibia, Lesotho, and Swaziland to find innovative and replicable solutions for the management of HIV/AIDS, particularly in women and children, and to increase access to healthcare.
- Bill Carris, the owner of Carris Reels, has begun the process of making the company wholly owned by its employees. Its employees also decide which charities should benefit from the profits.

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102. CEP website: <http://www.cepnyc.org/ccawin2000.htm>

103. Ibid.

- Once synonymous with bias and discrimination, Denny's has not only become a symbol of reinvention but one of the most successfully diverse places to work in America just four years after a lawsuit was brought against the company by two African American customers who alleged they had been refused service because of their race.
- Horizon Organic is the country's single national milk producer and is the unequivocal front runner in environmentally responsible dairy farming. It employs a network of 600 organic farms around the country.
- Collins Aikman developed the first fully recyclable carpet. The company also encourages customers to bring in their old carpeting (regardless of manufacturer), to create new carpet from the old. The company also developed an easier, simpler, and cleaner carpet installation process. The company's "peel and stick" backing was revolutionary and also eliminated a noxious "off-gassing" that was a by-product caused by the application of wet adhesives.
- Ricoh Corporation, a leading provider of digital imaging systems, has demonstrated an outstanding commitment to the environment through its innovative development and manufacturing of energy-efficient office equipment including digital copiers, facsimile machines, printers and scanners.

However, CEP considers many more categories of values, and actions that express those values. To illustrate the mind-boggling complexity of social grading, the following seven categories, weighted by subcategories, is taken from the CEP's website:<sup>104</sup> *(Percentages do not necessarily total 100%, as reported by CEP.)*

|    |   |      |
|----|---|------|
| I. | Environment                                   |      |
| 1. | Environmental impact                          | 46%  |
| 2. | Corporate environmental reporting             | 10%  |
| 3. | Compliance history                            | 10%  |
| 4. | Environmental management systems              | 35%  |
|    | (a) Corporate environmental commitment        | (8%) |
|    | (b) Corporate environmental policy            | (4%) |
|    | (c) Environmental audits                      | (4%) |
|    | (d) Employee training/accountability          | (4%) |
|    | (e) Waste management and pollution prevention | (4%) |
|    | (f) Product stewardship                       | (4%) |
|    | (g) Supplier relationship                     | (2%) |
|    | (h) Resource/energy usage                     | (2%) |
|    | (i) Industry specific issues                  | (4%) |

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104. CEP website: <http://www.cepnyc.org/sbwgradingcriteria.htm>

*SOCIALLY RESPONSIBLE INVESTING*

|      |   |        |
|------|---|--------|
| II.  | Women's Advancement   |        |
| 1.   | Women on the board  | 11%    |
| 2.   | Female corporate officers   | 13.75% |
| 3.   | Female officials and managers   | 13.75% |
| 4.   | Female new hires  | 6.875% |
| 5.   | Women in total workforce  | 6.875% |
| 6.   | Women in top 25 paid employees  | 11%    |
| 7.   | Programs to develop women for advancement   | 11%    |
| 8.   | Programs to develop women for advancement<br>employee participation rates   | 5.5%   |
| 9.   | Underwriting by woman-owned firms   | 8.25%  |
| 10.  | Investments handled by woman-owned firms  | 2.75%  |
| 11.  | Purchasing from woman suppliers   | 8.25%  |
| III. | Minority Advancement  |        |
| 1.   | Minorities on the board   | 10%    |
| 2.   | Minority corporate officers   | 12.5%  |
| 3.   | Minority officials and managers   | 12.5%  |
| 4.   | Minority new hires  | 8.75%  |
| 5.   | Minorities in total workforce   | 6.25%  |
| 6.   | Minorities in top 25 paid employees   | 12.5%  |
| 7.   | Programs to develop minorities for advancement  | 10%    |
| 8.   | Programs to develop minorities for advancement<br>employee participation rates  | 5%     |
| 9.   | Underwriting by minority-owned firms  | 7.5%   |
| 10.  | Investments handled by minority-owned firms   | 2.5%   |
| 11.  | Charitable contributions to minority organizations  | 5%     |
| 12.  | Purchasing from minority suppliers  | 7.5%   |
| IV.  | Charity   |        |
| 1.   | Total giving index = cash gifts + 0.25 (in-kind giving)   |        |
| (a)  | Cash gifts include contributions made through the company itself or the company's foundation. This does not include social investments. |        |



(b) In-kind gifts include products and services such as computers and pharmaceuticals, employee time, executive loan programs.

2. Company ranking = total giving index/average pre-tax earnings.

V. Workplace Issues

|     |  |     |
|-----|--|-----|
| 1.  | Individual insurance                   | 27% |
| 2.  | Pension matching maximum               | 12% |
| 3.  | Pension matching                       | 3%  |
| 4.  | Pension vesting time                   | 3%  |
| 5.  | Workplace training                     | 6%  |
| 6.  | Workplace bonus programs               | 6%  |
| 7.  | Stock programs                         | 6%  |
| 8.  | Individual programs                    | 6%  |
| 9.  | Displaced worker programs              | 12% |
| 10. | Workplace safety issues                | 6%  |
| 11. | Serious, willful, or repeat OSHA fines | 9%  |
| 12. | Current OSHA fines                     | 9%  |

VI. Family Benefits

|    |                            |     |
|----|----------------------------|-----|
| 1. | Dependent care             | 40% |
| 2. | Flexible work arrangements | 30% |
| 3. | Family insurance           | 15% |
| 4. | Family leave               | 15% |

VII. Disclosure – determined by number of CEP surveys a company completes. Returning surveys on all six issue areas above earns a top grade.

CEP also rates companies, without grades, on the following issue areas:<sup>105</sup>

- Community Outreach
  - Volunteer Programs
  - Community Programs

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105. CEP website: <http://www.cepnyc.org/criteria.htm>.

- Volunteer Efforts
- Internal Efforts
- Other Community Efforts
- Animal Welfare
  - Use of animals for testing of non-medical products
  - Use of animals for testing of medical products
- Gay/Lesbian Issues
  - Presence of a sexual orientation non-discriminatory policy
  - Full domestic partner health care insurance
  - Diversity/sensitivity training
  - Advertising in gay/lesbian media
- Weapons Contracts
  - Provision of civilian vs. non-civilian goods or services to the U.S. Department of Defense
  - Involvement in the production or sale of handguns or handgun parts

### **Calvert Social Index:**

The Calvert Group, Ltd. offers a very large family of social investment mutual funds in the United States. In the 1980s, Calvert pioneered the use of social investing on a broad scale. The Calvert Group claims that its Social Investment Fund became the first mutual fund to oppose apartheid in South Africa in 1982.<sup>106</sup> It has approximately \$7.3 billion in assets in 27 screened and unscreened portfolios and over 220,000 investors. According to the Calvert Group, it has become the leading provider of the broadest array of SRI mutual funds across equity, bond, and money market portfolios.<sup>107</sup>

Calvert also created the Calvert Social Index (CSI) as a way of measuring the performance of some of the largest American companies that have been socially screened. The CSI is a benchmark only and is not a fund in which investors can invest. (However, the

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106. Calvert: "Socially Responsible Investing" on <http://www.calvert.com/sri.html>. However, in Stephanie M. Kendall, "Green Funds Provide Good Returns In Good Conscience" at <http://www.socialinvest.org/Areas/Research/Other/CDA-GoodGreen.htm>, 5/10/01, according to the SIF, the oldest socially responsible fund is Pax World Fund, which was founded in 1971. Soon after, Dreyfus began its Third Century Fund and the Calvert Group opened its Social Investment Fund Managed Growth Portfolio. Since then, over 192 funds have been either founded or updated to reflect the morals of investors concerned with the integrity of their fund's holdings.

107. Ibid.

Vanguard Group began offering the Vanguard Calvert Social Index Fund as of May 2000.)<sup>108</sup> The CSI begins with a base of the 1,000 largest American companies representing stocks listed on the New York Stock Exchange and the NASDAQ-AMEX. These do not include closed-end mutual funds, ADRs (American Depositary Receipts representing foreign stocks), REITS (real estate investment trusts), and non-common shares. They are then ranked in descending order by market capitalization. Calvert's social research department conducts a social audit of each company in the base. The audit is conducted in the following six broad areas:<sup>109</sup>

- Environment
- Workplace issues
- Product safety
- Military weapons contracting
- International operations and human rights
- Respecting the rights of indigenous peoples

The stocks that meet these criteria make up the CSI.

*Environment:* The Calvert Group explains this criterion in more detail as follows:<sup>110</sup>

Our minimum environmental standard requires that companies comply with federal, state and local environmental regulations and maintain at least an average record within their respective industries. We do not invest in nuclear power plant operators, owners or contractors because we feel current nuclear power technology is neither environmentally nor economically viable. We also search for companies that are outstanding in their environmental practices. Beyond these basic criteria, we seek investments in companies that:

- Have developed products or processes that will reduce or minimize environmental impact.
- Have adopted technologies or redesigned products to conserve the use of energy, water, materials and/or land.
- Have implemented innovative pollution prevention programs.
- Have management practices, including audits that address their environmental performance.
- Disclose environmental policies and practices to shareholders, employees and communities in which the company operates.

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108. Dawn Smith article.

109. Calvert: press release June 28, 2001, "Calvert Social Index Quarterly Rebalancing Notification."

110. Calvert: [http://www.calvert.com/sri\\_647.html](http://www.calvert.com/sri_647.html).

*Workplace Issues:* This criterion is explained in more detail as follows:<sup>111</sup>

Companies eligible for Calvert portfolios provide safe and healthy work environments and promote the healthy development of all employees. We do not invest in companies that show a pattern of violating fair labor practices; occupational safety and health regulations; and equal opportunity standards concerning pay, promotion, and tenure with regard to race, religion, gender, age, sexual orientation, HIV/AIDS status or physical ability. We also reject firms that are the subject of serious actions by the Equal Employment Opportunity Commission or by the National Labor Relations Board. We favor companies that:

- Actively hire and promote minorities and women.
- Compensate their workers fairly.
- Enjoy good labor-management relations.
- Provide programs and benefits that support workers and their families.
- Provide a safe and healthy workplace.

*Product Safety:* With respect to the third criterion:<sup>112</sup>

Companies in our portfolios must produce safe products and services in accordance with federal consumer product safety guidelines. We do not invest in major manufacturers of alcoholic beverages and tobacco products because we believe they contribute to a variety of economic and health problems that can potentially put both the consumer – and the investor – at risk. We also exclude companies that operate gambling establishments. We seek to include companies that:

- Produce or market goods and services that enhance the health or quality of life for consumers.
- Maintain quality control and customer satisfaction.
- Respond promptly to correct problems with product safety.
- Demonstrate integrity in their advertising and labeling, both domestically and overseas.
- Conduct animal testing for consumer products, which provide a viable rationale for using animals, set standards for humane treatment of animals and support research on alternatives to animal testing. They are also required to demonstrate progress toward eliminating the use of animal testing.

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111. Ibid.

112. Ibid.

*Military Weapons Contracting:* The fourth criterion is explained as follows:<sup>113</sup>

Calvert's socially screened funds will not invest in companies significantly involved in weapons production. We avoid companies that have weapons contracts exceeding 10% of gross annual sales. Additionally, we do not invest in companies that comprise the top 85% of the total market for weapons contracts with the US Department of Defense, or the top 90% of the total market for nuclear weapons contractors.

*International Operations and Human Rights:* The fifth criterion is detailed as follows:<sup>114</sup>

We expect companies to be responsible corporate citizens abroad as well as at home. We pay particularly close attention to the activities of corporations in countries that have records of political repression and/or basic human rights violations. We seek to include companies that:

- Have adopted specific human rights standards to govern international operations and practices.
- Utilize more stringent environmental and workplace standards than required by host countries.
- Directly combat human rights abuses and environmental degradation.

*Indigenous Peoples' Rights:* Finally, the sixth criterion used by the Calvert Group is detailed below:<sup>115</sup>

We are concerned about the survival and security of indigenous people around the world. Companies operating on the land of indigenous peoples should support appropriate development that respects indigenous territories, cultures, environment and livelihoods. The Funds will not invest in companies that have a pattern of egregious practices toward indigenous people.

We seek to include companies that:

- Respect the dignity, human rights and cultural uniqueness of indigenous peoples.
- Have adopted and implemented guidelines that take proactive measures in dealing with indigenous communities. These include, among others, respecting the land, sovereignty and natural rights of indigenous peoples.
- Support the positive portrayals of indigenous peoples, including American Indians, and their religious and cultural heritage.

The CSI is updated ("reconstituted") annually. The updating is meant to reflect current market activities and performance. The three-month long process begins in June and takes effect

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113. Ibid.

114. Ibid.

115. Ibid.

on the third Friday of September after market close. Calvert does not make public the reasons why a certain company does not make the CSI or is deleted from it. Companies can be removed from the CSI for non-social reasons such as being acquired, merged, spun-off, or delisted from an exchange for any reason including bankruptcy. Otherwise, Calvert will only reveal that a company has been deselected for "social criteria."<sup>116</sup> However, Calvert is willing to speak to the company's management. According to Calvert's Director of Social Research, Jon Lickerman:<sup>117</sup>

A company must meet our minimum standards within each category to be eligible for investment. So if our analysis finds that Company X has a strong labor relations record but a below average environmental record, we don't say, 'Do we care more about the employees or the environment?' Because Company X didn't meet the minimum standard on the environment, it is not eligible for the Index. We use a very standards-based approach – we are not interested in balancing these core social issues... But there are many gray areas that we often have to wrestle with, such as the environment. A company with some level of environmental issues may still be included if we feel that management is working to reduce its environmental impact and has tangible results to show for it. Labor relations, community relations, animal testing, and other issues can provide equally challenging issues... *[Calvert recognizes that there are no perfect companies and thus seeks companies whose performance is above average in their industries.]* If the company doesn't meet our criteria, we won't invest in it. In some cases, if we feel a company needs to improve but still satisfies our criteria, we may invest in it and raise our concerns in a dialogue with company management... We won't include or exclude a company just to influence the company's social agenda. But there is an advocacy component to our work, and we will continue to encourage best corporate practices throughout our research and dialogue with companies.

An in-house social research department uses four key resources to conduct the social analyses of companies. According to Lickerman, these are:<sup>118</sup>

- (1) The Lexis-Nexis database of approximately 7,000 companies;
- (2) Interviews with company management;
- (3) Data from United States environmental and regulatory agencies; and
- (4) Discussions with advocacy groups.

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116. Calvert: [http://www.calvert.com/invwcal\\_816.html](http://www.calvert.com/invwcal_816.html). For example, in July 2001, Intermedia Communications, Inc., Houghton Mifflin Co., Harcourt General Inc., Digital Island, Inc., Aurora Biosciences Corp., Sawtek Inc., and Nova Corp. were all acquired by other companies. Five others had their ticker symbols changed or moved to a different trading exchange. In June 2001, two companies, First Tennessee National Corporation and Varco International Inc., were deleted from the CSI for not meeting "social criteria."

117. John Lickerman, Calvert Director of Social Research, [http://www.calvert.com/invwcal\\_752.html](http://www.calvert.com/invwcal_752.html) and [http://www.calvert.com/sri\\_571.html](http://www.calvert.com/sri_571.html).

118. Ibid.

Although the CSI is reconstituted annually – based on changes in market capitalization – the Calvert Social Index Committee meets each quarter to review and approve changes to the CSI based on corporate actions. For example, Calvert issued a press release on June 29, 2001 announcing the addition of two companies to, and the deletion of 13 companies from, the CSI, effective June 18, 2001.<sup>119</sup> As of June 28, 2001, the CSI contained 629 companies, as listed on the Calvert Group's website.<sup>120</sup>

The CSI differs from the S&P 500 Index in that the CSI will be lighter in industries that tend to have a substantial negative social or environmental impact, such as the steel industry, footwear and apparel manufacturers, and oil and mineral extractors, because it is tough for those companies to meet CSI's minimum criteria. On the other hand, it will probably have heavier weightings in less problematic industries such as technology or financial services.<sup>121</sup>

### **Domini 400 Social Index:**

Kinder, Lydenberg, Domini & Co., Inc. (KLD) is a leading provider of social research for institutional investors who wish to integrate social criteria into their investment decisions. KLD provides performance benchmarks, corporate accountability research, and consulting services analogous to those provided by financial research service firms. KLD provides the following institutional services:<sup>122</sup>

- Developing social investment policies and benchmarks
- Implementing social investment programs in conjunction with money managers
- Performing social audits of portfolios
- Screening customized universes
- Designing and supporting investment products distributed by other financial institutions

The firm is best known for its Domini 400 Social Index (DSI), launched in 1990. The DSI is a socially screened, capitalization-weighted index of 400 common stocks. (The Domini Social Equity Fund is a passively managed mutual fund based on the DSI.) Aside from the DSI, KLD also maintains the KLD Broad Market Social Index (BMSI) which consists of all companies within the Russell 3000 that pass KLD's screening criteria.<sup>123</sup> The intent of these

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119. Calvert June 28, 2001 press release.

120. [http://www.calvert.com/invwcal\\_calvertindex.asp?letter=All](http://www.calvert.com/invwcal_calvertindex.asp?letter=All). However, the number should be 628, according to its quarterly rebalancing: 2 of the 13 companies deleted were still listed (New Era of Networks Inc. (NEON) and Powertel Inc. (PTEL), while 1 of the 2 companies added had not been placed on the list – Ceridian Corp.(CEN).

121. Lickerman.

122. KLD website: <http://www.kld.com/about/about.html>.

*(Footnote continued on next page.)*

indices is to give investors benchmarks of socially screened companies against which to compare investment results. According to KLD:<sup>124</sup>

Using hundreds of sources referencing thousands of companies, KLD monitors the social records of selected publicly traded US and non-US corporations. Based on the data it gathers, KLD develops evaluations that take three forms: comprehensive corporate ratings; text profiles; and market-wide exclusionary screening. This information is available on KLD's Socrates database.

The BMSI screens out companies involved in alcohol, tobacco, firearms, gambling, nuclear power, and military contracting. All remaining companies are then evaluated for employee diversity, product, innovation, community involvement, and other criteria. All Russell 3000 companies passing these screens are included in the BMSI, which is reconstituted every June along with the Russell 3000.<sup>125</sup>

Companies in the DSI are selected in much the same way, but from a different universe – the Standard & Poor's 500 index. KLD screens out alcohol, tobacco, gambling, nuclear power, and military weapons related companies. Companies are then evaluated on the basis of performance relating to environmental impact, citizenship, employee relations, and diversity.<sup>126</sup>

About half the Standard & Poor[s] 500 companies qualified for the DSI in KLD's initial screening process. KLD then added about 150 new companies with two goals in mind. One goal was to get a broad representation of industries, so that our index would better reflect the stock market as it exists for social investors. Another goal was to find companies that are particularly strong models of corporate behavior... Occasionally the social profile of a company deteriorates, causing KLD to remove it. When a company is removed from the DSI, KLD replaces it with another company. In the selection process KLD considers the size of the company, the industry it is in, and of course its social profile.

As of March 31, 2001, the DSI's top ten holdings were: Microsoft Corporation, American International Group, Inc., Intel Corporation, Merck & Co., Inc., AOL Time Warner, Inc., SBC Communications Inc., Verizon Communications, Johnson & Johnson, Cisco Systems, Inc., and Coca-Cola Company.<sup>127</sup> The DSI has a low portfolio turnover rate – about 6% to 8% – similar to the S&P 500. A company is replaced if it merges or ceases to be traded or if it no longer meets the index's social criteria.

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123. The Russell 3000 is a market cap-weighted index of the 3,000 largest companies in the United States representing about 98% of all investable stocks domiciled in the United States and its territories.

124. KLD website: <http://www.kld.com/about/about.html>, (hereafter "KLD").

125. KLD: <http://www.kld.com/benchmarks/bmsi.html>.

126. KLD: <http://www.kld.com/benchmarks/dsifaq.html>.

127. KLD: <http://www.kld.com/benchmarks/dsicomposition.html>.



It is important to remember – as KLD itself notes – that the DSI does not try to copy the S&P 500 index. First, the DSI contains only about half the companies in the S&P 500. The DSI tries to reflect the market behavior of stocks that meets higher social criteria of the average social responsible investor.<sup>128</sup> On the other hand, the S&P 500 attempts to gauge the performance of the broad market for large capitalization stocks. Thus, performance comparisons between the two are not strictly valid because they are meant to measure different things.

KLD's "2001 Social Rating Criteria ©" is both complex and lengthy. Reproduced in its entirety by permission, it is attached as Appendix B. However, an outline here of the structure of its two screens, exclusionary and qualitative, is informative. The exclusionary screen consists of only "concerns" whereas the qualitative screen contains both "strengths" and "concerns." Thus, after the first cut, where no positives are considered, the qualitative screens take into account both positives and negatives. KLD uses this "2001 Social Rating Criteria ©" for the 2001 research cycle – from November 1, 2000 to October 31, 2001. (*Explanatory notes added in bracketed italics ([ ]) where necessary.*)

### **Exclusionary Screen**

- **Alcohol**
  - *Concerns*
    - Involvement [*revenue from production or sales*]
    - Other Concern
- **Gambling**
  - *Concerns*
    - Involvement
    - Other Concern
- **Tobacco**
  - *Concerns*
    - Involvement [*revenue from production*]
    - Other Concern
- **Military**
  - *Concerns*
    - Major Involvement [*≥ 2% or ≥ \$50 million revenue from sale of conventional weapons, or ≥ \$10 million from sales of nuclear weapons*]

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128. Ibid.

- Minor Involvement [ $\$10 \leq x \leq \$50$  million revenue from sale of conventional weapons, or  $\$1 \leq x \leq \$10$  million from sales of nuclear weapons]
- Major Supplies [ $\geq \$50$  million for U.S. DOD for fuel or other supplies related to weapons]
- Other Concern
- **Nuclear Power**
  - *Concerns*
    - Ownership
    - Design [*identifiable revenues from design of plants but excludes construction or maintenance service companies for plants*]
    - Fuel Cycle/Key Parts
    - Other Concern

### Qualitative Screen

- **Community**
  - *Strengths*
    - Generous Giving
    - Innovative Giving
    - Support for Housing [*for economically disadvantaged*]
    - Support for Education [*includes youth job-training*]
    - Indigenous Peoples Relations [*respect for sovereignty, land. Culture, human rights, intellectual property*]
    - Other Strength
  - *Concerns*
    - Investment Controversies [*lending practices of financial institutions*]
    - Negative Economic Impact
    - Indigenous Peoples Relations
    - Other Concern
- **Diversity**
  - *Strengths*
    - CEO [*women and minorities*]
    - Promotion

- Board of Directors [*≥ 4 seats for women, minorities, disabled, or ≥ 1/3 of seats for boards with < 12 seats*]
- Family Benefits
- Women & Minority Contracting [*≥ 5% subcontracting*]
- Employment of the Disabled
- Gay & Lesbian Policies [*particularly domestic partner benefits*]
- Other Strength
- *Concerns*
  - Controversies [*substantial fines or civil penalties over affirmative action*]
  - Non-Representation [*no women on boards or senior line managers*]
  - Other Concern
- **Employee Relations**
  - *Strengths*
    - Union Relations
    - Cash Profit Sharing
    - Employee Involvement [*stock options, gain sharing, stock ownership, sharing of financial information, participation in management decision-making*]
    - Retirement Benefits
    - Other Strength
  - *Concerns*
    - Union Relations
    - Safety Controversies
    - Workforce Reductions [*announced or actual 15% reductions in most recent year or 25% in past 2 years*]
    - Retirement Benefits Concern [*substantially underfunded defined benefit pension plan*]
    - Other Concern
- **Environment**
  - *Strengths*
    - Beneficial Products and Services [*excludes "environmental services" with questionable effects such as landfills, incinerators, waste-to-energy plants, and deep injection wells*]
    - Pollution Prevention

- Recycling
- Alternative Fuels
- Communications [*includes status as a signatory to the CERES Principles, (see below)*]
- Other Strength
- *Concerns*
  - Hazardous Waste [*> \$50 million liabilities for sites, or recent substantial fines or penalties*]
  - Regulatory Problems
  - Ozone Depleting Chemicals
  - Substantial Emissions
  - Agricultural Chemicals [*includes pesticides and chemical fertilizers*]
  - Climate Change [*substantial direct revenues from sale of coal or oil, or substantial indirect revenues from combustion such as electric utilities, fleet transport companies, auto and truck manufacturers*]
  - Other Concern
- **Non-U.S. Operations**
  - *Strengths*
    - Community
    - Indigenous Peoples Relations
    - Other Strength
  - *Concerns*
    - Burma (Union of Myanmar) [*any operation in Myanmar*]
    - Mexico [*major recent controversies, especially employee and environmental issues*]
    - International Labor
    - Indigenous Peoples Relations
    - Other Concern [*includes community, diversity, environment, product safety, and product quality*]
- **Product**
  - *Strengths*
    - Quality
    - R&D/Innovation

- Benefits to Economically Disadvantaged
- Other Strength
- *Concerns*
  - Product Safety
  - Marketing/Contracting Controversy
  - Antitrust
  - Other Concern
- **Other**
  - *Strengths*
    - Limited Compensation [*less is better; limit for a rating is total compensation of less than \$500,000 for CEO, or \$30,000 for outside directors*]
    - Ownership Strength
    - Other Strength
  - *Concerns*
    - High Compensation [*higher is worse; limit for a rating is total compensation of more than \$10 million for CEO, or \$100,000 for outside directors*]
    - Tax Disputes [*> \$100 million at federal, state, or local levels*]
    - Ownership Concern
    - Other Concern

### **Citizens Index:**

The Citizens Index is maintained by Citizen Funds (CF), a mutual fund company founded in 1982 with about \$2 billion in assets under management. Citizen Funds offers domestic, international, and global equity, fixed income, and money market funds.<sup>129</sup> CF asserts that "no investment is ever made for social reasons alone."<sup>130</sup> However, it employs a screening process similar to that adopted by KLD. That is, initially CF uses first-level exclusionary screens that eliminate outright certain companies for social reasons. Thereafter, CF applies qualitative screens. In this context, CF's statement likely applies to companies that have already passed its first-level exclusionary social screens. Similar to KLD's screens, CR considers both positives and negatives for companies that pass its initial exclusionary screens.

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129. Citizens Funds website: [http://www.citizensfunds.com/Live/about/about\\_ovr.asp](http://www.citizensfunds.com/Live/about/about_ovr.asp), (hereafter "CF").

130. CF: [http://www.citizensfunds.com/Live/about/approach\\_social.asp](http://www.citizensfunds.com/Live/about/approach_social.asp).

CF's exclusionary screens eliminate all companies that:<sup>131</sup>

- Produce tobacco or tobacco products
- Produce power from nuclear power plants or own a subsidiary that produces nuclear power
- Derive more than a small percentage of their revenue from the production of alcohol, firearms, or weapons
- Have gambling as their main line of business
- Lack diversity (at least one woman or person of color) on their board of directors or in senior management
- Test personal care products on animals

When assessing "international companies," due to "cultural differences," CF invokes the right to be flexible and changes the exclusionary diversity screen into a qualitative one.

CF's second-level qualitative screens deal with seven issue areas. The following is reproduced from CF's website:<sup>132</sup>

#### **"Product**

- We avoid companies whose products are not good and useful, for example, those with a poor safety record, who market products inappropriately to children or who produce entertainment that glorifies violence or promotes negative social stereotypes.
- We favor companies that make good and useful products, invest in consumer satisfaction, are responsive to consumer, investor and regulator concerns and which market products responsibly.

#### **Environmental Performance**

- We avoid companies that produce goods or services that are particularly damaging to the environment.
- We avoid companies that have a pattern of violating environmental laws or have below average environmental records for their industries.
- We favor companies that have minimal impact on the environment, perform well environmentally, have rigorous environmental policies and voluntarily work on proactive environmental initiatives.

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131. Ibid.

132. Ibid.

### **Human Rights**

- We avoid companies that utilize child labor, forced labor or other sweatshop conditions in the manufacture of their products.
- We avoid companies that do not have codes of conduct or vendor standards that govern their subcontracting of production.
- We favor companies that have adopted codes of conduct and vendor standards for their overseas operations and suppliers.

### **Diversity and Equal Opportunity**

- In addition to eliminating from investment consideration companies that lack diversity on their boards or in upper management, we avoid companies that have a pattern of discrimination based on age, gender, religion, race, disability or sexual orientation.
- We favor companies that promote equal opportunity, actively recruit, hire and promote women and people of color and have clearly defined policies and procedures for addressing discrimination complaints.

### **Employee Relations**

- We avoid companies that violate basic labor laws or otherwise engage in unfair labor practices.
- We avoid companies that lack policies to protect employees' health, safety and economic opportunities, or that are insensitive to employee concerns. We avoid companies that have poor safety records or consistent patterns of OSHA violations.
- We favor companies that provide family-friendly benefits, have good relationships with their unions, offer competitive salary, benefits and stock options or other forms of profit-sharing and which provide benefits to same-sex partners.

### **Community Relations**

- We avoid banks that have a poor record of lending to low-income and minority applicants or whose evaluation under the Community Reinvestment Act is less than "Satisfactory".
- We avoid companies that are unresponsive to community concerns about plant siting, pollution emissions or other local impacts of manufacturing.

- We favor companies that give back to their communities, whether it be through financial contributions to non-profit organizations or by encouraging volunteerism among their employees.

### **Animal Issues**

- In addition to eliminating from investment consideration companies that test personal care products on animals, we avoid those that have inadequate controls on their government-mandated animal testing.
- We avoid companies whose main line of business involves the inhumane treatment of animals, like fur and meat production.
- We favor companies that use alternative methods to animal testing or fund research into alternatives. We favor public disclosure of testing methods.

All holdings are continually monitored in an effort to ensure our standards for corporate responsibility continue to be met. In addition, each security held in our funds is subjected to a formal social responsibility review on an annual basis."

The Citizens Index is a collection of about 300 primarily large-capitalization companies that have passed CF's financial and social screens. Of these, about 200 are also in the S&P 500 Index.<sup>133</sup> The Citizens Index, and other SRI indices, cannot replicate the S&P 500 Index because they exclude certain industries and sectors such as tobacco and defense. As a result, most SRI indices, including the Citizens Index, are overweighted in "cleaner" and newer sectors such as telecommunications and technology. As of August 23, 2001, 307 companies were listed in the Citizens Index.<sup>134</sup>

### **Good Money Averages:**

A pair of lesser-known social indexes are the Good Money Industrial Average (GMIA) and the Good Money Utility Average (GMUA). These were designed to track the Dow Jones Industrial Average (DJIA) of 30 stocks and the Dow Jones Utility Average (DJUA) of 15 stocks, respectively.<sup>135</sup> The 30 stocks in the GMIA, to the extent possible, consist of those favored by social investors that are in the same industrial categories as the DJIA. Otherwise, companies were chosen from industries that "provide life-supportive products and services." A company is removed from the GMIA if it goes private, goes bankrupt, merges with a socially unacceptable company, or engages in unacceptable behavior.

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133. CF: [http://www.citizensfunds.com/Live/about/approach\\_index.asp](http://www.citizensfunds.com/Live/about/approach_index.asp).

134. CF: [http://www.citizensfunds.com/Live/about/approach\\_profiles.asp](http://www.citizensfunds.com/Live/about/approach_profiles.asp).

135. Ritchie Lowry, "How the GOOD MONEY Averages Were Designed": <http://www.goodmoney.com/averages.htm>



The cumulative 24-year performance of the GMIA against the DJIA from 1977 to 2000 is reported to be about 2,000% for the GMIA vs. slightly under 1,000% for the DJIA. Similarly, the reported performance of the GMUA vs. the DJUA was about 470% vs. about 280% for the DJUA.<sup>136</sup> None of the 15 utility companies in the GMUA are involved in nuclear power. They must be involved with cogeneration, conservation, or alternative and renewable energy.<sup>137</sup>

### Global Sullivan Principles:

Generally, the Global Sullivan Principles, established on February 1, 1999<sup>138</sup>, embody a set of environmental, labor, and human rights standards as applied to investments in emerging countries. The term is named after the Reverend Leon Sullivan. Reverend Sullivan is founder and president of International Foundation for Education and Self-Help (IFESH). Winner of the Presidential Medal of Freedom and author of the Global Sullivan Principles, Reverend Sullivan is a Philadelphia minister whose work has helped set the standard for nondiscriminatory employment practices in South Africa under apartheid. Sullivan's "Global Principles" asks corporations to work with communities to improve the quality of life, and to train and provide opportunities for workers from disadvantaged backgrounds. Among other things, the principles also aim to promote fair competition and the respect of property rights.<sup>139</sup>

To paraphrase, the principles are as follows:<sup>140</sup>

- Support universal human rights, employee rights, and rights of communities within which a company operates, and parties with whom companies do business.
- Promote equal opportunity for employees at all levels with respect to issues such as color, race, gender, age, ethnicity or religious beliefs, and operate without unacceptable worker treatment such as the exploitation of children, physical punishment, female abuse, involuntary servitude, or other forms of abuse.
- Respect employees' voluntary freedom of association.
- Compensate employees to enable them to meet at least their basic needs and provide the opportunity to improve their skill and capability in order to raise their social and economic opportunities.

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136. Lowry, <http://www.goodmoney.com/averages.htm>.

137. *Ibid.* An attempt at constructing a Good Money Transportation Average to track the Dow Jones Transportation Average of 20 transport companies failed because the requisite number of such companies with acceptable social records could not be found.

138. Information regarding the Global Sullivan Principles in: Future of Fiduciary Responsibility forum held on April 18-20, 2001 in San Francisco on <http://www.bottomlineconf.com/>.

139. Environmental News Network, "Chevron commits \$5 million to Nigeria" may 24, 1999, [http://www.enn.com/enn-news-archive/1999/05/052499/chevron\\_in\\_nigeria\\_3345.asp](http://www.enn.com/enn-news-archive/1999/05/052499/chevron_in_nigeria_3345.asp).

140. Posted at <http://www.globalsullivanprinciples.org/principles.htm>

- Provide a safe and healthy workplace; protect human health and the environment; and promote sustainable development.
- Promote fair competition including respect for intellectual and other property rights, and not offer, pay or accept bribes.
- Work with governments and communities in which companies do business to improve the quality of life in those communities – their educational, cultural, economic and social well being – and seek to provide training and opportunities for workers from disadvantaged backgrounds.
- Promote the application of these principles by business partners.

Social investors can use these principles as a screen for their investments. For example, it has been reported that the California Public Employees Retirement System decided in November 2000 to screen its investments in emerging markets for compliance with the Global Sullivan Principles.<sup>141</sup> The case below regarding Chevron's investment in community development in Nigeria is an example of international community investing.

In 1999, Chevron in partnership with IFESH, launched a \$5 million five-year community development program in the Niger Delta.

Nigeria, Africa's most populous nation with 108 million people, has incurred great political and social turmoil regarding its high oil production. The 70,000 square kilometer Niger Delta region produces Nigeria's 2 million barrels a day of crude oil, which accounts for more than 90 percent of its foreign earnings.

Violent protests by locals who feel deprived of the oil wealth produced on their land have been on the rise in recent years, severely disrupting oil operations. Residents have repeatedly protested the government's mismanagement of the oil industry and have demanded greater compensation from Shell, Chevron and others.

Sullivan has expressed great enthusiasm for the development program funded by Chevron. 'This program will focus on helping people help themselves,' said Sullivan. 'We will encourage residents of the Niger Delta to participate actively in – and not remain mere spectators of – their own social transformation.'

Specific objectives of the program include:

- Training and facilitating the self-employment of approximately 1,000 youths;
- Strengthening the food production capacity of fishermen/farmers in Chevron's area of operations;
- Providing basic education for primary school children, literacy classes for adults, and teacher training for primary school teachers;
- Facilitating the establishment of a self-run, privately funded credit/finance co-operative organization;

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141. Testimony from Mr. Scott Crawford of Responsible Markets before the Senate Committee on Economic Development and Technology regarding SCR No. 13, dated March 20, 2001.

- Providing basic business skills training and access to credit for existing small businesses.

The IFESH/Chevron partnership will impact an estimated 26,000 people at the end of the five-year term, including fishermen, women, teachers, community leaders, youths and children.

### **MacBride Principles:**

The MacBride Principles were launched by the Irish National Caucus ("INC") in November 1984. The MacBride Campaign, of which the MacBride Principles are a part, is a political and economic effort carried out in America designed to influence employment practices in Northern Ireland. According to the INC,<sup>142</sup> at the end of December 1997, 80 publicly traded U.S. companies were doing business in Northern Ireland. Of these, 44 have agreed to implement the fair employment practices embodied in the MacBride Principles.

The MacBride Campaign has been conducted at three levels. First, federal legislation has been introduced to prohibit U. S. companies in Northern Ireland from exporting to the United States if not in compliance with the MacBride Principles. Second, on the state and municipal levels, the MacBride Campaign lobbies to enact legislation to require compliance with the MacBride Principles for pension and retirement fund investment purposes. Finally, at the corporate shareholder level, the MacBride Campaign works to pass shareholder resolutions endorsing the MacBride Principles.

The MacBride Principles are as follows:<sup>143</sup>

- (1) Increase the representation of individuals from under-represented religious groups in the work force including managerial, supervisory, administrative, clerical, and technical jobs.
- (2) Provide adequate security for the protection of minority employees both at the workplace and while traveling to and from work.
- (3) Ban provocative religious or political emblems from the workplace.
- (4) Advertise publicly all job openings and make special recruitment efforts to attract applicants from under-represented religious groups.
- (5) Ensure impartiality for religious groups regarding layoff, recall, and termination procedures.
- (6) Abolish job reservations, apprenticeship restrictions, and differential employment criteria that discriminate on the basis of religion.

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142. Father Sean McManus, "The MacBride Principles: the Essence," December 1997, president, Irish National Caucus, 413 East Capitol Street, SE, Washington, D.C. 20003-3810: <http://www.knight-hub.com/inc/MacBride.html>.

143. *Ibid.*, paraphrased as necessary.

- (7) Develop training programs to prepare substantial numbers of current minority employees for skilled jobs, including expanding of existing programs and creating new programs to train, upgrade, and improve the skills of minority employees.
- (8) Establish procedure to assess, identify, and actively recruit minority employees with potential for further advancement.
- (9) Appoint a senior management staff member to oversee a company's affirmative action efforts and set up timetables to carry out affirmative action principles.

According to the INC, 16 states have passed some form of legislation regarding the MacBride Principles. Reportedly, these are: Connecticut, Florida, Illinois, Maine, Massachusetts, Michigan, Minnesota, Missouri, Nebraska, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Texas, and Vermont.<sup>144</sup> The INC further claims that the following cities and counties have either passed legislation or resolutions endorsing or supporting the MacBride Principles:<sup>145</sup>

Legislation: Albany county, NY, Baltimore, Binghamton, NY, Boston, Burlington, UT<sup>146</sup>, Chicago, Cleveland, Detroit, Hartford, Kansas City, Lackawanna county, PA, Monroe, NY, Orange City, NY<sup>147</sup>, Minneapolis, New Haven, New York City, Philadelphia, Pittsburgh, Rennslear, NY, Rochester, NY, San Francisco, Scranton, St. Louis, St. Paul, Springfield, MA, Tucson, Washington, D.C., Wilmington, DE, and Omaha.

Resolution: Bucks City, PA, Bridgeport, CT, Cambridge, MA, Carbondale, PA, Chicago, Honolulu<sup>148</sup>, Lawrence, MA, Nashua, NH, Orangetown, NY, Portland, ME, Providence, RI, Rockland county, NY, Union City, NJ, West Caldwell, NJ, Westchester county, NY, Worcester, MA, and Yonkers, NY.

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144. Ibid.

145. Ibid.

146. It is unclear whether the reference is to Burlington, VT, or UT.

147. There is an "Orange City" in Florida, Iowa, and South Dakota, and an "Orange, Virginia," but no "Orange City" in New York. Perhaps the reference is to "Orangetown, NY" which is also listed as having adopted a resolution. Orangetown, NY is in Rockland county, NY. The INC lists Rockland county separately.

148. These were Resolution No. 90-353 CD-1 entitled "URGING THE UNITED STATES CONGRESS TO FAVORABLY CONSIDER THE ENACTMENT OF LEGISLATION, CONSISTENT WITH THE MACBRIDE PRINCIPLES, REQUIRING UNITED STATES COMPANIES WHICH CONDUCT BUSINESS OR CONTROL ENTERPRISES IN NORTHERN IRELAND TO COMPLY WITH CERTAIN FAIR EMPLOYMENT PRINCIPLES," and Resolution No. 90-354 CD-1 entitled "URGING THE LEGISLATURE OF THE STATE OF HAWAII TO ENACT AMENDMENTS TO STATE STATUTORY PROVISIONS TO REQUIRE THAT PUBLIC CONTRACTS ARE AWARDED, IN THE CASE OF COMPANIES DOING BUSINESS OR CONTROLLING ENTERPRISES IN NORTHERN IRELAND, ONLY TO THOSE COMPANIES SUBSCRIBING TO AND PRACTICING THE MACBRIDE PRINCIPLES," both introduced by then-Councilmember Neil Abercrombie, and adopted on July 25, 1990.

## CERES Principles:

CERES is the Coalition for Environmentally Responsible Economies, an organization that describes itself as:<sup>149</sup>

- The leading U.S. coalition of environmental, investor, and advocacy groups working together for a sustainable future
- A community of forward-looking companies that have committed to continuous environmental improvement by endorsing the [CERES Principles](#), a ten-point code of environmental conduct
- A common ground where groups with widely different backgrounds, assumptions, and visions find concrete solutions to today's environmental challenges

The CERES network comprises over 70 environmental and investor organizations, comprising the CERES Coalition, and a community of over 50 companies that have endorsed the CERES Principles and have committed to environmental responsibility. The CERES Coalition reportedly includes "investors, advisers, and analysts representing over \$300 billion in invested capital."<sup>150</sup>

The following is a statement endorsing the CERES Principles that companies are urged to sign:<sup>151</sup>

**PRINCIPLE #1: Protection of the Biosphere** -- We will reduce and make continual progress toward eliminating the release of any substance that may cause environmental damage to the air, water, or the earth or its inhabitants. We will safeguard all habitats affected by our operations and will protect open spaces and wilderness, while preserving biodiversity.

**PRINCIPLE #2: Sustainable Use of Natural Resources** -- We will make sustainable use of renewable natural resources, such as water, soils and forests. We will conserve non-renewable natural resources through efficient use and careful planning.

**PRINCIPLE #3: Reduction and Disposal of Wastes** -- We will reduce and where possible eliminate waste through source reduction and recycling. All waste will be handled and disposed of through safe and responsible methods.

**PRINCIPLE #4: Energy Conservation** -- We will conserve energy and improve the energy efficiency of our internal operations and of the goods and services we sell. We will make every effort to use environmentally safe and sustainable energy sources.

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149. CERES: <http://www.ceres.org/about/index.html>.

150. [Ibid.](#)

151. CERES: <http://www.ceres.org/about/principles.html>.

**PRINCIPLE #5: Risk Reduction** -- We will strive to minimize the environmental, health and safety risks to our employees and the communities in which we operate through safe technologies, facilities and operating procedures, and by being prepared for emergencies.

**PRINCIPLE #6: Safe Products and Services** -- We will reduce and where possible eliminate the use, manufacture or sale of products and services that cause environmental damage or health or safety hazards. We will inform our customers of the environmental impacts of our products or services and try to correct unsafe use.

**PRINCIPLE #7: Environmental Restoration** -- We will promptly and responsibly correct conditions we have caused that endanger health, safety or the environment. To the extent feasible, we will redress injuries we have caused to persons or damage we have caused to the environment and will restore the environment.

**PRINCIPLE #8: Informing the Public** -- We will inform in a timely manner everyone who may be affected by conditions caused by our company that might endanger health, safety or the environment. We will regularly seek advice and counsel through dialogue with persons in communities near our facilities. We will not take any action against employees for reporting dangerous incidents or conditions to management or to appropriate authorities.

**PRINCIPLE #9: Management Commitment** -- We will implement these Principles and sustain a process that ensures that the Board of Directors and Chief Executive Officer are fully informed about pertinent environmental issues and are fully responsible for environmental policy. In selecting our Board of Directors, we will consider demonstrated environmental commitment as a factor.

**PRINCIPLE #10: Audits and Reports** -- We will conduct an annual self-evaluation of our progress in implementing these Principles. We will support the timely creation of generally accepted environmental audit procedures. We will annually complete the CERES Report, which will be made available to the public.

### **Global Reporting Initiative:**

The Global Reporting Initiative (GRI) is new. It was convened in 1997 by CERES in partnership with the United Nations Environment Program. GRI's mission is to develop "globally applicable sustainability reporting guidelines for voluntary use by organizations reporting on the economic, environmental, and social dimensions of their activities, products, and services."<sup>152</sup> According to the GRI:<sup>153</sup>

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152. Global Reporting Initiative, Sustainability Reporting Guidelines on Economic, Environmental, and Social Performance Boston, Mass., June 2000, p. 1 (hereafter "GRI 2000 Guidelines"): <http://globalreporting.org/GRIGuidelines/June2000/June2000GuidelinesA4.pdf>.

153. Global Reporting Initiative website: <http://globalreporting.org/AboutGRI/Overview.htm> (hereafter "GRI website").

The GRI's Sustainability Reporting Guidelines were released in exposure draft form in London in March 1999. The GRI Guidelines represent the first global framework for comprehensive sustainability reporting, encompassing the 'triple bottom line' of economic, environmental, and social issues.... Revised Guidelines were released in June 2000. By 2002, the GRI will be established as a permanent, independent, international body with a multi-stakeholder governance structure. Its core mission will be maintenance, enhancement, and dissemination of the Guidelines through a process of ongoing consultation and stakeholder engagement....

The GRI seeks to make sustainability reporting as routine and credible as financial reporting in terms of comparability, rigour, and verifiability. Specifically, the GRI's goals are to:

- Elevate sustainability reporting practises worldwide to a level equivalent to financial reporting;
- Design, disseminate, and promote standardised reporting practises, core measurements, and customised, sector-specific measurements;
- Ensure a permanent and effective institutional host to support such reporting practises worldwide.

A generally accepted framework for sustainability reporting will enable corporations, governments, NGOs, [*non-governmental organizations*] investors, labour, and other stakeholders to gauge the progress of organisations in their implementation of voluntary initiatives and toward other practises supportive of sustainable development. At the same time, a common framework will provide the basis for benchmarking and identifying best practises to support internal management decisions.

The GRI guidelines encompass the following three elements:<sup>154</sup>

- Economic (including but not limited to financial information)
  - Wages and benefits
  - Labor productivity
  - Job creation
  - Expenditures on outsourcing
  - Expenditures on research and development
  - Investments in training and other forms of human capital
- Environmental
  - Impacts of processes, products, and services on air, water, land, biodiversity, and human health
- Social

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154. GRI 2000 Guidelines, p. 1

- Workplace health and safety
- Employee retention
- Labor rights
- Human rights
- Wages and working conditions at outsourced operations

Finally, the Investment Company Institute categorizes mutual funds into four basic types: equity (stock), money market, bond, and hybrid, which invests in a combination of stocks, bonds, and other securities). It further classifies mutual funds into 33 broad categories according to their basic investment objectives. However, social criteria do not appear in the ICI's classification scheme. Apparently, the ICI does not consider non-financial objectives such as socially responsible investing under its rubric of "investment objective." For the four basic types of mutual funds, Appendix C<sup>155</sup> lists the categories and their investment objectives.

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155. Adapted from ICI 2001 data, pp. 3-6.



## Chapter 3

# SOCIALLY RESPONSIBLE INVESTING AND FIDUCIARY STANDARDS

### A. Introduction

This chapter examines the various fiduciary standards to which a trustee could be held in facing questions concerning the prudence of certain investment decisions when "socially responsible investment" is involved. This chapter limits its focus to the Employees' Retirement System of the State of Hawaii. As a public pension fund for nearly all state and county employees in Hawaii, the Employees' Retirement System is the single largest source of funds likely to be available for long-term investment purposes.

In 1986, the National Conference of State Legislatures and the National Association of Legislative Fiscal Officers conducted a survey to determine investment policies of the states' public employees retirement systems. According to that survey, Hawaii's Employees' Retirement System investment policies:

- (1) Followed a "legal list" system for investment policies;
- (2) Allowed investment in venture capital for some of its moneys; and
- (3) Helped pension members acquire housing through a targeted housing program.

The survey also sought to identify each state's fiduciary standard for its public employee retirement system's trustees. While some twenty-three states followed the prudent investor rule and about fourteen follow the prudent person rule, Hawaii was not listed under either for its public pension trustees.<sup>1</sup> As will be seen below, the Hawaii Department of the Attorney General has opined in 1987 that the "prudent person standard" would likely apply to the Employees' Retirement System, but the fiduciary duty of Hawaii's public employee retirement system's trustees has not yet been examined by a court. This chapter will discuss this issue.

### B. A Trustee's Duty

A trustee is in a fiduciary relationship with the beneficiaries of the trust. As such the trustee's first and foremost duty is one of loyalty to the beneficiaries.<sup>2</sup> Therefore, in the

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1. Gina Mitchell, Social Investing of Public Pension Funds. National Conference of State Legislatures Washington, D.C., November 1986, pp. 6-7.

*(Footnote continued on next page.)*

administration of the trust the trustee is required to exercise due care, diligence, and skill.<sup>3</sup> This standard of care, diligence, and skill is generally referred to as the "prudent person rule".<sup>4</sup> The prudent person rule is variously described as the "standard of care of an ordinary prudent person in the conduct of his or her private affairs under similar circumstances."<sup>5</sup> Where a trustee has special or professional knowledge or skill, (for example as a professional or corporate trustee)<sup>6</sup> the general rule of the prudent person still applies, but that trustee is under a duty to exercise that knowledge and skill where applicable.<sup>7</sup> The courts in Hawaii have examined the fiduciary duty of a corporate trustee in Steiner v. Hawaiian Trust Co., 47 Hawaii 548, 561-62, 393 P.2d 96, 105 (1964) and Matter of Estate of Dwight, 681 P.2d 563, 67 Haw. 139 (1984). What follows is an examination of Hawaii's fiduciary standard applicable to the Employee's Retirement System based on:

- (1) Early case law;
- (2) Attorney General opinions to the Board of Regents of the University of Hawaii (1985) and the Board of Trustees of the Employees' Retirement System (1987) regarding investment policies with respect to companies doing business with South Africa; and
- (3) Recent developments in statutory law.

### C. Early Case Law in Hawaii: Steiner and Dwight

Hawaii's case law deals with the standards of a private trust company acting as trustee of an individual's trust. The leading case is Steiner v. Hawaiian Trust Co., 47 Hawaii 548, 561-62, 393 P.2d 96, 105 (1964), followed by Matter of Estate of Dwight, 681 P.2d 563, 67 Haw. 139 (1984) both of which will be discussed below.

In Steiner v. Hawaiian Trust Co. 47 Haw. 548, 393 P.2d 96 (1964) the Hawaii Supreme Court said that it is the duty of a trustee to make such investments as a prudent man would make of his own property having primarily in view the preservation of the estate and the amount and

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2. 2A Scott on Trusts, 4th edition 1987 section 169, Duty to administer the trust.
  3. 76 Am Jur 2d Trusts, section 390, Care, diligence, and skill, generally.
  4. 76 Am Jur 2d Trusts section 391 Standard or measure of care or diligence; prudent person rule.
  5. 76 Am Jur 2d section 391, Standard or measure of care of diligence; prudent person rule.
  6. 2A Scott on Trusts, 4th ed. Section 174.1 Corporate or professional trustees.
  7. 76 Am Jur 2d section 393 Where trustee possesses special or professional knowledge.

regularity of the income to be derived. Several breaches of trust were examined in Steiner, including:

- (1) Selling stocks in the trusts to the trustee and to one of its major stockholders;
- (2) Selling securities without prior consent of the settlor; and
- (3) Failing to obtain the settlor's consent within a reasonable time after the sale.

The issue in Steiner was whether the trustee had a duty to diversify certain trust assets where a large portion of the trust assets were in one company and because the market value and earnings of this asset indicated a poor investment risk. In affirming the lower court's finding of breach of trust, the court held that the trustee had a duty to consult with the settlor to advise the settlor to diversify, and a duty to consult a court if consent was refused. The statutory section examined in Steiner was the predecessor of what is now section 412:8-400, Hawaii Revised Statutes (Code of Financial Institutions, Investment of Fiduciary Assets) which sets the standard for a trust company (emphasis added) at the level of a prudent investor. The standard may have been different if the trustee were an individual.

Steiner has been cited and discussed in several other cases, most recently in Matter of Estate of Dwight, 681 P.2d 563, 67 Haw. 139 (1984) in which the trustee was held to have breached its fiduciary duties by failing to maintain real property that was part of the trust assets. The court reiterated Steiner's holding that a trustee has a duty to make investments as a prudent man would make of his own property having primarily in view of the preservation of the estate and the amount and regularity of the income to be derived from such investments. The court in Dwight said:

In the absence of specific directions in the trust instrument concerning the investment of trust funds, our court has held that the trustee's duties to the beneficiaries are controlled by statute (citing Steiner). The statute applicable to this case, section 406-22 (1968)<sup>8</sup> codified the generally accepted "prudent investment rule." In Steiner our court said, "Thus, by statute, defendant as trustee was not only bound to the duty of exercising the prudence of a reasonably prudent businessman but was also bound to use the higher degree of skill that it possessed as an expert professional fiduciary." (at 144.)

## **D. Attorney General Opinions: Nos. 85-26 and 87-2**

### **1. Attorney General's opinion to the University of Hawaii's Board of Regents**

In 1985, the Board of Regents of the University of Hawaii requested an opinion from the Attorney General on two questions that grew out of the widespread concern that responsible investment practices should preclude supporting the repressive practices in South Africa at that

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8. Now, section 412:8-400, Hawaii Revised Statutes.

time, namely apartheid, and where investment already existed in South African funds, to divest that investment. In AG Opinion No. 85-26, the Attorney General was asked for advice on the following questions:

1. What is the relevant standard of care applicable to members of the Board of Regents in making decisions on University investment policy?
2. Would the application of that standard preclude the Board from adopting a policy which could lead to the divestiture of certain investments based on what is viewed as unacceptable corporate policies and practices that cause substantial social injury?

In Opinion No. 85-26, the Attorney General explained that the relevant standard of care applicable to members of the Board of Regents in making decisions on University investment policy was the "prudent man" rule.

The Attorney General further opined that the application of that standard did not preclude the Board from adopting a policy which could lead to the divestiture of certain investments based on what is viewed as unacceptable corporate policies and practices that cause substantial social injury.

## 2. **Attorney General's Opinion to the Board of Trustees of the Employees' Retirement System**

Two years later, in Opinion No. 87-2, the Attorney General addressed nearly the same general issue when asked by the Employees' Retirement System of the State of Hawaii for advice on whether the opinion relating to the Board of Regents of the University of Hawaii also applied to the Trustees of the Employees' Retirement System. In its discussion for each opinion, the Attorney General referred to both the statutory provision provided in the Probate Code and a Hawaii Supreme Court case. Section 560:7-302, Hawaii Revised Statutes, provides as follows:

**§560:7-302 Trustee's standard of care and performance.** Except as otherwise provided by the terms of the trust, the trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent person dealing with the property of another, and if the trustee has special skills or is named trustee on the basis of representations of special skills or expertise, the trustee is under a duty to use those skills.

The Attorney General's Opinion No. 87-2 went on to say:

Under the rule, codified in section 560:7-302,...investment decisions could be premised upon social and moral factors as long as the resulting transaction did not sacrifice the safety of the trust corpus and production of an adequate return on investments.... The duties of the trustees of public pension funds are established by state law, either by statutes or judicial decisions. Therefore, in the absence of a statute requiring or proscribing a certain type of investment, public pension trustees must respond to the traditional elements of fiduciary law: trust law versions of the duties of loyalty and care....[a]s with a private pension fund, the trustees' overriding purpose must

be to provide the beneficiaries with their benefits; social considerations are permissible only if they are incidental—that is, if they have no adverse effect on the funds' finances....[w]hat the pension plan fiduciary needs to determine about an investment is not, first, whether it is socially good or bad but how the proposed investment will serve the plan's participants and beneficiaries.... The standard for the fiduciary...is, and must continue to be, not that the investment is socially useful but that it is made prudently and solely in the interests of the plan's participants and beneficiaries....[a] policy of divestment carried out solely for that purpose and without consideration of factors which would further the System's only purpose for being, i.e., deriving funds with which to provide retirement income for its members, would, in our opinion, violate the 'prudent man' standard. (emphasis added).

## **E. Changes to Hawaii Statutes Since 1987**

This section further describes recent new laws that have adopted either the prudent person rule or the prudent investor rule and their likely impact on the duty of the trustees of the Employees' Retirement System.

### **1. Amendments to Section 179-14, HRS Since Steiner**

During the intervening years since the Attorney General issued the foregoing opinions, several amendments have been made to the statutory section specifically examined by the Steiner court.

The Hawaii court, in Steiner (1964), examined what is now Section 412:8-400<sup>9</sup>, Hawaii Revised Statutes, which was referred to in Dwight as "codifying the generally accepted "prudent investment rule."<sup>10</sup> (at least for financial institutions). This section is the statutory successor (adopted in 1993) to section 179-14, Revised Laws of Hawaii 1955, which itself was amended in 1968 to become section 406-22(a), Hawaii Revised Statutes.

In 1968, section 406-22(Investments) (a) Fiduciary accounts, provided as follows:

...a trust company shall exercise the judgment and care which, under the circumstances then prevailing, men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds and property considering both probable income and probable safety of capital.

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9. Relating to general requirements in the Code of Financial Institutions wherein the prudent investor standard is found.

10. Matter of estate of Dwight, 67 Haw (1984)139, at 144.

Today, section 412:8-400 reads as follows:

Within the limits of the standard of a prudent investor, a trust company as fiduciary,...may acquire and retain every kind of property, real, personal...and may retain property properly acquired without limitation as to time and without regard to its suitability for original purchase.... Nothing herein shall authorize a departure from or variation of, the express terms or limitations set forth in the instrument creating the fiduciary relationship, but the terms "legal investment" or authorized investment", or words of similar import, means any investment conforming to the foregoing standard.

The Legislature, since 1987, has enacted other laws pertaining to the fiduciary responsibilities of trustees. Depending on the nature of the trust (for example, charitable, financial, educational, or public or private pension) the "prudent person rule" or its variant, the "prudent investor rule" continues to be the basic standard applicable to a trustee.

The "prudent person" standard includes the following:

- (1) The duty to maximize the return on the investments within an acceptable margin of safety;
- (2) The duty to diversify the fund's investments to minimize the risk of investments while increasing the return on investments; and
- (3) The duty to act solely in the interests of the participants and beneficiaries.<sup>11</sup>

By contrast, the "prudent investor" rule holds the standard of care to that of an expert acting in the investment field.<sup>12</sup> The court in Dwight referring to section 406-22(a) Hawaii Revised Statutes<sup>13</sup>, described this standard as follows: "Thus, by statute, defendant as trustee was not only bound to the duty of exercising the prudence of a reasonably prudent businessman, but was also bound to use the higher degree of skill that it possessed as an expert professional fiduciary." Citing Steiner and Restatement (Second) Trusts sec. 174 (1959). (Emphasis added).

The "prudent investor rule" is the standard found in the Employment Retirement Income Security Act of 1974 (ERISA) as amended. Although ERISA does not apply to government pension plans such as the Employees' Retirement System, some states have adopted the prudent investor rule as their fiduciary standard for their public pension fund trustees. According to a 1990 survey conducted by the National Conference of State Legislatures and the National

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11. Gina Mitchell, p.3.

12. 76 Am Jur 2d section 393, Where trustee possesses special or professional knowledge.

13. Now, section 412:8-400, HRS.

Association of Legislative Fiscal Officers<sup>14</sup>, public pension systems invest their funds according to the prudent person standard in 76 out of 77 systems in 40 states and Puerto Rico that responded to a 50-state survey.<sup>15</sup> Another report indicated that 32 states follow the prudent person standard while, three states, California, Kentucky and Montana follow the "prudent expert" (or prudent investor) standard for their public pension funds.<sup>16</sup> By 1995, according to another writer, twenty-three states followed the prudent expert standard (by statute or case law) and fourteen followed the prudent person rule.<sup>17</sup>

NCSL differentiates the prudent person and the ERISA prudent investor rules as follows:<sup>18</sup>

Prudent person rule: "All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds considering the probable income as well as the probable safety of the capital invested."

Prudent investor rule: "The care, skill, prudence, and diligence are to be measured in circumstances then prevailing according to how a prudent person in a like capacity and familiar with such matters would act in the conduct of an enterprise of like character and with like aim."

These rules are virtually identical. According to the same NCSL report:

These variants of the same principle establish a standard of care by which the actions of investment authorities are judged and require that standard to be applied to the factual situation as it was understood at the time, not through hindsight. It also requires knowledgeable, cautious investment, emphasizing "prudence, discretion, and

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14. The 1990 survey is a different study, and not an update of the 1986 survey published by the NCSL (telephone call with Rita Morris, NCSL Publications Office by Jean K. Mardfin, Researcher, September 24, 2001).
  15. Ronald K. Snell and Susan Wolfe, Public Pension Funds' Investment Practices, results of a survey conducted by the National Conference of State Legislatures and the National Association of Legislative Fiscal Officers. NCSL legislative Finance Paper # 72 Feb 1990, p.v.
  16. Gina Mitchell, Social Investing of Public Pension Funds, National Conference of State Legislatures, Washington, D.C., November 1986, p. 3.
  17. Carol Calhoun, "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cmcl.html](http://www.benefitsattorney.com/child/cmcl.html)), p. 17 of 24.
  18. NCSL, Public Pensions: a Legislator's Guide, Washington, D.C. 1995, p. 4 (Citing *Harvard College v. Amory*, 26 Mass. 446, 9 Pick.454 (1830) for the prudent person rule).

intelligence" while prohibiting speculation. In addition, it emphasizes the joint aims of protecting capital and maximizing investment income, requiring a balance of the two.<sup>19</sup>

The "prudent person rule" or its variant, the "prudent investor rule", can be found in several uniform laws adopted in Hawaii. The following describes some of the typical language used in these uniform laws and shows how widely accepted is the fiduciary principle of prudence, discretion, and loyalty.

## **2. Uniform Laws**

### **(a) The Uniform Principal and Income Act (Chapter 557A, Hawaii Revised Statutes)**

Hawaii adopted the Uniform Principal and Income Act as chapter 557A, Hawaii Revised Statutes, in 2000. As of 2001, seventeen states have enacted the 1997 version of the UPIA.<sup>20</sup> Section 557A-104, Hawaii Revised Statutes, relating to the trustee's power to adjust between principal and income indicates the standard in this chapter is that "the trustee invests and manages trust assets as a prudent investor." Other fiduciary duties and general principles described in section 557A-103, Hawaii Revised Statutes, include administering the estate in accordance with the terms of the trust or will, acting impartially, fairly, and reasonably to the beneficiaries.

### **(b) Uniform Trustees' Powers Act (Chapter 554A, Hawaii Revised Statutes)**

Adopted in 1985, the "prudent person" is defined in this chapter to mean a trustee whose exercise of trust powers is reasonable and equitable in view of the interests of income or principal beneficiaries, or both, and in view of the manner in which persons of ordinary prudence, diligence, discretion, and judgment would act in the management of their own affairs<sup>21</sup> and applies to any trust with a situs in Hawaii.<sup>22</sup>

### **(c) Uniform Prudent Investor Act (Chapter 554C, Hawaii Revised Statutes)**

This chapter applies to trusts existing on and created after April 14, 1997. The duty of the trustee under this chapter is that of the prudent investor "...considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the

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19. NCSL, Public Pensions: a Legislator's Guide, Washington, D.C. 1995, p. 5.

20. Supplement to Scott on Trusts, Preface.

21. Section 554A-1, Hawaii Revised Statutes.

22. Section 554A-8, Hawaii Revised Statutes.



trustee shall exercise reasonable care, skill, and caution. Further, a trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."<sup>23</sup>

**(d) The Hawaii Uniform Probate Code, Chapter 560, Hawaii Revised Statutes**

Section 560:7-302, Hawaii Revised Statutes, requires trustees to observe the standards in dealing with the trust assets that would be observed by a prudent person dealing with the property of another, but if the trustee has special skills the trustee is under a duty to use those skills. This law was adopted in 1976.

According to the Attorney General Opinion in 1987, Hawaii's Supreme Court "seems to favor strict application of the 'prudent man' (or, to use gender neutral terminology, 'prudent person') rule of section 560:7-302, Hawaii Revised Statutes, to the conduct of trustees (of public as well as private trusts), recognizing in Steiner v. Hawaiian Trust Co., 47 Hawaii 548, 561-62, 393 P.2d 96, 105 (1964) that in the absence of specific directions in the trust instrument, a trustees' duties are controlled by statute."<sup>24</sup>

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23. Section 554C-2, Hawaii Revised Statutes, reads as follows:

**§554C-2 Standard of care; portfolio strategy; risk and return objectives.** (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

- (1) General economic conditions;
- (2) The possible effect of inflation or deflation;
- (3) The expected tax consequences of investment decisions or strategies;
- (4) The role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
- (5) The expected total return from income and the appreciation of capital;
- (6) Other resources of the beneficiaries;
- (7) Needs for liquidity, regularity of income, and preservation or appreciation of capital; and
- (8) An asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.

(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

24. Hawaii. Attorney General, Att. Gen Op. No. 87-2 (1987).

*(Footnote continued on next page.)*

(e) **The Law Today Regarding the ERS Trustees' Duty**

The fiduciary standard for trustees' administration of trust assets has not changed since the opinions issued by the Attorney General in 1985 and 1987. The prudent person rule, and for those trustees with special skills and knowledge, the prudent investor rule, will still apply. A trustee, whether as an individual, bank, or trust company will be held to the duties of loyalty, care, and diligence in the administration of the trust.

Requiring social investments by the ERS board would not necessarily constrain application of the prudent person/prudent investor rule. However, before discussing the impact of social investment on the fiduciary standard, the next section will describe other considerations affecting the work of trustees including legal lists, criminal sanctions, and indemnification of trustees.

**F. Other Considerations**

**1. Legal Lists**

In 2001, twenty-six states had legal lists for investment decisions.<sup>25</sup> A legal list specifies for the retirement board what kinds of investments are allowed or prohibited.<sup>26</sup> According to Mitchell, a legal list can be a statutory requirement, like Hawaii's, or a policy developed by a division of state government.<sup>27</sup> Hawaii's legal list is provided in section 88-119, Hawaii Revised Statutes, which is a "laundry list" of eleven types of investments allowed by the Employees Retirement System law.<sup>28</sup> For example, section 88-119 (11) provides for the Employees'

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25. Carol Calhoun, "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cmcl.html](http://www.benefitsattorney.com/child/cmcl.html)), p. 17 of 24.

26. Gina Mitchell, Social Investing of Public Pension Funds. National Conference of State Legislature Washington, D.C. November 1986, pp. 6-7.

27. Ibid., p. 5.

28. Section 88-119, Hawaii Revised Statutes, provides as follows:

**§88-119 Investments.** Investments may be made in:

(1) Real estate loans and mortgages. Obligations (as defined in section 431:6-101) of any of the following classes:

- (A) Obligations secured by mortgages of nonprofit corporations desiring to build multirental units (ten units or more) subject to control of the government for occupancy by families displaced as a result of government action;
- (B) Obligations secured by mortgages insured by the Federal Housing Administration;
- (C) Obligations for the repayment of home loans made under the Servicemen's Readjustment Act of 1944 or under Title II of the National Housing Act;

*(Footnote continued on next page.)*

- (D) Other obligations secured by first mortgages on unencumbered improved real estate owned in fee simple; provided that the amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the real estate and improvements mortgaged to secure it, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the real estate and improvements mortgaged to secure it; provided further that the obligation is insured or guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty per cent of the value of the real estate and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the real estate and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board of trustees. Real estate shall not be deemed to be encumbered within the meaning of this subparagraph by reason of the existence of any of the restrictions, charges, or claims described in section 431:6-308;
- (E) Other obligations secured by first mortgages of leasehold interests in improved real estate; provided that:
  - (i) Each such leasehold interest at such time shall have a current term extending at least two years beyond the stated maturity of the obligation it secures; and
  - (ii) The amount of the obligation at the time investment is made therein shall not exceed eighty per cent of the value of the respective leasehold interest and improvements, and except that the amount of the obligation at the time investment is made therein may exceed eighty per cent but no more than ninety per cent of the value of the leasehold interest and improvements mortgaged to secure it;

provided further that the obligation is insured or guaranteed against default or loss under a mortgage insurance policy issued by a casualty insurance company licensed to do business in the State. The coverage provided by the insurer shall be sufficient to reduce the system's exposure to not more than eighty per cent of the value of the leasehold interest and improvements mortgaged to secure it. The insurance coverage shall remain in force until the principal amount of the obligation is reduced to eighty per cent of the market value of the leasehold interest and improvements mortgaged to secure it, at which time the coverage shall be subject to cancellation solely at the option of the board of trustees;
- (F) Obligations for the repayment of home loans guaranteed by the department of Hawaiian home lands pursuant to section 214(b) of the Hawaiian Homes Commission Act, 1920; and
- (G) Obligations secured by second mortgages on improved real estate for which the mortgagor procures a second mortgage on the improved real estate for the purpose of acquiring the leaseholder's fee simple interest in the improved real estate; provided that any prior mortgage does not contain provisions that might jeopardize the security position of the retirement system or the borrower's ability to repay the mortgage loan.

The board of trustees may retain such real estate, including leasehold interests therein, as it may acquire by foreclosure of mortgages or in enforcement of security, or as may be conveyed to it in satisfaction of debts previously contracted; provided that all such real estate, other than leasehold interests, shall be sold within five years after acquiring the same, subject to extension by the governor for additional periods not exceeding five years each, and that all such leasehold interests shall be sold within one year after acquiring the same, subject to extension by the governor for additional periods not exceeding one year each;

- (2) Government obligations, etc. Obligations of any of the following classes:

*(Footnote continued on next page.)*

Retirement System to invest in venture capital that "...in the informed opinion of the board of

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- (A) Obligations issued or guaranteed as to principal and interest by the United States or by any state thereof or by any municipal or political subdivision or school district of any of the foregoing; provided that principal of and interest on such obligations are payable in currency of the United States; or sovereign debt instruments issued by agencies of, or guaranteed by foreign governments;
  - (B) Revenue bonds, whether or not permitted by any other provision hereof, of the State or any municipal or political subdivision thereof, including the board of water supply of the city and county of Honolulu, and street or improvement district bonds of any district or project in the State; and
  - (C) Obligations issued or guaranteed by any federal home loan bank including consolidated federal home loan bank obligations, the Home Owner's Loan Corporation, the Federal National Mortgage Association, or the Small Business Administration;
- (3) Corporate obligations. Below investment grade or nonrated debt instruments, foreign or domestic, in accordance with investment guidelines adopted by the board of trustees;
  - (4) Preferred and common stocks. Shares of preferred or common stock of any corporation created or existing under the laws of the United States or of any state or district thereof or of any country;
  - (5) Obligations eligible by law for purchase in the open market by federal reserve banks;
  - (6) Obligations issued or guaranteed by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, or the African Development Bank;
  - (7) Obligations secured by collateral consisting of any of the securities or stock listed above and worth at the time the investment is made at least fifteen per cent more than the amount of the respective obligations;
  - (8) Insurance company obligations. Contracts and agreements supplemental thereto providing for participation in one or more accounts of a life insurance company authorized to do business in Hawaii, including its separate accounts, and whether the investments allocated thereto are comprised of stocks or other securities or of real or personal property or interests therein;
  - (9) Interests in real property. Interests in improved or productive real property in which, in the informed opinion of the board of trustees, it is prudent to invest funds of the system. For purposes of this paragraph, "real property" includes any property treated as real property either by local law or for federal income tax purposes. Investments in improved or productive real property may be made directly or through pooled funds, including common or collective trust funds of banks and trust companies, group or unit trusts, limited partnerships, limited liability companies, investment trusts, title-holding corporations recognized under section 501(c) of the Internal Revenue Code of 1986, as amended, similar entities that would protect the system's interest, and other pooled funds invested on behalf of the system by investment managers retained by the system;
  - (10) Other securities and futures contracts. Securities and futures contracts in which in the informed opinion of the board of trustees it is prudent to invest funds of the system, including currency, interest rate, bond, and stock index futures contracts and options on such contracts to hedge against anticipated changes in currencies, interest rates, and bond and stock prices that might otherwise have an adverse effect upon the value of the system's securities portfolios; covered put and call options on securities; and stock; whether or not the securities, stock, futures contracts, or options on futures are expressly authorized by or qualify under the foregoing paragraphs, and notwithstanding any limitation of any of the foregoing paragraphs (including paragraph (4)); and
  - (11) Private placements. Investments in institutional blind pool limited partnerships or direct investments that make private debt and equity investments in privately held companies, including but not limited to investments in Hawaii high technology businesses or venture capital investments that, in the informed opinion of the board of trustees, are appropriate to invest funds of the system. In evaluating venture capital investments, the board of trustees shall consider, among other things, the impact an investment may have on job creation in Hawaii and on the state economy.

trustees are appropriate to invest funds of the system." The NCSL survey identified fourteen states with a venture capital investment policy to promote economic growth and seventeen states (including Hawaii) with an investment policy designed to promote affordable housing in the State.

Even if a state's legal list permits certain types of investment by the board, the trustees are still required to examine the permitted investment in light of its underlying fiduciary duty of loyalty and care to its beneficiaries under the prudent person rule and the prudent investor rule.

## 2. Liability for Imprudent Investments in Socially Responsible (or Other) Investments

What, if any, are the liabilities faced by a trustee for harm (financial and non-financial) caused by imprudent investments or for imprudent divestiture?

First of all, 'imprudence' can range from gross malfeasance, reckless investment choices, to simple negligence, failure to exercise care, skill, and caution of a prudent person, failure to be impartial, and so on. Criminal statutes can apply for the more serious and flagrant breaches of trust. According to Calhoun, "...criminal statutes under federal law, and the laws of each of the states, require institutional investors to abide by their fiduciary duties. However, in practice, prosecutors and the courts have applied these laws only to gross malfeasance, not to imprudent but not reckless investment choices."<sup>29</sup> In Hawaii, a trustee could face criminal liability which is covered by section 708-874, Hawaii Revised Statutes, in the Penal Code relating to misapplication of entrusted property.<sup>30</sup>

If an investment was disposed of improperly (in the sense that the trustee breached the trustee's duty of loyalty, care, or other fiduciary duty), the trustee could be held liable for the loss of value of the stock at the time of the court's decree, plus the value of the income that would

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29. Carol Calhoun's "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cmcl.html](http://www.benefitsattorney.com/child/cmcl.html)) p. 21 of 24.

30. Section 708-874, Hawaii Revised Statutes, reads as follows:

**§708-874 Misapplication of entrusted property.** (1) A person commits the offense of misapplication of entrusted property if, with knowledge that he is misapplying property and that the misapplication involves substantial risk of loss or detriment to the owner of the property or to a person for whose benefit the property was entrusted, he misapplies or disposes of property that has been entrusted to him as a fiduciary or that is property of the government or a financial institution.

(2) "Fiduciary" includes a trustee, guardian, personal representative, receiver, or any other person acting in a fiduciary capacity, or any person carrying on fiduciary functions on behalf of a corporation or other organization which is a fiduciary.

(3) To "misapply property" means to deal with the property contrary to law or governmental regulation relating to the custody or disposition of that property; "governmental regulation" includes administrative and judicial rules and orders as well as statutes and ordinances.

(4) Misapplication of property is a misdemeanor.

have accrued to the trust if the stock had been retained, plus transaction and market impact costs, offset by the investments and earnings of the replacement assets.

For example, in Steiner, the trustee was surcharged the difference between the \$22 per share that would have been realized in 1945 had the trustee sold it then instead of the \$6.50 per share when the stock was sold in 1955, plus interest.

In contrast to imprudent divestment of investments, the trustees' failure to invest in appropriate investments, perhaps due to improper screening, could lead to financial losses. In this scenario it would be more difficult to show that had an investment been made, the trust would have earned more and the portfolio increased. According to Calhoun:

...[A]nyone who claims that a fiduciary's failure to acquire stock was imprudent must show what an appropriate return would have been if the fiduciary had invested more prudently. Prudent investment would not necessarily have involved the screened-out investments; it might have involved other investments which appeared to have, at the time of the investment, a risk/reward at least equal to the socially screened investments. Thus, it is necessary to show what the returns would have been on assets in which the trust never invested—necessarily a more difficult task than showing actual returns on known assets.<sup>31</sup>

In South Carolina, the fiduciary's compliance with law is to be evaluated in context of the whole portfolio, not in hindsight; in light of the facts and circumstances existing at the time of the decision or action; not in isolation but in context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the retirement system.<sup>32</sup> Very similar language can be found in chapter 554C, Hawaii Revised Statutes, the Uniform Prudent Investor Act, specifically in section 554C-2.<sup>33</sup>

### 3. Indemnification of Board Members

Section 26-35.5, Hawaii Revised Statutes, provides for indemnifying the board of trustees of the Employees' Retirement System, as well as other members of state boards and commissions.<sup>34</sup> A trustee is not liable in a civil action unless the member acted with a malicious

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31. Carol Calhoun's "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cmc1.html](http://www.benefitsattorney.com/child/cmc1.html)) p. 21 of 24.

32. S.C. Code of Laws section 9-16-60 Retirement System Funds.

33. See section 554C-2 under uniform laws section.

34. Section 26-35.5, Hawaii Revised Statutes, reads as follows:

**§26-35.5 Members of boards and commissions; immunity from or indemnification for civil liability; defense of members.** (a) For purposes of this section, "member" means any person who is appointed, in accordance with the law, to serve on a temporary or permanent state board, including

*(Footnote continued on next page.)*

members of the local school board of any new charter school established under section 302A-1182, council, authority, committee, or commission, established by law or elected to the board of trustees of the employees' retirement system under section 88-24; provided that "member" shall not include any person elected to serve on a board or commission in accordance with chapter 11.

(b) Notwithstanding any law to the contrary, no member shall be liable in any civil action founded upon a statute or the case law of this State, for damage, injury, or loss caused by or resulting from the member's performing or failing to perform any duty which is required or authorized to be performed by a person holding the position to which the member was appointed, unless the member acted with a malicious or improper purpose, except when the plaintiff in a civil action is the State.

(c) Except as provided in subsections (d) and (f), the State shall indemnify a member from liability by paying any judgment in, or settlement or compromise of, any civil action arising under federal law, the law of another state, or the law of a foreign jurisdiction, including fees and costs incurred, unless the loss, injury, or damage for which the judgment or settlement amount is required to be paid:

- (1) Is fully covered by a policy of insurance for civil liability purchased by the State;
- (2) Is caused by or is the result of the member's performing an act authorized or required to be performed by a person holding the position to which the member was appointed so as to effect a malicious or improper purpose;
- (3) Is caused by or is the result of the member's failure to perform an act required or authorized to be performed by a person holding the position to which the member was appointed so as to effect a malicious or improper purpose.

(d) The State shall not indemnify a member who would otherwise be entitled to indemnification under subsection (c), if the member fails to cooperate fully in the defense of the civil action which is made available to the member under subsection (e). The State shall not indemnify a member for any portion of a judgment that represents punitive or exemplary damages. The State shall not indemnify a member for any portion of a settlement which is deemed unreasonable by the legislature.

(e) The attorney general shall represent and defend a member in any civil action for which immunity is conferred under subsection (b), or when the attorney general determines that indemnification is available to the member under subsection (c), and the member against whom the action is brought has submitted a written request for representation and has provided the attorney general with all process or complaint served upon the member within a reasonable period of time, but no more than five days after being served with the process or complaint. The attorney general may terminate the representation and defense of the member at any time if, after representation and defense is accepted, the attorney general determines that indemnification would not be available to the member under subsection (c).

(f) A member may retain counsel of the member's own choice at the member's own expense. If the member chooses to retain counsel at the member's own expense, the State shall not indemnify the member even though the member would have been entitled to indemnification under subsection (c). The attorney general may enter an appearance in any action in which the member is represented by counsel of the member's own choice, even though no request for the appearance has been made by the member.

(g) Nothing in this section precludes a member from compromising or settling any claim against the member at the member's own expense. If such a settlement or compromise is effected, however, the member shall be deemed to have waived any claims which the member might have made under this section unless the provisions of subsection (i) apply.

(h) If the attorney general denies representation to the member under subsection (e) and the member proceeds to judgment in the action for which representation was denied, the member may commence an action against the State in the circuit court to recover reasonable costs and fees incurred by the member in defending against that action, including attorney's fees, court costs, investigative costs, and expert witness fees. The State shall pay the judgment or reimburse the member if the member has satisfied the judgment in an action for which representation was denied; provided the member was found not liable in that action or the member establishes by a preponderance of the evidence that the member is entitled to indemnification under subsection (c). A finding of negligence against the member in the civil action for which representation was denied shall not be binding upon the circuit court in any action brought under this

*(Footnote continued on next page.)*

or improper purpose; the attorney general represents and defends the member in any civil action for which immunity is conferred, although the member may retain counsel of the member's own choice at the member's own expense if the member so chooses.

## **G. Impact on Fiduciary Duty if State Law Requires ERS to Invest in SRI**

Social investment has been defined as the "consideration of a goal other than the exclusive financial objective of maximizing return on investment."<sup>35</sup> If the state Legislature adopted a law (perhaps as another paragraph in section 88-119) specifying that the ERS administer the trust in socially responsible investments, would the fiduciary responsibility of the trustees change?

Under the fiduciary duty of loyalty, trustees cannot invest in or manage trust property that is not solely in the interests of the beneficiaries. "This prohibition also applies to investing in a manner intended to serve interests other than those of the beneficiaries or the purposes of the settlor."<sup>36</sup> However, "social considerations may properly influence investment decisions to the extent permitted by the terms of the trust, or by consent of the beneficiaries, and to a greater extent, in the case of charitable trusts."<sup>37</sup>

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subsection. The member shall commence any action under this subsection no later than two years after entry of judgment in the action for which the member was denied representation if no appeal is filed, or two years after the conclusion of the final appeal from that judgment if an appeal is filed.

(i) If the attorney general denies representation to the member under subsection (e) and the member negotiates a compromise or settlement without an entry of judgment in the action for which representation was denied, the member may seek to introduce a bill in the legislature to secure an appropriation to reimburse the member for the amount of the settlement or that portion which constitutes a reasonable settlement, and for reasonable costs and fees incurred by the member in defending against that action, including attorney's fees, court costs, investigative costs, and expert witness fees.

(j) Any moneys which the State is required to pay to a member under this section shall be paid from an appropriation made by the legislature at the next session after the requirement to pay inures to the member. The appropriation shall be sufficient to include any postjudgment interest which the member was required to pay if the member has personally satisfied the judgment, or at the rate specified in section 478-3 for the period from the entry of judgment for which indemnification is available until the appropriation is enacted if the judgment was not satisfied. Any bill necessary to effect a payment required by subsections (h) and (i) shall be submitted by the member to a legislator; all other bills necessary to effect payments required by this section shall be initiated by the attorney general.

(k) This section shall not be construed as eliminating, waiving, reducing, or limiting any defense, immunity, or jurisdictional bar conferred upon or available to a member or the State by any other statute or by case law.

35. Gina Mitchell, Social Investing of Public Pension Funds, National Conference of State Legislatures, Washington, D.C. November 1986, p. 2.

36. Restatement (Third) Trusts, Prudent Investor Rule, section 227, p. 12.

37. Supplement to Scott on Trusts, 2000, section 227.17, Moral considerations as to making and retaining investments, p. 481.

*(Footnote continued on next page.)*



Comment c in Restatement (Third) Trusts (Prudent Investor Rule) describes the case law on "social investing" as "not illuminating".<sup>38</sup> A case in Oregon was dismissed at the appellate court level for lack of standing instead of the court's deciding on whether a directive of the Oregon Board of Higher Education violated the state's prudent investor statute.<sup>39</sup> In Maryland, the court of appeals upheld the validity of a city ordinance requiring certain public employee retirement funds to divest from certain companies.<sup>40</sup> In Michigan, it was determined that legislation requiring divestment by public universities could not regulate university investments under that state's constitution.<sup>41</sup>

In Carol Calhoun's "The Issues Institutional Investors Face in Doing Social Investing", she writes:

Different types of institutional investors are subject to different legal standards.

A state or local retirement system would typically be subject to regulation under federal and state Constitutional principles, as well as under extensive state statutory provisions. An institutional investor other than a pension fund might be subject to regulation under a state (profit or nonprofit) corporations act, the Uniform Management of Institutional Funds Act (UMIFA), other state statutes, or common law fiduciary standards.

A second point to remember is that the case law has not been particularly instructive when it comes to socially responsible investing. Thus, in many cases, the only authority consists of cases and other authorities which deal with fiduciary standards generally. And court cases have typically dealt with situations involving reckless or grossly imprudent investment choices, rather than situations in which a fund might lose a few basis points of investment return due to consideration of social factors. Thus, the language of case law is often quite broad and sweeping. However, in actual practice, trustees have not to date been held liable for damages incurred due to consideration of social factors in instances in which the difference in return between a socially screened fund and other available funds is small.<sup>42</sup> Moreover, the case law regarding the

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38. Restatement (Third) Trusts, Prudent Investor Rule, section 227, Comment c. p.68

39. Associated Students of University of Oregon v. Oregon Investment Council, 82 Or App. 145, 728 P. 2d 30 (1986) rev. den, 303, Or 74, 734 P.2d 354 (1987).

40. Board of Trustees of Employee's Retirement System v. Mayor and City Council of Baltimore etal. 317 Md 72, 562 A.2d 720 (1989) cert. Den sub nom. Lubmon v. Mayor etal., 110S.Ct. 1167, 107 L. Ed 2d 1069 (1990).

41. Regents of the University of Michigan v. State, 166 Mich. App. 314, 419 N.W. 2d 773 (1988).

42. Carol Calhoun "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cm1.html](http://www.benefitsattorney.com/child/cm1.html)), p. 3 of 24.

application of these rules (on fiduciary standards) to 'social investing' is sparse and mostly unhelpful.<sup>43</sup> (Emphasis added.)

## **H. Conclusion on Fiduciary Standards for Employees' Retirement System Trustees**

In Hawaii, it is well settled that for all trustees of any type of trust, the duties of loyalty, care, diligence, and skill would be the components of fiduciary duty owed to the beneficiaries of the trust. Therefore, the prudent person rule would apply to the ERS trustees. The trustees may be viewed as having professional or special knowledge or skills so that the standard of care may be more in line with the prudent investor rule where the trustees would likely be held to "exercise the judgment and care which, under the circumstances then prevailing, men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds and property considering both probable income and probable safety of capital."<sup>44</sup>

Fiduciary standards provide the overlay on trustees' investment decisions, even with statutory legal lists or a statutory requirement that trustees make "socially responsible investment" choices. Socially responsible investments would not be incompatible with a trustee's fiduciary duty of loyalty as long as there is reasonable expectation of improving the ERS's overall investment for its beneficiaries. "The selection of a "socially responsible" investment, however, should be made only if the fiduciary determines that the fund is expected to provide an investment return commensurate to alternative investments having similar risks. Fiduciaries must consider the role of the particular investment in the plan's investment portfolio, considering such factors as diversification, liquidity, and risk/return characteristics."<sup>45</sup> More than likely, these are considerations that occur under the current provisions of section 88-119(10) and (11) when the board makes investments "that in the informed opinion of the board of trustees are appropriate to invest funds of the system." Therefore, the prudent investor rule would apply with or without the requirement to make socially responsible investments.

Taken as a whole, the foregoing discussion suggests that if socially responsible investment decisions are required of the ERS trustees, the trustees must first respond to the traditional elements of fiduciary law: the duties of loyalty and care where the overriding purpose is to provide the beneficiaries with their benefits. The fiduciary needs to determine how the

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43. Carol Calhoun "The Issues Institutional Investors Face in Doing Social Investing" (found at [www.benefitsattorney.com/child/cmcl.html](http://www.benefitsattorney.com/child/cmcl.html)), p. 12 of 24.

44. Matter of estate of Dwight, 67 Haw (1984) 139, at 144.

45. Virginia L. Gibson, Bonnie K. Levitt, and Karine H. Cargo, "Overview of Social Investment and Fiduciary Responsibility of County Employee Retirement System Board Members in California". (Sacramento, CA, Nov. 16, 2000). p. 9.

proposed investment will serve the plan's participants and beneficiaries.<sup>46</sup> Then, if all other things are equal, the social impacts of the investment decision can be considered. It is unlikely that any single investment would be evaluated in isolation, but rather the whole portfolio and the overall risk and return will be looked at to determine whether reasonable care, skill, and caution were considered by the trustees. This means that the facts and circumstances existing at the time of the decisionmaking, not hindsight, would determine whether the trustees acted as a prudent investor.

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46. Paraphrased from Hawaii. Attorney General, Att. Gen. Op. No. 87-2 (1987).

## Chapter 4

### LAWS AND PRACTICES IN OTHER JURISDICTIONS; STUDIES

Senate Concurrent Resolution No. 13, S.D. 2 (2001), also requested the Bureau to conduct research on socially responsible investing (SRI) by examining the laws and practices in other states, and current reports and studies in the field. Section I of this chapter examines how some public institutions have engaged in SRI, chiefly through divestiture of securities and domestic community investment and international investments. Section II presents selected academic studies on various aspects of socially responsible investing.

#### I. LAWS AND PRACTICES IN OTHER JURISDICTIONS

##### Restrictions on State Funds and Divestiture

Some states have tried to legislate certain restrictions on how state funds are invested. For the most part, this approach has been problematic. Certain public institutions, particularly public employee retirement funds, have also taken the initiative to divest themselves of various stocks. This approach has been relatively more straightforward.

##### **Texas – HB1, Divestiture in Music Industry**

On June 20, 1997, the Texas legislature passed HB1, its budget appropriation bill. Attached was a rider – article IX, section 174 regarding restrictions on investment of state funds. The law, the first of its kind in the nation, prohibits any state entity from investing in any company that owns at least 10% of a business that records or produces certain kinds of music. The law, below, took effect on September 1, 1998:

Sec. 174. Restriction on Investment of State Funds. Becoming effective September 1, 1998, neither the state nor any entity of state government, including but not limited to the comptroller, any department, commission, board or office of state government, any university system or institution of higher education as defined in Section 61.003 of the Education Code, any public retirement system as defined in Section 802.001 of the Government Code or any state depository board shall use state funds to invest in or purchase securities, including obligations, of a private corporation or other private business entity that owns 10% or more of a corporation or business entity, which records or produces any song, lyrics or other musical work that explicitly describes, glamorizes or advocates:

- (1) act of criminal violence, including murder, assault, assault on police officers, sexual assault, and robbery;
- (2) necrophilia, bestiality, or pedophilia;
- (3) illegal use of controlled substance;

- (4) criminal street gang activity;
- (5) degradation or denigration of females; or
- (6) violence against a particular sex, race, ethnic group, sexual orientation, or religion

The Texas law is broad and applies to all Texas state entities including the \$13 billion Texas Public Employees Retirement System and the Teacher Retirement System. The former reportedly held \$12.2 million in Time Warner in 1997 (before its merger with America Online). It also owned about \$7.1 million in the Seagram Company, Ltd., which owns a substantial portion of MCA Records, which in turn, owns substantial portions of Interscope, Nothing, and Death Row Records.<sup>1</sup> The Teacher Retirement Fund owned about 1.6 million shares of the Seagram Company.<sup>2</sup> The law is also broad because it can apply to almost any song or lyrics. It is not hard to catalog any number of songs that “describe” any of the six proscribed categories under the law.

In January 1998, the Recording Industry Association of America (RIAA) and various beneficiaries of state retirement systems questioned the constitutionality of the law’s provisions. The RIAA claims that the law directs pension fund officers to “...make decisions based on their take on song lyrics – not the financial best interest of the fund,” thus interfering with their “constitutional fiduciary duty” imposed on pension fund managers.<sup>3</sup> The suit claims the law is unconstitutional because, among other things, it<sup>4</sup>

...breaches the overriding constitutional mandate that the management of state retirement funds and the permanent state education funds be guided by principles of sound financial investment, not by the changing winds of political expediency.

The RIAA is currently, or has recently, also engaged in fighting similar divestiture laws and proposals in California, Wisconsin, Pennsylvania, Maryland and Virginia.<sup>5</sup> In addition, there are constitutional issues of censorship and free speech involved. However, the RIAA felt that the courts would likely first address the fiduciary issue.

The Texas law is also vague. It is not clear whether state entities that own the prohibited stock must divest or whether the law applies only to future purchases. Most Texas retirement plans are funded with municipal money. However, the law refers to entities of *state* government

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1. Janet Aschkenasy, “Social investing, or censorship? Constitutional challenges face a Texas law which prevents state funds from investing in record companies that purvey violent or sexist song lyrics,” in Plan Sponsor, September 1997.
  2. Rock Out Censorship website: <http://www.theroc.org/updates/tx1923.htm>.
  3. Aschkenasy article.
  4. Texas, Board of Education, agenda item and recommendation by the Commissioner of Education to the Committee on School Finance/Permanent School Fund to adopt procedures to comply with the Texas law, posted at: <http://www.tea.state.tx.us/sboe/schedule/9803/admcg080.html>.
  5. Recording Industry Association of America website: <http://www.riaa.com/Freedom-Issues.cfm>.

and the use of *state* funds. As a result, some pension funds, such as the Houston Firemen's Relief and Retirement Fund, interpret the law as not applying to *municipal* pension funds.

On March 6, 1998, the Texas Board of Education took action to comply with HB1, article IX, section 174. The law would affect the Board's Permanent School Fund, which is not a retirement fund but a plan which subsidizes the education of Texas students. The Board stated that it would need to modify all benchmarks against which investment performance is measured to accurately evaluate the Fund's performance without music industry holdings. These would include the S & P 500 Index, the Russell 1000 and Russell 2000 Indices, the Lehman Aggregate Index, the Salomon High Yield Cash Pay Index, and the Morgan Stanley Capital International Europe, Australia Far East Index. Furthermore, the Board recommended stopping investing in **all** music-related companies as the only way to comply with the law:<sup>6</sup>

[g]iven the limited resources of the Permanent School Fund, monitoring for compliance by companies engaged in the music industry is not practical. The most reasonable policy for the Fund to follow is to simply cease investment in all companies engaged in the music industry.

### **Texas State Board of Education – Divestiture in Specific Company**

The Texas State Board of Education is comprised of 15 elected officials. In 1997, it voted to divest the Texas Permanent School Fund of its 1.2 million shares of the Walt Disney Co., worth more than \$47 million. At the time, the Fund had about \$17.65 billion in assets. In managing the fund, the board operates under the prudent person rule.<sup>7</sup>

In 1998, an article appearing in Plan Sponsor reported that the decision was made in controversy. The article is self-explanatory:

State Representative Harryette Ehrhardt (D-Dallas) believes that the decision to divest was motivated by conservative board members who were pressured by ultra-conservative constituents with an undisclosed agenda, with little or no regard to investment returns. In a speech to the board of education finance committee on the night before the divestiture, Rep. Ehrhardt stated that 'The American Family Association has been less forthcoming about its true objection to the Disney Company, but most of us know they want to punish Disney for its internal corporate benefits policy.' Rep. Ehrhardt cited Disney's extension of health benefits to the partners of its gay and lesbian employees.

Ultra-conservative groups had publicly argued against investing state money in companies whose films depict graphic violence and explicit sex. Several board members

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6. Texas, Board of Education.

7. Unless otherwise noted, information on the Texas Permanent School Fund is taken from Peter Marcus, "Bye, bye Mickey: Texas board washes its hands of Disney stock – and opens Pandora's Box" in Plan Sponsor, September 1998, published by Asset International Inc.: <http://www.assetpub.com/archive/ps/98-08pssept/sept98PS52.html>.

told Plan Sponsor that the Texas American Family Association sent them each a videotape titled 'Dumping Disney' with selected film clips from such films as 'Pulp Fiction,' 'Chasing Amy,' and 'Trainspotting,' produced and distributed by Disney subsidiary Miramax.

But Will Davis, chairman of the Permanent School fund finance committee, says that the board was swayed more by *political and personal motives* against Disney than by its *fiduciary duty* as overseers of the Permanent School fund. Davis, who opposed the Disney divestiture from the beginning, says that the move originated not from concern about the performance of Disney's stock but from ultra-conservative groups leaning on conservative board members to make a statement. Among the groups in question, he says, are the Southern Baptist Convention and the American Family Association.

And yet the fact is that Disney's stock price had *fallen* roughly 17% in the 60-day period prior to the Texas board's vote in early July, says one conservative board member who cites fiduciary responsibility as the primary reason for the Disney divestiture.... The Permanent fund sold its shares for an average of \$39.29 apiece. The Disney investment represented just over 0.25% of the Permanent School fund's total holdings.

But Davis says that in the two years while the Permanent fund held Disney stock, it *appreciated* more than 108%. Thus, Davis holds that the vote was 'political more than anything else.'

Carlos Resendez agrees. Resendez, now CEO of the Resendez Group, a San Antonio-based consulting firm, served as executive director of the Permanent School fund from 1993 to 1996. He calls the divestiture 'a very dangerous precedent for the future' – and not only because he believes that purely *social and political motives* prompted the decision.

Selling off its Disney holdings means the Permanent fund can no longer bring shareholder influence to bear on the company's practices, Resendez observes. And he notes that the Permanent School fund first bought its Disney stock in July 1996, four years after the movie 'Pulp Fiction' was produced.

The board "could be leaving [itself] open for a *legal action* based on breach of fiduciary responsibility," he says.

Richard Koppes, an attorney with an corporate law firm Jones Day Reavis & Pogue in Sacramento, California, and former general counsel with the California Public Employees' Retirement System, notes that the Permanent School Fund is not a retirement fund but a plan which subsidizes the education of Texas students. But the divestiture clearly has ramifications for public plan sponsors at large, Koppes says. "Once you start on this slippery slope [of social investing], pension funds in general will end up not owning any stock. The duty of loyalty is to the beneficiaries, not to the political world."...

Davis says that the vote was unique in one important respect: Frequently, the board may discuss classes of stock representing the tobacco industry, for example. But here, for "the very first time, the board of education directly made a decision on a unique and particular security," he says. Generally, it is investment managers that make decisions on individual stocks, he says.

Texas does not stand alone in social investing, of course. Minutes from a 1996 board meeting of the now \$11 billion Kentucky Teachers Retirement Fund showed auditors that the fund had sold \$51.9 million of its tobacco stock in August of that year.

Christopher Tobe, an investment specialist in State Auditor Ed Hatchett's office in Frankfort, Kentucky, notes that the auditor "was concerned that [the board] took tobacco stocks out of an S&P index fund. If it's an index fund you're not supposed to mess with it," Tobe says, adding that "The last thing I expected to find in Kentucky was a major tobacco divestiture."

The auditor's report will be sent to the Kentucky State Legislature which may take action against the fund administrators.

Jennifer Harris, executive director of the Public Retirement Institute, a Washington-area research firm, explains that those responsible for social investing believe they are benefiting society or the community.

Not only that, but *as an elected official*, "you are in a different position from other fiduciaries because *you have your constituents to answer to*," says Dr. Robert Offutt, a San Antonio dentist who sits on the board of education.

"Ultimately, it depends on whether or not it's your issue," says David Bradley, an insurance agent in Beaumont, Texas, who voted for the divestiture. "There's a large amount of hypocrisy from liberal constituents who are not vocal about social investing targeting tobacco, or alcohol. I personally participate in the Disney boycott, but I wear a different hat as a fiduciary. We operate under the prudent man rule." *[Emphasis added.]*

### **Virginia – House Joint Resolution No. 248, Study on Music Industry Divestiture**

On January 26, 1998, the Virginia House of Delegates and the Senate introduced House Joint Resolution No. 248. The resolution requested the Virginia Retirement System:<sup>8</sup>

...to conduct a comprehensive study of the impact of the divesting of all assets in any company that directly or indirectly writes, records, produces, advertises, markets, sells, or otherwise promotes any song, lyric, or other musical work that advocates, glamorizes, or explicitly describes acts of violence, including murder, rape, sexual assault, robbery, battery, illicit drug or alcohol abuse, and acts of sexual deviance, including necrophilia, pedophilia, or bestiality. The study shall assess the impact of such divestiture, both direct and indirect, as appropriate.

### **California – Assembly Bill No. 2357, Divestiture in Music Industry**

On February 20, 1998, Assembly Member Keith Olberg introduced Assembly Bill No. 2357, which eventually failed to pass. The bill would have prohibited certain state entities from investing in business firms that promote certain types of music. These entities include the Public Employees' Retirement Fund (CalPERS), State Teachers' Retirement Fund (CalSTRS), the Legislators' Retirement Fund, the Judges' Retirement Fund, the Judges' Retirement System II

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8. Virginia legislature: <http://leg1.state.va.us/cgi-bin/legp504.exe?981+ful+HJ248>.



Fund, and the Volunteer Firefighter Fund, among others. These entities would not have been allowed to<sup>9</sup>

...make additional or new investments or to renew existing investments in any business firm that directly or indirectly through ownership of 10 percent or more of another business firm, writes, records, or produce any song or musical work with lyrics that promote ... violent felonies....

These offenses included violent and serious felonies, hate crimes, domestic violence, the illegal use of controlled substances. Songs that are defined as obscene are also included. The bill would have taken effect on January 1, 1999 and required a phased divestment of those investments beginning January 1, 2000, and continuing thereafter until January 1, 2002.

If the bill had become law, CalPERS would have had to divest itself of ownership in the Walt Disney Company, Sony Corporation, Viacom, Time Warner, and PolyGram NV. CalPERS estimated that it has about \$2 billion invested in such companies.<sup>10</sup> Representative Olberg argued that “there is a government duty to protect the public.” An RIAA spokesman countered that the bill “asks government to use its power to determine good music from bad music.” Other critics were troubled by the “throw-the-baby-out-with-the-bathwater idea” when all investments in all music companies stop to comply with such a law. CalPERS, long noted for its investment shareholder activism, has been a fervent opponent of attempts by the legislature to mandate retirement investment policy. A CalPERS spokesman testified that lawmakers were taking a big risk by trying to dictate how the retirement fund invests:<sup>11</sup>

When you start playing politics with CalPERS, it could be damaging to the growth of the fund and the financial future of our members.

Assemblywoman Carole Migden (D-San Francisco), a member of CalPERS’ retirement fund committee, is reported to have said of the bill’s supporters: “These are the same guys who say guns don’t kill. Now they’re saying music does.”<sup>12</sup>

### **California – Tobacco Divestiture**

**CalSTRS:** On June 7, 2000, CalSTRS became the country’s largest pension fund to decide to divest its tobacco industry holdings. CalSTRS is the nation’s third-largest pension

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9. California Legislature, Assembly Bill No. 2357, 1998: [http://www.leginfo.ca.gov/pub/97-98/bill/asm/ab\\_2351-2400/ab\\_2357\\_bill\\_19980416\\_amended\\_asm.pdf](http://www.leginfo.ca.gov/pub/97-98/bill/asm/ab_2351-2400/ab_2357_bill_19980416_amended_asm.pdf).

10. Suzanne Marmion, “Entertainment Industry Survives Calif. Divestiture Bid,” (Reuters) Sacramento, April 22, 1998.

11. Marmion article, quoting CalPERS spokesman Brad Pacheco.

12. Mass Mic, a free speech group: <http://www.massmic.com/calegis.html>.

fund with \$114 billion in assets. The decision requires it to strip its indexed stock portfolio of all \$238 million in tobacco shares.

State Treasurer Phil Angelides contended that “It was the right thing to do from a financial standpoint and also the right thing to do given the ill effects of tobacco on California.”<sup>13</sup> Angelides also pressured sister state fund, CalPERS, to divest its \$670 million in tobacco holdings. (The fund defines a tobacco company as any that derives at least 10% of its revenues from the sale of cigarettes or tobacco leaf products.) CalPERS has historically opposed tobacco divestment, however, preferring the shareholder activism route instead.

CalSTRS had been under intense pressure by the state’s biggest teacher-lobbying groups who argue that educators are hypocritical to preach against smoking while their pension funds invest in tobacco companies. Furthermore, the \$238 million in tobacco shares amount to less than one-tenth of one percent of CalSTRS’ total assets. CalSTRS maintained that legal and financial pressures facing the tobacco industry threaten bankruptcy and thus jeopardized the fund, and that divestiture for that reason alone was prudent.<sup>14</sup>

Opponents of the decision warned of setting a dangerous precedent that allows those espousing other moral causes to trigger further divestitures. The only CalSTRS member not voting in favor of the 8-0-1 decision was a member of the Department of Finance. The Department explained its lone abstention vote was due to uncertainty as to whether divestiture is in the best interest of CalSTRS’ more than 630,000 beneficiaries.<sup>15</sup>

We didn’t want to appear to be endorsing unhealthy habits such as smoking. We also felt the first responsibility of the board is to ensure the financial best interest of the state’s retirees.

The decision, however, allows for an annual review. Thus, if uncertainty in the tobacco industry is resolved, the fund may decide to reinvest. (See “1. *Portfolio Screening: Potential Problems, The Nature and Composition of an Entity*” in Chapter 2.)

**CalPERS:** On October 16, 2000, CalPERS decided to join CalSTRS in divesting its tobacco company holdings. Although CalSTRS had almost entirely divested by December 2000, CalPERS would not reveal when or if it had started to divest.<sup>16</sup>

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13. Andrew LePage, “CalSTRS letting go of tobacco: Fund’s \$238 million in shares to be shed,” Sacramento Bee, June 8, 2000: [http://www.sacbee.com/ib/news/old/ib\\_news02\\_20000608.html](http://www.sacbee.com/ib/news/old/ib_news02_20000608.html).

14. LePage article, quoting Patrick Mitchell, CalSTRS’ outgoing chief investment officer.

15. LePage article.

16. Melanie Payne, “Costly move by pension funds? CalSTRS, CalPERS voted to leave booming tobacco stocks,” Sacramento Bee, January 9, 2001: [http://www.sacbee.com/ib/news/old/ib\\_news05\\_20010101.html](http://www.sacbee.com/ib/news/old/ib_news05_20010101.html).

As of January 2001, CalSTRS would have gained \$110 million had it not divested. From January 3, 2000 to January 1, 2001, shares of Philip Morris Companies, Inc. increased 93% in value. Shares of R. J. Reynolds Tobacco Company rose 217% over the same period.<sup>17</sup> At the same time, the S&P 500 Index fell 10.14% and the Nasdaq composite index dropped 39.29%.

California's state controller, who is a member on both the CalSTRS and CalPERS boards, supported the CalSTRS divestiture vote but abstained from the CalPERS vote. Apparently, her reluctance to support the later CalPERS decision stemmed at least in part from what she felt was flawed advice from a CalSTRS investment consultant:<sup>18</sup>

I kept questioning him, and he insisted it [CalSTRS divestiture of tobacco stocks] was a necessary and prudent decision to make given their review of the market. Obviously the advice did not turn out to be correct.

The charge was denied by the consultant who maintained that an analysis was provided to CalSTRS who made the decision. Furthermore, the consultant pointed out that the divestiture would not affect either CalSTRS or CalPERS much because tobacco stocks accounted for less than one-half of one percent of their respective assets. State treasurer Phil Angelides contends that the threat of tobacco industry bankruptcy is a significant long-term risk. Some tobacco analysts disagree that litigation poses a long-term risk and maintain that, as defensive stocks, tobacco will remain stable in a depressed economy.<sup>19</sup>

### **Community Investing**

Advocates of SRI encourage the use of up to 1% of institutional funds for community investing. (See chapter 2, "3. Community Investing.")

### **California – Domestic Community Investing in California**

CalPERS announced in May 2001 that it had set aside \$475 million as part of its first fund directed at community investing in California.<sup>20</sup> CalPERS is the nation's largest public pension fund with assets of more than \$170 billion. Of the \$475 million, \$30 million is intended for companies in the state's agricultural heartland, the San Joaquin and Sacramento valley region. Furthermore, \$20 million is earmarked for information technology companies. The California-directed investments are aimed at capitalizing on the state's expected growth of some 6 million new residents, mostly in the largest cities of Los Angeles, San Francisco, and San

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17. Payne article.

18. Payne article. Kathleen Connell is the state treasurer and Allan Emkin of Pension Consulting Alliance is the consultant.

19. Payne article, citing remarks by Ann Gurkin of Davenport & Co.

20. Reuters, San Francisco, "Calpers sets aside \$475 million for California", May 14, 2001: <http://news.excite.com/news/r/010514/19/tech-calpers-venture>.

Diego. While also expecting “superior returns” from its investments in underserved areas, CalPERS intends the moneys to fuel growth in jobs and businesses in the state.

CalPERS will invest an additional \$250 million in California urban real estate through the California Urban Real Estate Initiative. CalPERS currently invests \$775 million in such California infill and retail projects.<sup>21</sup> About \$20 billion of CalPERS’ total investments is directed to California investments in real estate, corporate bonds, and public and private corporations.<sup>22</sup>

CalPERS also committed \$75 million to California-based Sanderling Venture Partners V, L.P. for investment in therapeutic, biotechnology, medical, and diagnostic companies.<sup>23</sup>

In May 2000, CalPERS established a \$500 million investment program called Global Innovation Partners, which is managed by C.B. Richard Ellis Investors, L.L.C. In May 2001 CalPERS, through Global Innovation Partners, invested \$15 million in RealEnergy, Inc., a Los Angeles-based provider to commercial properties of on-site energy generation technology, including natural gas engines and solar power.<sup>24</sup>

### **International Investing**

#### **California – Foreign Investments/Human Rights in Developing Nations; CalPERS**

On November 13, 2000, CalPERS voted to screen all its investments in emerging market nations for compliance with the Global Sullivan Principles and certain other international labor standards.<sup>25</sup> The Global Sullivan Principles, a package of human rights, environmental, and labor standards, has received support from some major U. S. corporations and activist groups. (*See Chapter 2, “Global Sullivan Principles” under “Social Values, Screens, and Indices.”*) CalPERS’ decision would also put all its emerging markets investments of \$1.8 billion under active management in which advisers are contracted to pick individual stocks rather than buying index funds.<sup>26</sup> (Index funds automatically purchase a standard cross section of targeted markets.)

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21. California, California Public Employees Retirement System (hereafter cited as “CalPERS”), Office of Public Affairs, “CalPERS Board Takes Action On Investment And Other Measures,” press release, November 15, 2000.
  22. Reuters 5/14/2001 article.
  23. CalPERS press release of 11/15/2000.
  24. Reuters 5/14/2001 article.
  25. Robert Collier, “Pension Fund Tightens Foreign Stock Rules[:] CalPERS board gives weight to human rights,” in San Francisco Chronicle, November 14, 2000.
  26. CalPERS press release of 11/15/2000; and Collier article.

According to a press release from CalPERS<sup>27</sup>, these managers will also be selected based on their adherence to the International Labor Organization's Declaration on Fundamental Principles and Rights at Work. The International Labor Organization is a specialized agency of the United Nations created in 1919 to promote social justice and internationally recognized human and labor rights. Membership includes representatives from government, business, and labor from its member countries.<sup>28</sup> The "Fundamental Principles" were adopted in 1998. They include workers' rights to reject child labor, to refuse forced labor, to work free from discrimination, and to bargain collectively.<sup>29</sup> The United States Department of State's Office of International Labor Affairs, Bureau of Democracy, Human Rights, and Labor encourages observance of the "Fundamental Principles."<sup>30</sup>

CalPERS also approved a list of five emerging markets screens. These outline financial and economic factors and three others including transparency, political stability, and prohibitions on abuse labor practices.<sup>31</sup>

The San Francisco Chronicle reported on November 14, 2000 that the months-long campaign before the vote regarding investments in emerging markets deeply divided the normally low-profile fund. The vote was seven in favor, two opposed, and four abstentions. It was further reported that many of those who abstained apparently opposed the measure but feared stirring the wrath of state labor unions, which wield considerable influence at CalPERS because most state workers are unionized.<sup>32</sup> Supporters, including California's main labor unions, declared it a victory for labor unions. Phil Angelides,<sup>33</sup> the state treasurer and leading proponent of the decision, announced the plan was

...a much needed step that recognizes the correlation between political stability and human rights and the long-term stability and profitability of our investments.

Another supporter, Art Pulaski, secretary-treasurer of the California Labor Federation, whose members include about 600,000 CalPERS beneficiaries, said:<sup>34</sup>

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27. CalPERS press release of 11/15/2000.
  28. National Retail Federation website: <http://www.sweatshops-retail.org/nrf%20website/ilo.htm>
  29. Global Policy Forum, "Labor Leaders to Publicize ILO's Worker Rights List," February 14, 2001: <http://www.globalpolicy.org/soecon/inequal/labor/ilo.htm>
  30. United States Department of State website. A follow-up was declared in 1999: [http://www.state.gov/www/global/human\\_rights/drl\\_labor\\_mission.html](http://www.state.gov/www/global/human_rights/drl_labor_mission.html).
  31. CalPERS press release of 11/15/2000.
  32. Collier article.
  33. *Ibid.*
  34. *Ibid.*

This is an important step to protect our members' hard-earned investments.... By taking rights, worker rights and the environment into consideration, CalPERS will be doing its fiduciary duty.

However, on the other hand, the San Francisco Chronicle offered the following observation:<sup>35</sup>

Pulaski and other labor leaders bent over backward to portray the measure as a level-headed financial move rather than an adventure in social activism... Despite Pulaski's bottom-line language, labor unions' strong support for the CalPERS initiative is part of a broad fight by unions nationwide against what they see as the use of their members' money to further unfettered, corporate-driven globalization. The unions complain that all too often, their pension funds have invested in overseas companies that compete against American firms while oppressing their nations' workers.

Opposing board members charged the decision will involve the fund in "social activism" and could bar the fund from investing in some of California's major trading partners. Kathleen Connell, the state controller, said "I'm concerned that we don't know what we're doing here." Governor Grey Davis' representative, state personnel director Marty Morgenstern, complained that the didn't understand the proposal.<sup>36</sup>

This is a very complex motion on a very complex issue. I don't think anyone here understands the motion, and I much less so.

### **California – Foreign Investments/Northern Ireland; CalSTRS and CalPERS**

Section 7513.3, California Government Code requires both the California's Teachers' Retirement Board and the Board of Administration of the Public Employees' Retirement System to do three things:

- Report annually to the legislature on the extent to which U. S. and international corporations operating in Northern Ireland invested in by CalSTRS and CalPERS, in compliance with the law applicable in Northern Ireland, adhere to the principles of nondiscrimination in employment and freedom of workplace opportunity (MacBride Principles).
- Compile a list of domestic and international corporations invested in by CalSTRS and CalPERS that, directly or through a subsidiary, do business in Northern Ireland, and determine if they have taken substantial action during the preceding year to comply with the MacBride Principles.
- Support shareholder resolutions designed to encourage domestic and international corporations invested in by CalSTRS and CalPERS to pursue a

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35. Ibid.

36. Ibid.

policy of affirmative action in Northern Ireland in compliance with MacBrdie Principles.

### **Rhode Island – Foreign Investments/Northern Ireland**

Section 35-1-14, Rhode Island Code, requires Rhode Island’s general treasurer, acting as the treasurer/custodian of the state’s employees’ retirement system and the teachers’ retirement system, and as the chairperson of the state investment commission, to:

...monitor ... the extent to which corporations organized under the laws of the United States or the several states and operating in Northern Ireland, in which the assets of the retirement systems or of the pension reserves investment trust fund are invested, adhere to principals of nondiscrimination in employment and freedom of workplace opportunity.

Similar to the California statute, the general treasurer is also required to report to the legislature, with recommendations consistent with fiduciary practice, as to whether those companies invested in adhere to the MacBride Principles. As in California, Rhode Island’s general treasurer is required to support shareholder petitions or initiatives requiring corporate action in compliance with the MacBride Principles, but subject to the approval of the state investment commission.

Furthermore, the law “encourages” the general treasurer, in accordance with sound investment criteria, to make future pension fund investments in firms that comply with the MacBride Principles. The general treasurer also is given the option and is “encouraged” to divest companies that do not comply.

(Rhode Island also has a statute (section 35-10-12, Rhode Island Code) that lifts the previous ban on investments in companies doing business in South Africa. This statute encourages domestic firms to comply with the “Code of Conduct for Businesses Operating in South Africa.” This code, set forth by the South African Council of Churches, is designed to promote equal opportunity, workers’ rights, environmental protection, and community economic development benefiting all South Africans.)

### **Connecticut – Foreign Investments/Northern Ireland**

Section 3-13h(a), Connecticut General Statutes, gives the state treasurer the power to urge companies in which the state has invested that do business in Northern Ireland to comply with the MacBride Principles. The same section empowers the state treasurer, where necessary and appropriate, to initiate or support shareholder initiatives requiring remedial corporate action.

Section 3-13h(b), Connecticut General Statutes, requires the state treasurer, by May 18, 1990, to “... disinvest all state funds<sup>37</sup> currently invested in any corporations doing business in

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37. Section 3-13c, Connecticut General Statutes. Entities affected include the Connecticut Municipal Employees’ Retirement Fund A, Connecticut Municipal Employees’ Retirement Fund B, Soldiers, Sailors and Marines Fund, State’s Attorney Retirement Fund, Teachers’ Annuity Fund, Teachers’ Pension Fund,  
(Footnote continued on next page.)

Northern Ireland and invest no new state funds in any such corporation unless such corporation has implemented the MacBride principles.” The state treasurer is further required to invest state funds available for future investment in Northern Ireland only in corporations that comply with the MacBride Principles. This is to be done “...in accordance with sound investment criteria consistent with prudent standards of fiduciary responsibility.”

(As an aside, still on the books is a 1980 statute (section 3-13g, Connecticut General Statutes) that requires the state treasurer to ensure that state funds are not invested in companies doing business in Iran that is contrary to U.S. foreign policy or national interests, “particularly in respect to the release of all American hostages held in Iran.”)

### **New Hampshire – Foreign Investments/Northern Ireland**

According to section 6:34, New Hampshire Revised Statutes, effective June 16, 1989:

Consistent with sound investment policy and prudent fiduciary standards, the treasurer shall, with respect to state funds available for future investment in corporations doing business in Northern Ireland, invest such funds in corporations conducting their operations in Northern Ireland in accordance with the MacBride principles and fair employment practices.

It appears that the requirement is to first qualify such corporations before the state treasurer can invest in them, rather than requiring all future state funds to be invested only in such corporations.

### **Massachusetts – South Africa, Northern Ireland, Tobacco Products**

Section 32-23(2)(h), Massachusetts General Laws, prohibits investment of state funds in banks that lend money to weapons industries supplying South Africa or Northern Ireland.

...no investment of funds shall be made in any bank or financial institution which directly or through any subsidiary has outstanding loans to any individual corporation engaged in the manufacture, distribution or sale of firearms, munitions, including rubber or plastic bullets, tear gas, armored vehicles, or military aircraft for use or development in any activity in South Africa, and no new investment of funds shall be made in the stocks, securities or other obligations of any company so engaged;... and provided, further, that no funds are to be invested in any bank or financial institution which directly or through any subsidiary has outstanding loans to any individual corporation engaged in the manufacture, distribution or sale of firearms, munitions, including rubber or plastic bullets, tear gas, armored vehicles, or military aircraft for use or deployment in any activity in Northern Ireland, and no assets shall be invested in the stocks, securities or other obligations of any such company so engaged.

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Teachers’ Survivorship and Dependency Fund, School Fund, State Employees Retirement Fund, the Hospital Insurance Fund, Policemen and Firemen Survivor’s Benefit Fund and all other trust funds administered, held or invested by the treasurer.



The same section does allow investment in banks, financial institutions, or companies doing business in South Africa, other than the above, “as much as reasonably possible” that adopt certain guiding principles. These provide some overlap with the Global Sullivan Principles (section 32-23(5)(a) to (g), Massachusetts General Laws):

- (a) Worker’s rights: companies should uphold worker’s rights including the recognition of representative unions and their rights to bargain collectively, to strike, to picket peacefully, the establishment of a policy that strike breakers will not be hired and that investment should enhance employment creation;
- (b) Equality of opportunity: companies should eliminate all discrimination on the basis of race, religion, sex, political opinion or physical handicap and implement affirmative action programs;
- (c) Environmental protection: investment should incorporate environmentally sound and clean practices and technology;
- (d) Training and education: investment should enhance the productive capacities of South Africans, and in particular, institute training and adult education programs for workers in consultation with the trade union movement;
- (e) Conditions of work and life: conditions of work and life offered by companies should compare favorably with the best conditions in the relevant sector domestically;
- (f) Security of employment: investment should contribute to the security of employment of South Africans;
- (g) Empower black business: companies should, where possible, adopt business practices which enhance the development of black business in South Africa.

## **II. STUDIES ON VARIOUS ASPECTS OF SRI**

Like most other issues, there are pros and cons to SRI. Most studies have focused on the performance of SRI-screened investments. Also like other issues, there is no silver bullet that indisputably and unequivocally proves things one way or the other. Because fiduciary duty must be met, academic support was needed to show that SRI-screened investments were superior, or at least not inferior, in order to justify using an SRI approach to investing public institutional funds. At least, the use of social screens could not be shown to be significantly inferior to normal investing without restrictive social screens.

SRI represents a relatively new field of study in which researchers strive to apply new methodologies of portfolio analysis to determine the merits of SRI investing. On the whole, it cannot unequivocally be said that SRI investing is either superior or that it is significantly inferior. There is some evidence that in some instances, it is statistically indistinguishable from non-SRI investing, or that use of SRI screens do no harm.

However, SRI investing is a phenomenon too new for anything definitive to be proclaimed. Only two years ago, the great bull market of the 1990s – and the erstwhile “new

economy” and the irrational exuberance that it engendered – came to an end. It could have been said that SRI investments over that period, especially by SRI mutual funds, were superior to non-SRI investments. It also happened that SRI funds had systematically weeded out slow “old economy” companies and heavily overweighted investments in “new economy” growth technology stocks. This disproportionate weighting returned to haunt SRI funds when the “new economy” bubble burst. People realized that fundamental rules of valuation could not be supplanted by new rules made up to justify insupportable stock valuations.

Just as technology stocks gave SRI funds a significant pop in performance during the bull market, the decline of these stocks in the ensuing bear market has caused them relatively heavier losses. Nonetheless, SRI funds’ underperformance recently cannot be said to be an inherent weakness of the SRI approach, just as their outperformance earlier cannot be said to be an inherent strength. Those who look with disfavor upon SRI investing would do well not to claim victory at SRI funds’ recent losses. Indeed, no one knows if SRI funds will once again do well if (or when) the market turns up. The following digests various studies in the field.

### **Grossman and Sharpe (1986)<sup>38</sup>**

In “Financial Implications of South Africa Divestment,” Grossman and Sharpe found that portfolios free of South African stocks actually performed a little better than unscreened portfolios during the period from 1960 to 1983. They concluded that the variance was due to the small-cap effect.<sup>39</sup> (The “small-cap” effect refers to the pattern of significant outperformance by the average small capitalization stock over the largest capitalization stocks. This effect was based on a study by Banz (1981) of the period from 1926 to 1980.)<sup>40</sup>

Widely regarded as the formative work on analysis of screened portfolios, this study compares the returns of a value-weighted South Africa-free portfolio to those of a comparable unscreened New York Stock Exchange portfolio. After diluting the South Africa-free portfolio with Treasury bills to make total risk equal to the benchmark, the authors find that it outperformed the benchmark from 1960 to 1983. This benefit, however, appears to be entirely attributable to the small-cap size effect.

After adjusting for all other factors, doing business in South Africa appeared to be associated with positive returns of 0.77%, although the difference was significant only for the

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38. Blake Grossman and William Sharpe, “Financial Implications of South Africa Divestment,” in Financial Analysts Journal, July/August 1986.

39. The analysis of the Grossman and Sharpe article is from Lloyd Kurtz, a Director of the Colloquium on Socially Responsible Investing and Chairman of the Social Investment Forum’s Moskowitz Prize committee, which annually recognizes the most outstanding academic study of socially responsible investing. Kurtz is also a research analyst at Harris Bretall Sullivan and Smith, a San Francisco money management firm: [http://www.sristudies.org/Bibliography/body\\_bibliography.html](http://www.sristudies.org/Bibliography/body_bibliography.html). Brief biographical description of Kurtz is from Brian R. Bruce, ed., The Investment Research Guide to Socially Responsible Investing, Investment Research Forums, Inc. 1998, p. 3.

40. Netfolio: [http://www.netfolio.com/info/netfolio\\_university/market\\_cap.jsp](http://www.netfolio.com/info/netfolio_university/market_cap.jsp).

1960 to 1975 time period, when the disparity reached 2.05%. The factor turned negative for the period 1975 to 1983, and although not significant, the authors observed it "... is nonetheless sufficient magnitude to reject the hypothesis that [South Africa] stocks have substantially outperformed [South Africa-free] stocks with similar characteristics in the recent past."

#### **A. Rudd (1981)<sup>41</sup>**

Rudd compared the characteristics of the S&P 500 with the characteristics of an optimized S&P 500 portfolio that excluded companies with operations in South Africa. Rudd found that "... the extra market covariance induced by excluding companies with operations in South Africa is small, resulting in an expected annual return only 0.037% lower than [sic] the return on the S&P 500."

#### **Hamilton, Jo, and Statman (1993)<sup>42</sup>**

Hamilton, et al. studied the performance of 17 socially responsible mutual funds established before 1985 in "Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds." The funds were examined during the period 1986 to 1990. These funds were compared to unscreened non-SRI mutual funds of similar risk.

The authors found that the SRI mutual funds outperformed their counterparts by 6 basis points (6/100%) monthly, or 0.76% per year in risk-adjusted returns. The difference was not statistically different from zero unscreened funds. That is, the two sets of funds were statistically indistinguishable.

Hamilton, et al. tested three hypotheses: that the risk-adjusted returns of SRI portfolios are (1) equal to, (2) lower than, or (3) higher than those of conventional portfolios. They conclude in favor of the first hypothesis.<sup>43</sup>

Our results indicate that the market does not price social responsibility characteristics. Investors can expect to lose nothing by investing in socially responsible mutual funds; social responsibility factors have no effect on expected stock returns or companies' cost of capital. Our results might disappoint socially responsible investors who hope to do well while doing good. They might also disappoint socially responsible investors who

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41. A. Rudd, "Divestment of South African Equities: How Risky?" in Journal of Portfolio Management, Fall, 1979, as cited by Hamilton et al. in The Investment Research Guide, pp. 27, 29.

42. Sally Hamilton, Hoje Jo, and Meir Statman. "Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds," in Financial Analysts Journal, November/December 1993, with permission from Association for Investment Management and Research, reprinted in The Investment Research Guide to Socially Responsible Investing, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 25-29.

43. Hamilton, et al., in The Investment Research Guide, p. 28.

are willing to receive low returns as fair exchange for changing the world. But not all socially responsible investors attempt to change the world.

**Luck (1998)<sup>44</sup>**

Luck used BARRA's Performance Analysis software (fundamental factor model) to analyze the Domini Social Index's returns since inception in May 1990 to June 1998. (*See Chapter 2 for discussion on the DSI.*) The study found that the DSI outperformed the S&P 500 by 1.68% annually. However, none of the explanatory factor biases, including those introduced by social screens, were statistically significant at the 90% confidence level. Social screens introduced the style bias (capitalization orientation, value and momentum bias) and industry bias. The other explanatory factor biases were specific asset selection, systematic timing premium, and market risk.

One factor, the systematic market-timing premium (or beta policy), contributed to the outperformance of the DSI. By happenstance, the stocks making up the DSI have a greater average beta measure than the stocks in the S&P 500. The beta statistic measures how greatly a stock's value will fluctuate compared to the S&P 500. To explain, by definition, the S&P 500 has a beta of 1.00. If a stock has a beta of 1.5, its price will rise or drop 50% more than the S&P 500. Thus, if the S&P 500 rises by 10%, that stock will rise by 15% (50% more than 10%). Conversely, it will drop 50% more than the S&P 500 when the entire market falls. Luck acknowledges that his study focused on "... a period in which the market has performed extremely well."<sup>45</sup> Therefore, because the DSI has a greater beta than the S&P 500, it would perform better when the entire market (S&P 500) rises. Nonetheless, even this factor was not statistically significant.

Factors introduced by the social screens, the style and industry biases, worked in opposite directions. With regard to the style bias, the DSI has persistently and disproportionately excluded the larger-capitalization and value stocks. That is, it has disproportionately included growth stocks as opposed to value stocks, and smaller vs. larger capitalization stocks. According to Luck, this style bias is consistent with other socially screened portfolios.<sup>46</sup> For example, the DSI and other screened portfolios tend to invest more in relatively new technology companies and fewer larger "old economy" companies such as steel-makers and those that make consumer products such as toothpaste and laundry bleach. The style bias has actually led to a slight negative underperformance by the DSI, although not statistically significant.

In another study, Luck and Pilotte (1993)<sup>47</sup> found that the DSI outperformed the S&P 500 Index primarily due to the higher growth sensitivity of the DSI from May 1990 to September

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44. Christopher G. Luck, "Domini Social Index Performance," in The Investment Research Guide to Socially Responsible Investing, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 177-181.

45. Luck, in The Investment Research Guide, p. 179.

46. Ibid., p. 180.

*(Footnote continued on next page.)*

1992. They noted that the period examined was characterized by positive growth factor and size returns (smaller stocks outperformed larger stocks and growth stocks outperformed value stocks). Luck and Pilotte found that the 400 securities in the DSI produced an annualized active return of 233 basis points relative to the S&P 500. On the other hand, specific asset selection, that is, eliminating certain “bad” companies and including “good” companies accounted for 199 basis points of the active return. This provided evidence that the outperformance was attributable to selecting socially responsible companies.

Returning to Luck (1998), the industry bias led to a slight outperformance by the DSI, although not statistically significant. For example, the DSI has avoided the oil, chemical, tobacco, alcohol, nuclear power, and automotive industries.

Luck expressed surprise that<sup>48</sup>

...the outperformance has been driven not so much by the factor biases in the DSI [social screening] relative to the S&P500 ... but by specific asset selection... The surprise here, again, is that the bulk of the outperformance arises *not* from the factor biases introduced by the social screens, but from the asset specific selection return itself, the fact that the stocks selected have simply performed well. There is a specific return premium to the [DSI] index over this time period that is possibly (presumably?) related to the social screens KLD has developed, although the *results are not quite statistically significant*. *The higher return does not come without higher risk*, though. The DSI has maintained an average beta of 1.04 relative to the S&P500. [*Emphasis added.*]

### DiBartolomeo (1996)<sup>49</sup>

In “Explaining and Controlling the Returns of Socially Screened Portfolios,” DiBartolomeo analyzes the Domini Social Index using models similar to Luck’s. While agreeing that style effects are generally a wash and that industry effects are important, DiBartolomeo does not agree that there might be an SRI effect at work. His model finds no unexplained performance.

DiBartolomeo reviews the performance of the DSI from May 1990 to April 1995 also using a fundamental factor model. According to Kurtz:<sup>50</sup>

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47. John B. Guerard, Jr., “Is There a Cost to Being Socially Responsible in Investing?” in *Journal of Investing*, Summer 1997, .reprinted at SIF website, p. 2, citing Christopher Luck and N. Pilotte, “Domini Social Index Performance,” in *Journal of Investing*, 1993, pp. 60-62: <http://www.socialinvest.org/Areas/Research/Moskowitz/1996.htm>.

48. Luck, in *The Investment Research Guide*, pp. 179, 180.

49. Dan DiBartolomeo, “Explaining and Controlling the Returns of Socially Screened Portfolios,” speech to the New York Society of Security Analysts, September 10, 1996, as described by Kurtz at: : [http://www.sristudies.org/Bibliography/body\\_bibliography.html](http://www.sristudies.org/Bibliography/body_bibliography.html).

50. Kurtz website.

This model finds that the DSI's industry exposures explain much of its relative performance, and has a non-significant residual, suggesting the absence of a social factor.

**Guerard (1997)**<sup>51</sup>

In "Is There a Cost to Being Socially Responsible in Investing?" Guerard uses an expected return model incorporating value and growth components to examine returns from 1987 to 1994 by screened and unscreened portfolios. He finds no statistically significant difference in performance between the two. He comments that these social criteria did not cost the investor any meaningful average return during the 1987-1994 period. In fact, they may have produced positive active returns relative to the S&P 500 Index during some sub-periods.

Guerard makes use of Vantage Global Advisor's universe of 1,300 unscreened stocks and a 950-stock screened universe. His model examines their respective returns at the 95% confidence level. The screens used in this analysis were provided by KLD and are as follows: Military, Nuclear Power, Product (Alcohol, Tobacco and Gambling), and Environment. He finds that there is no significant difference between the average monthly returns of the screened and unscreened universes during the period under study. From January 1987 to December 1994, there was less than a 15 basis point differential in equally weighted annualized stock returns. The unscreened 1300 stock universe produced a 1.068% average monthly return, such that a \$1.00 investment grew to \$2.77. A corresponding investment in the socially-screened universe would have grown to \$2.74, representing a 1.057% average monthly return.

While there was no long-term return difference, Guerard contends that short term variations were due to style and size biases of the screened portfolio. He cites as an example the financial characteristics of the stocks in the two universes of stocks as of December 1994:<sup>52</sup>

The unscreened universe of had BARRA growth and book-to-price sensitivities of 0.185 and 0.306, whereas the socially-screened universe had corresponding sensitivities of 0.269 and 0.279, respectively. The unscreened universe had an average market capitalization of \$3.433 billion in December 1994 whereas the socially-screened universe had a mean capitalization of \$2.796 billion. The average BARRA growth and book-to-price sensitivities of the excluded securities were -0.164 and 0.414, respectively, and the average market capitalization of the excluded stocks exceeded \$6.1 billion. *[Explanation: stocks in the screened universe were smaller cap and more growth oriented.]*

Guerard states that the screened universe is more sensitive to the growth factor return than the unscreened universe and thus SRI investors should expect better performance when the market favors growth vis-à-vis value stocks. *(Growth and value investing represent two different investing styles. Growth investors look for high-quality, successful companies that have posted*

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51. Guerard.

52. Ibid.

*strong performance and which are expected to continue to do well. Their success is usually reflected in higher stock prices. Growth investors rely on continued earnings growth and appreciation in a stock's price. Value investors, on the other hand, look for companies that have fallen out of favor but still have good fundamentals. They buy these stocks at bargain prices below the stocks' average historic levels or below the current levels in their industry groups. They believe that stocks of good companies may bounce back in time when their true value is recognized by other investors.)*

Guerard advises that one "... should be attentive when selecting a socially-screened mutual fund or manager. Performance can vary dramatically across managers, but should not vary due to social screening over the long term."<sup>53</sup>

Guerard cites three examples including two previous studies that show the inconclusive nature of the literature on the impact of social screening on returns:<sup>54</sup>

The College Retirement Equities Fund (CREF) Social Choice Account, also provides a real world example of how socially responsible funds can outperform. The Social Choice Fund ... is a balanced account of approximately 62 percent equity and 38 percent long-term bonds (as of December 31, 1995). The Social Choice Account earned an average annual return of 12.41 percent for the five years ending December 31, 1996. CREF's Stock Account, composed stocks representative of U.S. equities (66 percent), U.S. growth stocks (17 percent), and foreign stocks (17 percent), earned a 13.58 percent average annual return for the five-years ending December 31, 1996. It is difficult to compare the equity performance of the CREF Social Choice Account with the CREF Stock Account because the various equity and asset compositions may create different risk levels; however, one does not find the substantial underperformance in the CREF Social Choice Account relative to the Stock Account. The CREF Social Choice experience lends credence to the theory that socially responsible funds can produce good performance.

J. Rothchild espoused a very different view as he labeled socially-screened investing a "dumb" idea in *Fortune*, May 1996. It is the case that 24 socially-screened mutual funds in the Morningstar universe have substantially underperformed the S&P 500 during the past five and ten years. However, the difference between the average return on socially-screened equity mutual funds and the 2034 unscreened equity mutual funds drops from -417 basis points over the past five years to -105 basis points over the past ten years, a less meaningful differential, particularly given the very small number of socially-screened equity mutual funds with long-term track records. There are only six socially-screened equity mutual funds with five-year track records in the Morningstar universe and only Dreyfus Third Century and Parnassus have ten year records.

J. D. Diltz presented a third, more neutral, point of view in two recent studies in which he found no statistically significant difference in returns for 14 socially screened stock portfolios vs. 14 unscreened stock portfolios generated from a universe of 159

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53. Ibid.

54. Ibid.

securities during the 1989-1991 period. Diltz found that only the environmental and military business screens created a statistically significant difference in returns at the five percent confidence level during the 1989-1991 period.

Guerard concludes that the literature on the impact of social screening on returns provides mixed conclusions. At a minimum, the studies of the DSI and the CREF Social Choice Account suggest that it does not cost investors to invest socially.

### **Russo and Fouts (1997)<sup>55</sup>**

Russo and Fouts tested the hypothesis that environmental performance and economic performance are positively “linked” and that industry growth moderates that relationship. In other words, a positive environmental policy generates broader organizational advantages that enable a firm to capture premium profits, or that “it pays to be green.” This effect is hypothesized to be greater in higher-growth industries.

Russo and Fouts analyzed the performance of 243 stocks in 1991 and 1992 using the Compustat database. They found that, after controlling for industry concentration, industry growth rate, firm growth rate, firm size, capital intensity, and advertising intensity, companies with better environmental records appear to have better-than-average returns on assets. The environmental rating has a statistically significant positive impact on the firm’s return on assets ( $p < 0.01$ ). The effect was small<sup>56</sup> but highly significant and stronger for firms in higher-growth industries.

The argument is that a “proactive” environmental policy that stresses prevention over mere compliance leads to internal redesign of production and service delivery processes. The products of this redesign become new resources, or assets, of the company, which give it a competitive advantage. These new processes also create other intangible assets such as new technological know-how. Other intangible assets include a reputation for environmental leadership – which contributes to profits – and political acumen, defined as the “ability to influence public policies in ways that confer a competitive advantage”<sup>57</sup> to the firm.

The Russo and Fouts study did not directly examine the effectiveness of SRI investing. However, the results suggest that an SRI investor may achieve better than average returns by

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55. Michael V. Russo and Paul A. Fouts, “A Resource-Based Perspective on Corporate Environmental Performance and Profitability,” with permission from Academy of Management’s Academy of Management Journal, (1997) vol. 40, no. 3, reprinted in The Investment Research Guide to Socially Responsible Investing, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 109-132.

56. Russo and Fouts, in Investment Research Guide, p. 122: “At this point, we feel it necessary to reiterate that our variables of interest do not account for more than a modest level of variation in firm performance.... But given that a number of well-established control variables were entered into the equation, we consider the finding of relatively consistent patterns of significance and coefficients on our variables of interest of clear scholarly value.”

57. Russo and Fouts, in Investment Research Guide, p. 114.



using an environmental screen in high-growth industries to choose companies with strong environmental policies.

**Angel and Rivoli (1997)<sup>58</sup>**

Angel and Rivoli conducted a study in 1997 and reported the results in “Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Perspective.” Rather than focusing on investor returns, this study tried to determine whether ethical screens used by SRI investors have any effect on a company. The authors conclude that:

We show that the effect of investor ethical screens is not uniform across firms. For certain types of firms, such screens may result in higher capital costs, and may therefore be effective in investor attempts to change firm behavior. For other firms, the effects of this investor behavior are likely to be negligible.

The theory is that when ethical investors refuse to invest in certain firms, they create a segmented market in which the excluded firms have access to only one segment of the capital market, but not to another. The theoretical effect is that the cost of equity capital will increase for those firms, which in turn reduces their economic profits.

Angel and Rivoli first posit two separate SRI strategies: voice and exit. The former refers to active investor response, such as introduction of shareholder resolutions, to a company’s perceived ethical lapses. The exit strategy refers to divestment or screening of shares. They further distinguish between customer exit and investor exit. If customers stop buying a company’s products, the company will be stimulated to make changes in product price or quality. Thus, customer exit has some effect. However, when investors divest their shares, in a perfect and liquid market, there will always be other investors willing to pay for those shares divested. Therefore, investor exit, in terms of divestment, does not affect the company.

However, Angel and Rivoli examine the screening aspect of the investor exit strategy – that is, when a certain percentage of investors refuse to invest in a company for ethical reasons. In other words, there are not “enough” investors who will buy the company’s stock. This situation leads to a segmented capital market in which the cost of capital rises and thus reduces the economic profit of the company.<sup>59</sup>

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58. James J. Angel and Pietra Rivoli, “Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Perspective,” with permission from *Institutional Investor’s Journal of Investing*, reprinted in The Investment Research Guide to Socially Responsible Investing, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 104-108.

59. Angel and Rivoli, pp. 105-106. They use Merton’s model of market segmentation (one segment is willing to invest in a security while another segment is unwilling). The model uses the assumptions of the capital asset pricing model (CAPM) which asserts that investors require compensation for the risk that a particular stock introduces into their portfolio. The result is that if only a fraction of investors are willing to hold a stock, the result is a rise in the firm’s cost of capital.

Translated into SRI terms, unless a substantial fraction of the capital market boycotts a firm, the increase in the cost of equity as a result of a boycott by ethical investors is likely to be quite small. For example, the increase cost of capital would be less than 0.5% per year if as many as 65% of all investors engage in the boycott. However, that cost is forecast to rise precipitously if additional investors boycott. They estimate about a 2.75% capital cost to the firm if 90% of all investors boycott. Angel and Rivoli further argue that the impact of a boycott will be greatest on fast-growing firms.

The upshot is that investor boycott, or screening out of certain companies, will increase those companies' cost of capital, but only to a very small degree, depending on the extent of the boycott.

### **Teper (1992)<sup>60</sup>**

Several studies have suggested that SRI may interfere with active management strategies. There is some evidence that this interference has occurred. According to Kurtz (1999), Teper reported in 1992 that:

...in the late 1980s risk-adjusted returns for social money managers and mutual funds were 80 basis points lower, on an annualized basis, than those of a backtest of the DSI. Today, as the DSI outperforms the S&P 500, Morningstar's [1996] Principia for Mutual Funds reports that of the twenty-two SRI mutual funds with three-year track records, nine were below-average relative to their peers, nine were average, and only four were above-average.

Teper argues that social investors must incur a cost, estimated at 1% per annum for equity accounts. He compares unrestricted accounts with SRI screened accounts and finds that, from December 1984 to September 1990, the SRI accounts incurred a risk-adjusted cost of 1.1%.

### **Hale; Hall; Hickey – Morningstar Ratings in 1997, 1999, 2000**

In 1997, Jon Hale, an analyst at Morningstar, an independent and leading provider of mutual fund, stock, and variable-annuity investment information, published unfavorable "star" ratings of 42 SRI funds that it tracked:<sup>61</sup>

Of 42 socially screened funds with three-year records, the record isn't very pretty: Not a single fund has a 5-star rating and when SRI funds are compared with non-screened offerings that follow similar investment strategies, only two would place in the top 15%

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60. Jeffrey Teper, "Evaluating the Cost of Socially Responsible Investing," in *The Social Investment Almanac*, Kinder, Lydenberg, & Domini, eds. 1992, as cited by Lloyd Kurtz, "'Mr. Markowitz, Meet Mr. Moskowitz': A Review of Studies of Socially Responsible Investing," in *The Investment Research Guide to Socially Responsible Investing*, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 32-53.

61. Jon Hale, "Socially Responsible Investing" in Morningstar.com: <http://newsmorningstar.com/news/MS/FundFocus/SRI/sri1.html>.

on the basis of their risk-adjusted performance over the trailing three years. In general, socially screened funds' star ratings and their performances relative to funds with similar investment strategies are skewed towards the bottom third of the mutual fund universe.

Much of the blame for the low ratings lies with one of SRI's biggest names, The Calvert Group. Calvert has 10 funds (multiple shareclasses included) with records of at least three years. None have [*sic*] star ratings above three, and all place in the middle or bottom third relative to the funds with similar investment approaches over the trailing three years. If not for the Calvert factor, the distribution of the remaining SRI funds would be much closer to that of the fund universe in general.

Morningstar's Risk-Adjusted Rating is commonly called the star rating and brings both performance and risk together into one evaluation. According to Morningstar:<sup>62</sup>

#### Morningstar Star Rating

... To determine a fund's star rating for a given period (three, five, or 10 years), the fund's Morningstar Risk score is subtracted from its Morningstar Return score. The resulting number is plotted along a bell curve to determine the fund's rating for each time period: If the fund scores in the top 10% of its broad investment class (domestic stock, international stock, taxable bond, or municipal bond), it receives 5 stars (Highest); if it falls in the next 22.5%, it receives 4 stars (Above Average); a place in the middle 35% earns it 3 stars (Average); those in the next 22.5% receive 2 stars (Below Average); and the bottom 10% get 1 star (Lowest). The star ratings are recalculated monthly.

#### Morningstar Risk

The Morningstar Risk statistic evaluates the fund's downside volatility relative to that of other funds in its broad investment class (domestic stock, international stock, taxable bond, or municipal bond). Morningstar uses a proprietary risk measure that operates differently from traditional risk measures, such as beta and standard deviation, which see both greater- and less-than-expected returns as added volatility. Morningstar believes that most investors' greatest fear is losing money – defined as underperforming the risk-free rate of return an investor can earn from the 90-day Treasury bill – so our risk measure focuses only on that downside risk. To calculate the risk score, we plot monthly fund returns in relation to T-bill returns. We add up the amounts by which the fund trails the T-bill return each month and divide that total by the period's total number of months. This number, the average monthly underperformance statistic, is then compared with those of other funds in the same broad investment class to assign our risk scores. The resulting risk score expresses how risky the fund is relative to the average fund in its class. The average risk score for the category is set equal to 1.00; a Morningstar Risk score of 1.35 for a taxable-bond fund means that the fund has been 35% riskier than the average taxable-bond fund for the period considered. Note that Morningstar does not rate any fund that has less than three years of performance data.

#### Morningstar Return

The Morningstar Return figure rates a fund's performance relative to other funds in its broad investment class (domestic stock, international stock, taxable bond, or municipal bond). After adjusting for maximum front-end loads, applicable deferred loads, and

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62. Morningstar at: <http://quicktake.morningstar.com/DataDefs/FundRatingsAndRisk.html>.

applicable redemption fees, Morningstar calculates the excess return for each fund, defined as the fund's load-adjusted return minus the return of the 90-day T-bill over the same period. The use of excess instead of raw returns reflects our belief that mutual funds should be rated highly for only those returns earned beyond those of a T-bill, which is essentially a risk-free investment. The excess returns are then compared with the higher of the average excess return of the fund's broad investment class or the 90-day T-bill return. This last adjustment prevents distortions caused by having low or negative average excess returns in the equation's denominator, as might occur during a protracted down market. The equation is:  $(\text{Return on Fund} - \text{T-bill}) / \text{Higher of (Category Return} - \text{T-bill) or T-bill}$ .

The review goes on to analyze some of the better-performing SRI funds across a range of investment categories.

- Large-capitalization blend – the Domini Social Equity fund (a passive SRI fund alternative to S&P 500 index funds): “Since inception in 1991, the fund’s annualized return lags the S&P 500 by less than 100 basis points, and its 18.2% trailing five-year return lands in the top half of all large-blend funds.”
- Large-capitalization growth – Citizens Index fund, a more growth-oriented fund than the Domini Social Equity fund: In 1997, the fund was not yet three years old. It beat the S&P 500 in 1996 and was leading the benchmark in 1997 at the time of the review.
- Mid- and small-capitalization growth – “... the dismal Calvert Strategic Growth (A shares -12.4% for the year to date) and Citizens Emerging Growth (+14.2%)...”: The latter’s three-year returns are competitive with many mid-cap growth funds, but its tendency to hold large amounts of cash has kept it in Morningstar’s domestic hybrid category, where it earns a low category rating... Its 21.6% three-year return would place in the middle of the mid-cap growth category and its volatility has been lower than most mid-cap growth funds”<sup>63</sup>
- Smaller-capitalization value – Neuberger & Berman’s Socially Responsive Fund: Its three-year return placed it in the top third of Morningstar’s mid-cap blend category and a risk score in the middle.
- World/foreign stock – Citizens Global Equity and Calvert World Values International Equity: The former invests in domestic and other developed markets, focusing on large-capitalization growth companies. Its 12.4% three-year return and risk score land in the middle of the category. The latter invests only in foreign stocks. Its 12-month returns placed it in the top third of the category.
- Fixed Income – Citizens Intermediate Bond Fund devotes about two-thirds of its portfolio to investment-grade and one-third to high-yield corporate bonds. The fund’s 7.6% trailing five-year return ranks in the category’s top third and its volatility

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63. Hale article.

relative to its peers is low. For the trailing three years, its risk-adjusted performance places it in the top half of all intermediate-bond funds.

In 1999, Emily Hall of Morningstar revisited Hale's 1997 review of SRI funds. While acknowledging that "Academics studying the link between commonly used social criteria and stock performance haven't found a clear-cut relationship, positive or negative" Hall admits that "A lot can change in two years."<sup>64</sup>

Compared to 1997 when not a single SRI fund merited a 5-star rating, in 1999, 21% of the SRI funds in Morningstar's database that have the necessary 3-year history, sport the 5-star rating. Only 19% of SRI funds have either 1- or 2-star ratings. Furthermore,<sup>65</sup>

SRI funds stack up even better when they are compared to their specific Morningstar categories. One quarter of these funds currently sport a top category rating of 5, and half have category ratings of 4 or 5.

The smaller group of SRI funds that have a five-year record (35 in all) is less impressive, though still acceptable. A total of 19 have outperformed their category peers over the trailing five years while 16 underperformed.

That doesn't mean social screens add value, but it's hard to make the case that they subtract it.

Hall acknowledges the improved performance. On the other hand, she voices the common observation that the improvement was largely due to SRI's screening out some of the market's worst performers over the past few years. For example, avoiding tobacco companies, nuclear power utilities, and other firms with poor environmental records has left the typical SRI domestic-equity fund underweighted in value stocks and overweighted in growth stocks. SRI growth funds outnumber value funds 14 to 5. Most SRI domestic-equity funds are also large-cap offerings. And it is large-cap growth stocks that have outperformed in recent years (up to 1999). This explains SRI's improved star ratings, which compare funds within broad investment classes.

However, SRI funds also improved in their category ratings. A Morningstar category reflects how a fund usually invests, which is the best indicator of which kind of funds it should be compared to. A fund's category is determined by averaging the fund's past three years' worth of portfolios.<sup>66</sup> Hall attributes this to the use of two much used SRI indices, the Domini Social Index and the Citizens Index. According to Hall, six of the top-rated SRI funds track either one or the other index. They have "... prospered for the same basic reason that the S&P 500 index has over the past couple of years: The stocks at the top of these capitalization-weighted indexes

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64. Emily Hall, "How Do Socially Responsible Funds Stack Up?" in Morningstar.com, posted on 6/30/2000: <http://news.morningstar.com/doc/article/01,1,3179,00.html>.

65. *Ibid.*

66. Peter Di Teresa, "Keeping on Top of Your Fund's position," Morningstar.com 11/9/2000 at: <http://news.morningstar.com/doc/article/0,1,3895,00.html>.

were those that led the market's rise."<sup>67</sup> In all, about half of SRI funds that have category ratings of 5 are indexed offerings.

Hall admits that even accounting for the index effect and the large-growth bias, SRI funds remain skewed toward the top of the category ratings. If the large-cap growth and large-cap blend funds are eliminated, half of the remaining SRI funds have category ratings of 4 or 5. SRI offerings boast top category ratings in seven different categories. Despite this, Hall doubts whether it is possible to build a well-diversified portfolio solely of socially screened funds.

A year later in 2000, Catherine Hickey updated Hall's star and category ratings of SRI funds. Although, as a group, they still performed well, their numbers fell off from 1999:<sup>68</sup>

A tough year for technology, and especially mega-cap tech stocks, can take a lot of the blame for the funds' slide. These latest figures also point out the potential pitfalls for investors looking to build an entire portfolio out of socially responsible funds.

Through August 31, 2000, nine out of 68 SRI funds, with records of three years or more, had notched 5-star ratings – a rate of about 13%. That's good enough to edge ahead of the broader fund universe as only 10% of funds in Morningstar's universe receive 5-star ratings. Still, that percentage has fallen substantially since last year, when 21% of SRI funds with records of three years or more boasted 5-star ratings.

The funds' category ratings have fallen off a bit in 2000 as well. Twenty-one out of 68 SRI funds in Morningstar's database, with three or more years of history, clock in with category ratings of 4 or 5. Although that's right in line with the typical distribution of top-category ratings for the broad universe of funds, it's well below socially responsible funds' standings in 1999, when fully half of SRI funds garnered category ratings of 4 or 5.

As Hickey explains, many SRI funds are weighted heavily in technology stocks because those companies often pass their environmental and workplace screens. By the same token, SRI funds often invest little or nothing in traditional value sectors like energy and utilities, because companies in those sectors tend to fail their screens. Being so heavy in technology (and so light on value-priced energy and utilities stocks) was a huge boon for these funds in the last couple years, because growth stocks were all the rage in the market.

But beginning in 2000's second quarter, technology stock performance has been rocky, while the energy and utilities sectors had banner years. This trend has bruised SRI funds' rankings within the overall fund universe and within their peer groups.

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67. Hall article.

68. Catherine Hickey, "2000 Update: How Do Socially Responsible Funds Stack Up?" in Morningstar.com, posted on 10/5/2000: <http://news.morningstar.com/doc/article/0,1,3717,00.html>.

**McWilliams and Siegel (1997)<sup>69</sup>**

McWilliams and Siegel criticize researchers in the SRI field for rarely and explicitly examining the costs and benefits of corporate social responsibility. Instead, they charge that researchers have searched for evidence of a relationship between corporate social responsibility (“doing good”) and financial performance (“doing well”). A further criticism is that:<sup>70</sup>

Researchers who publish in management journals use methodologies that have been imported from economic and finance and do not always pay adequate attention to research design and implementation. Therefore, they may arrive at conflicting and spurious results. Management studies of CSR [corporate social responsibility] have reported both large positive effects of acting socially responsible, and large negative effects. We are suspicious of both results and the methods used... CSR-related research studies published in top management journals are poorly designed and executed, rendering the results spurious.

McWilliams and Siegel argue that socially responsible behavior may add value to a firm’s product, but it will also add costs. If the company engages in the “optimal” level of social responsibility (where marginal revenue equals marginal cost), the impact should be neutral. For example, they cite – as an act of “doing good” – a company’s using more expensive technology to avoid animal testing. If there is no offsetting increase in demand for the company’s products, such an action will result in higher costs and lower profitability. On the other hand, other researchers claim that doing good is in the best interests of shareholders and actually increases financial performance.

Instead, McWilliams and Siegel believe that corporate social responsibility attributes (such as spending more to avoid animal testing) are like any other product attribute. They are worth investing in up to the level where the demand for the attribute increases revenue to the point where it exactly offsets the increase in costs associated with supplying that attribute.<sup>71</sup>

We argue that the link between performance and CSR comes through the mechanism of consumer demand. CSR may increase demand for a firm’s products (including a willingness to pay a higher price for the same product produced under different conditions.) Where increased demand offsets increased costs associated with CSR, there need be no tradeoff between the benefits created for special interest groups and shareholders. Therefore, prudent managers could be expected to engage in CSR only when there is offsetting revenue gains. If managers engage in the optimal level of CSR, there should be no impact on profitability or stock price.

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69. Abigail McWilliams and Donald Siegel, “How Fund Managers Can Contribute to Academic Research on Corporate Social Responsibility,” in The Investment Research Guide to Socially Responsible Investing, Brian R. Bruce ed., Investment Research Forums, Inc. 1998, pp. 83-103.

70. Ibid., p. 83.

71. Ibid., p. 84.

After examining 29 recent event studies, McWilliams and Siegel conclude that those studies often do not provide enough information to allow assessment of the validity of critical assumptions. They further found that:<sup>72</sup>

...research design issues are treated cavalierly in management studies, especially in the area of CSR [corporate social responsibility]. Our comparison of multiple studies of the withdrawal from South Africa illustrates that the method is not very robust, that is, that researchers can reach very different conclusion with similar samples.

Studies which used regression analysis, assuming a causal relationship between corporate social performance ... and firm financial performance, may also suffer from design flaws. In particular, these studies have suffered from misspecification due to omitted variables. The critical omitted variables are R&D [research and development] expenditures and industry characteristics (such as entry barriers). Previous studies have demonstrated that these variables have a positive impact on performance. Because these variables are positively correlated with the variables used to measure CSR, omitting them results in an overstatement of the 'return' to CSR.

Given the problems with both types of studies, we recommend that the investment community be extremely wary of results that purport to show that CSR yields either positive or negative financial returns.

The results of another study by McWilliams and Siegel were further quoted in a 1999 New York Times article.<sup>73</sup> That study was reported to have found no real impact on the performance of those companies with an activist social agenda. The study compared the 10-year stock price performance of 950 companies selected for good corporate social performance with 1,200 randomly selected companies. No major statistical differences in price performance were found. According to Professor Siegel, "There is simply no relationship between corporate social responsibility and any financial measure of performance.... The empirical connection is between economic performance and R&D, not social responsibility."

## Summary

As already discussed at the beginning of Section II, no study unequivocally proves that SRI is superior, inferior, or statistically insignificant in performance with respect to financial returns compared to non-SRI investments. Studies exist that support each of these three hypotheses; however, viewed together, none ring convincingly true.

On the one hand, SRI obviously satisfies the second bottom line of performance with respect to *social* returns. SRI advocates make the case that the *financial* performance of SRI investments is either enhanced or suffers no harm. However, many of these inquiries into SRI performance occurred during an extraordinary time (amidst the longest-running bull market) that

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72. Ibid., p. 93.

73. Claudia H. Deutsch, "Not Doing Better By Doing Good," Business: Diary, in New York Times, September 6, 1999.



gave rise to results uncharacteristic of normal stock performance. It remains unclear how SRI strategies will fare in more normal times. For example, SRI mutual funds in general have not performed as well as non-SRI funds since the beginning of the bear market in March 2000. However, it is unfair to characterize SRI funds as inferior because of this. It is just as uncalled for to proclaim their superiority during the bull market because “clean” companies were better moneymakers. As far as financial return is concerned, the evidence on the whole gives pause to institutional investors entrusted with others’ money contemplating adopting an SRI approach. One would hope such institutional investors would seek a greater comfort zone with respect to financial return to ensure fulfilling fiduciary obligations before embarking on the use of social screens.

## Chapter 5

### SUMMARY

Socially responsible investing (SRI) is what an investor makes it. SRI does not come as a prepackaged whole. Engaging in SRI does not require one to be actively involved in all three SRI strategies: social stock screening, shareholder advocacy or activism, and community investing. One can pick and choose.

First, an investor may decide that there is more to investing than just making money by screening out companies that contribute to social harm, regardless of financial return. The investor can also divest ownership in such companies. SRI, as a social stock screening strategy, is completely beyond reproach for the individual investor, who has as much right to screen stocks as to choose grapefruit juice over orange juice.

Second, the investor can engage in shareholder advocacy or activism as a second SRI strategy. One can attend company meetings, introduce shareholder resolutions, and hold direct dialog with company officials to influence the company's *social* behavior. Modeled on corporate governance activity, which attempts to influence corporate behavior to improve *financial* performance, corporate "*social*" governance attempts to affect a company's *social* performance. An investor is fully justified in trying to influence a grapefruit juice maker to improve its product to make it more profitable (corporate governance). If desired, the investor may further try to influence the grapefruit juice maker to recycle its product packaging to minimize environmental impact (corporate social governance or shareholder advocacy). Even if the investor buys a nominal number of shares just in order to introduce a shareholder resolution, this is the investor's choice. In this case, it is clear that financial return is not the primary motive. In any case, engaging in one SRI strategy such as social stock screening does not require the investor to engage in another SRI strategy such as shareholder advocacy.

Third, the investor can also adopt the SRI strategy of community investing, which constitutes a very small proportion of SRI. Community investing in general offers lower than market returns to make funds available to help the "poorest of the poor" in areas such as affordable housing, small business, and community development. Here, it is often clear that financial return is not the primary consideration. The loss of investment return is relatively small, which may help explain why the SRI investor is willing to sacrifice return in this case.

However, there is a need to carefully distinguish between the individual investor and the *institutional* investor, particularly quasi-public institutions that invest funds in trust for groups such as public worker retirees. On the one hand, the individual investor should have the right to choose how to invest. That is, choosing either an SRI or a non-SRI approach is the individual investor's right. If the former, selecting any one or all of the three SRI investing strategies outlined above remains the individual investor's right.

On the other hand, the appropriateness of public institutional investors adopting SRI investing strategies, or requiring them to, is open to debate.

First, social screening involves values. Not all investors hold the same values. This is true for both individual and institutional investors. Legislatures and public retirement trust funds may hold different values, or they may start out agreeing but differ over time. Rank and file members of retirement trust funds may hold values different from those of board directors. Aside from fiduciary concerns and relative financial returns on investments, trust fund boards – by socially screening stocks – may not always fairly represent members' individual or collective social values.

Choosing one company for investment over another for social and not financial reasons is, above all else, a political act. It is a policy-making power that does not unequivocally inhere to public trust fund boards. That the money used to leverage a trust fund board's political decision via social stock screening does not belong to the board further underscores the question of appropriateness.

This reasoning easily extends to the second SRI strategy– shareholder advocacy. The danger is that both the executive and legislative branch may come to view the vast sums of money in retirement funds as a separate source of revenue to further varying political agendas. At the most basic level, certain companies or industries may be rewarded or punished through equity purchases or sales based on social or political reasons. For example, although the spin may be to altruistically better the lot of foreign laborers, companies that use foreign labor may be divested to support domestic labor unions. Whether any of these actions is deemed "good" or "bad" is a matter of policy decision or personal belief.

Some public institutional investors, notably California's Public Employees Retirement System, favor shareholder advocacy over stock divestiture. Taking it a step further than stock screening or divestiture, a trust fund board may try to directly influence a company, say a casino operator, to change a certain practice that benefits the board or its supporters. For example, because of its shareholder advocacy activity, CalPERS carries on an unprecedented and conflicted relationship with some of California's energy producers. CalPERS owns many of them and they make money for CalPERS. However, the energy producers' practices sometimes harm California residents, including CalPERS' retired public employee constituents. This puts CalPERS in an extraordinary position to directly influence those energy producers, a power that neither California's executive nor its legislature has. It is highly unlikely that either branch intended for CalPERS, or a similar institution, to have that sort of policy-influencing power. The lesson is: a trust fund board, leveraging a large pool of money belonging to trust fund members, may be able to place itself in a de facto public policy-making position by adopting an SRI strategy.

A trust fund board, acting on its own, may decide to adopt any or all of the three SRI strategies. If it does so, it must answer to its own fiduciary duty and beneficiary constituents. It is also unclear what recourse rank and file members of trust funds may have to dispute trust fund boards' actions with respect to SRI decisions. On the other hand, legislatively mandating a trust fund board to adopt any SRI strategy is an even more radical act which preempts a board's duty and responsibility to make its own decisions.

A further danger is the unpredictability of value shifts over time. Those in elected or appointed policy-making positions may often agree with the social policy goals of SRI-minded institutional investors. However, this may not always remain the case. Liberal backers of institutional shareholder advocacy may discover their support misplaced if institutions change course and endorse conservative values instead, and vice versa. SRI is only a tool – or a double-edged sword – and can cut both ways. As chapter 2 shows, there is a plethora of values ranging from one end of the spectrum to the other. Shareholder activism is an outlet for a trust fund board to advocate whatever values and social policies it may choose. When values are involved, it is almost impossible to keep politics – at any level – out of shareholder advocacy. Accordingly, whether institutional investors should be encouraged, or mandated, to exercise policy-making powers through shareholder advocacy should be carefully thought through.

Thus, if government does not interfere, public institutions decide for themselves on a case-by-case basis whether any SRI strategy is appropriate. Although one can make a case that social stock screening at minimum does no harm in terms of financial return, the evidence cannot be said to be clear and convincing. On the whole, it cannot unequivocally be said that social stock screening is either superior or that it is significantly inferior. There is some evidence that in some instances, it is statistically indistinguishable from investing without social stock screening, or that the use of social screens does no harm. Each fiduciary board needs to make its own determination.

However, if legislatures mandate adoption of SRI strategies, this may very well confer on trust fund boards potent, if unintended, and unpredictable de facto policy-making powers. At the least, legislatures must fully understand that "socially responsible investing" is what one makes of it, that it can be expressed in any one of three separate strategies, and that each strategy has its pitfalls. By far the most potentially perilous is that of shareholder advocacy.

If legislatures were to consider requiring, by law, public institutional trust fund boards to adopt "SRI," they must be clear about what strategy or strategies they wish to mandate. Permitting such boards to socially screen stocks is one thing. Will boards be forced to screen for values hand-picked by legislatures? Allowing boards to engage in shareholder activism is an altogether different option fraught with policy implications.

For the foregoing reasons, the Bureau recommends that the Legislature refrain from legislatively mandating the Employees' Retirement System to adopt the use of socially responsible investing in the form of shareholder advocacy or activism as an investing strategy. The Bureau further recommends that the Legislature refrain from legislatively mandating the ERS to adopt social stock screening and stock divestiture although this practice is not as significant as shareholder advocacy. Finally, the Bureau acknowledges that community investing, as part of the SRI strategy, is already being carried out in some form by the ERS. As such, there appears to be no need to legislatively mandate the ERS to do so. If the Legislature so desires, it may consider encouraging the ERS board to increase the level of its community investing to a certain percentage not greater than one percent of its assets available for investment.

**Report Title:**

Socially Responsible Investment

THE SENATE

TWENTY-FIRST LEGISLATURE, 2001

STATE OF HAWAII

**S.C.R. NO.** 13

S.D.2

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# SENATE CONCURRENT RESOLUTION

ENCOURAGING, AND REQUESTING A REPORT ON, SOCIALLY RESPONSIBLE INVESTMENT.

WHEREAS, Socially Responsible Investment (SRI), also known as double-bottom line investment, mission-related investment, and natural investing, is the rapidly growing practice in the United States of basing investment decisions on considerations of societal values and concerns as well as financial returns, thus balancing the investor's financial aims and needs with an investment's impact on society by the operations of the corporation or entity in which the investment is made; and

WHEREAS, distinct but related aspects involved in an SRI strategy are: (1) avoiding companies whose record conflicts with the investor's values; (2) seeking out companies whose record is consistent with the investor's values; (3) targeting investments directly into communities; and (4) taking an active role as a shareholder in influencing corporate policies; and

WHEREAS, socially conscious investors will often include in their investment portfolios corporations with positive records on product quality, consumer relations, environmental performance, corporate citizenship, and employee relations, while screening out corporations involved in industries such as alcohol, tobacco, gambling, military weapons, and nuclear power; and

WHEREAS, investments that are sound from a fiduciary standpoint and which also promote equality of opportunity, environmental protection, and other causes critical to Hawaii's long-term future, have what is known as a "double bottom line" return; and

WHEREAS, SRI has its roots in the colonial era when abolitionist Quakers refused to invest in any business associated with slavery, and blossomed in the 1970's, influenced by strong social movements focusing on the environment, fair employment practices, the

military-industrial complex, and the rights of minorities and women; and

WHEREAS, in the 1980's, anti-apartheid activists brought the idea of socially responsible investing into full public view by insisting that their schools and churches stop investing in companies which did business in South Africa; and

WHEREAS, this very successful campaign to remove foreign capital from South Africa marked a powerful new era for SRI; and

WHEREAS, the SRI movement has rapidly increased its strength since the early 1990s as the financial world became more aware of the force of social movements; and

WHEREAS, the Social Investment Forum, a Washington group that surveys the investment landscape, has indicated that in 1999, about \$1 of every \$8 of investments under professional management—some \$2 trillion overall—was directed toward socially responsible investment, which is eighty-two per cent above 1997 statistics; and

WHEREAS, a large number of new SRI mutual funds have been created as increasing numbers of investors have chosen to put their money into socially screened funds; and

WHEREAS, the growth of SRI among the union pension funds, educational endowments, and not-for-profit foundations which control substantial resources has been hampered by lingering false perceptions that socially responsible investments will not fulfill the trustee's fiduciary responsibility to achieve a reasonable rate of return on the fund's corpus; and

WHEREAS, as SRI funds have become well established, they have demonstrated their financial soundness over the last five years, showing that not only are social and environmental concerns not a handicap in investing, but that social and environmental values and standards can actually correlate with superior financial performance; and

WHEREAS, studies by investment firms ranging from Spare, Kaplan, Bischel & Associates, to Merrill Lynch demonstrate that, in recent years, SRI stocks have outperformed non-SRI stocks by up to two per cent per year; and

WHEREAS, SRI can have significant beneficial consequences for the State of Hawaii in that SRI can help promote the growth of mercantile entities presently doing business here and who engage in business practices that enhance and promote Hawaii's fragile environment and contribute to the well-being of Hawaii's population, and can also be helpful in attracting other businesses that engage in similar practices; and

WHEREAS, the Legislature of the Twenty-First Legislature of the State of Hawaii, wishes to encourage our State's financial institutions, financial advisors, banks, trust companies, trustees of our State's funded and landed trusts, trustees of the State of Hawaii Employee's Retirement System, and all other individuals and entities handling and managing financial investments, to become more familiar with the principles of SRI and to apply those principles to their financial advice and decisions; and

WHEREAS, Responsible Markets LLC and the Native Hawaiian Advisory Council sponsored a Summit on Double-Bottom Line Investing in Hawai'i, `Aha Ho`opuka Pono, at the State Capitol in Honolulu on February 26, 27, and 28, 2001, in which nationally known experts in the field of investments, and particularly in SRI, discussed its principles, merits, and benefits; and

WHEREAS, the Legislature of the Twenty-First Legislature of the State of Hawaii appreciates and recognizes the value of SRI to the State, and wishes to foster and encourage wider discussion, understanding, acceptance, and practice of SRI in the community; now, therefore,

BE IT RESOLVED by the Senate of the Twenty-First Legislature of the State of Hawaii, Regular Session of 2001, the House of Representatives concurring, that the Legislature encourages the Chief investment officer, administrator, and trustees of the State Employees' Retirement System to apply the principles of SRI in their investment practices and decisions, and encourages other investment counselors and money managers to also apply SRI to their investment portfolios; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau is requested to conduct research on SRI by examining the laws and practices in other states, and current reports and studies in the field; and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau is requested to submit a report of findings and recommendations to the Legislature no later than twenty days prior to the convening of the 2002 Regular Session; and

BE IT FURTHER RESOLVED that certified copies of this Concurrent Resolution be transmitted to the Governor, the Employees' Retirement System, the Department of Business, Economic Development, and Tourism, the Office of Hawaiian Affairs, the Chamber of Commerce of Hawaii, Responsible Markets, the Native Hawaiian Advisory Council; and the Director of the Legislative Reference Bureau.

**Appendix B**

**SOCIAL RATING CRITERIA**

**2000 - 2001**





# 2001 Social Rating Criteria **ã**

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## INTRODUCTION

This document presents the criteria developed by KLD to analyze the social records of public companies. KLD assigns social ratings to companies based on these criteria, to provide investors a tool with which to evaluate the social impact of corporate activities. Social investors use these ratings to inform their investment decision-making and to screen their portfolios.

### *Social Rating Criteria*

The Social Rating Criteria are divided into two categories: *Social Issues*, and *Industry Involvement Issues*.

- *Social Issues* analyze the impact of corporate behavior on the environment and on stakeholders, including communities, employees, customers, and suppliers. The ratings assigned to companies in *Social Issues* are based on specific quantitative and qualitative indicators.
- *Industry Involvement Issues* identify companies that produce goods or services in specific markets of interest to social investors. On these issues, companies are designated as either *Involved* or not. KLD bases its evaluation on the type of participation and/or level of revenues derived in these markets.

KLD presents its social research in two formats: *Company Profiles* and *Industry Involvement Reports*.

- *Company Profiles* are detailed reports covering all the *Social Issues* and many *Industry Involvement Issues*. *Profiles* contain ratings, analysis, and statistics to provide a comprehensive view of a company for social investors.
- *Industry Involvement Reports* contain annotated lists of companies for each industry. The information is limited to details of each company's involvement, including a general business description, the nature of its involvement, and the percent of revenues derived from that activity (if available).

KLD's social research is distributed in **SOCRATES - The Corporate Social Ratings Monitor<sup>SM</sup>**. SOCRATES is a web-based application that provides access to the full range of KLD's research on the social records of U.S. and international companies.

## I. COMPANY PROFILES

### A. SOCIAL ISSUES

#### *COMMUNITY*

##### **STRENGTHS**

***Generous Giving.*** The company has consistently given over 1.5% of trailing three-year net earnings before taxes (NEBT) to charity, or has otherwise been notably generous in its giving.

***Innovative Giving.*** The company has a notably innovative giving program which supports nonprofit organizations particularly those promoting self-sufficiency among the economically disadvantaged. Companies that permit nontraditional federated charitable giving drives in the workplace are often noted in this section as well.

***Support for Housing.*** The company is a prominent participant in public/private partnerships that support housing initiatives for the economically disadvantaged, *e. g.*, the National Equity Fund or the Enterprise Foundation.

***Support for Education.*** The company has either been notably innovative in its support for primary or secondary school education, particularly for those programs that benefit the economically disadvantaged, or the company has prominently supported job-training programs for youth.

***Indigenous Peoples Relations.*** The company has established relations with indigenous peoples in the areas of its proposed or current operations that respect the sovereignty, land, culture, human rights, and intellectual property of the indigenous peoples.

***Other Strength.***

## **CONCERNS**

***Investment Controversies.*** The company is a financial institution whose lending or investment practices have led to controversies, particularly ones related to the Community Reinvestment Act.

***Negative Economic Impact.*** The company's actions have resulted in major controversies concerning its economic impact on the community. These controversies can include issues related to environmental contamination, water rights disputes, plant closings, "put-or-pay" contracts with trash incinerators, or other company actions that adversely affect the quality of life, tax base, or property values in the community.

***Indigenous Peoples Relations.*** The company has been involved in serious controversies with indigenous peoples that indicate the company has not respected the sovereignty, land, culture, human rights, and intellectual property of indigenous peoples.

***Other Concern.***

## ***DIVERSITY***

### **STRENGTHS**

***CEO.*** The company's chief executive officer is a woman or a member of a minority group.

***Promotion.*** The company has made notable progress in the promotion of women and minorities, particularly to line positions with profit-and-loss responsibilities in the corporation.

***Board of Directors.*** Women, minorities, and/or the disabled hold four seats or more (with no double counting) on the board of directors, or one-third or more of the board seats if the board numbers less than 12.

***Family Benefits.*** The company has outstanding employee benefits or other programs addressing work/family concerns, *e.g.*, childcare, elder care, or flextime.

***Women & Minority Contracting.*** The company does at least 5% of its subcontracting, or otherwise has a demonstrably strong record on purchasing or contracting, with women- and/or minority-owned businesses.

***Employment of the Disabled.*** The company has implemented innovative hiring programs, other innovative human resource programs for the disabled, or otherwise has a superior reputation as an employer of the disabled.

***Gay & Lesbian Policies.*** The company has implemented notably progressive policies toward its gay and lesbian employees. In particular, it provides benefits to the domestic partners of its employees.

***Other Strength.***

### **CONCERNS**

***Controversies.*** The company has either paid substantial fines or civil penalties as a result of affirmative action controversies, or has otherwise been involved in major controversies related to affirmative action issues.

***Non-Representation.*** The company has no women on its board of directors or among its senior line managers.

***Other Concern.***

## ***EMPLOYEE RELATIONS***

### **STRENGTHS**

***Union Relations.*** The company has a history of notably strong union relations.

***Cash Profit Sharing.*** The company has a cash profit-sharing program through which it has recently made distributions to a majority of its workforce.

***Employee Involvement.*** The company strongly encourages worker involvement and/or ownership through stock options available to a majority of its employees, gain sharing, stock ownership, sharing of financial information, or participation in management decision-making.

***Retirement Benefits.*** The company has a notably strong retirement benefits program.

***Other Strength.***

### **CONCERNS**

***Union Relations.*** The company has a history of notably poor union relations.

***Safety Controversies.*** The company recently has either paid substantial fines or civil penalties for willful violations of employee health and safety standards, or has been otherwise involved in major health and safety controversies.

***Workforce Reductions.*** The company has reduced its workforce by 15% in the most recent year or by 25% during the past two years, or it has announced plans for such reductions.

***Retirement Benefits Concern.*** The company has either a substantially underfunded defined benefit pension plan, or an inadequate retirement benefits program.

***Other Concern.***

## ***ENVIRONMENT***

### **STRENGTHS**

***Beneficial Products and Services.*** The company derives substantial revenues from innovative remediation products, environmental services, or products that promote the efficient use of energy, or it has developed innovative products with environmental benefits. (The term "environmental service" does not include services with questionable environmental effects, such as landfills, incinerators, waste-to-energy plants, and deep injection wells.)

***Pollution Prevention.*** The company has notably strong pollution prevention programs including emissions reductions and/or toxic-use reduction programs.

***Recycling.*** The company either is a substantial user of recycled materials as raw materials in its manufacturing processes, or a major factor in the recycling industry.

***Alternative Fuels.*** The company derives substantial revenues from alternative fuels. The term "alternative fuels" includes natural gas, wind power, and solar energy. The company has demonstrated an exceptional commitment to energy efficiency programs or the promotion of energy efficiency.

***Communications.*** The company is a signatory to the CERES Principles, publishes a notably substantive environmental report, or has notably effective internal communications systems in place for environmental best practices.

***Other Strength.***

### **CONCERNS**

***Hazardous Waste.*** The company's liabilities for hazardous waste sites exceed \$50 million, or the company has recently paid substantial fines or civil penalties for waste management violations.

***Regulatory Problems.*** The company has recently paid substantial fines or civil penalties for violations of air, water, or other environmental



regulations, or it has a pattern of regulatory controversies under the Clean Air Act, Clean Water Act or other major environmental regulations.

***Ozone Depleting Chemicals.*** The company is among the top manufacturers of ozone depleting chemicals such as HCFCs, methyl chloroform, methylene chloride, or bromines.

***Substantial Emissions.*** The company's legal emissions of toxic chemicals (as defined by and reported to the EPA) from individual plants into the air and water are among the highest of the companies followed by KLD.

***Agricultural Chemicals.*** The company is a substantial producer of agricultural chemicals, *i.e.*, pesticides or chemical fertilizers.

***Climate Change.*** The company derives substantial revenues from the sale of coal or oil and its derivative fuel products, or the company derives substantial revenues indirectly from the combustion of coal or oil and its derivative fuel products. Such companies include electric utilities, transportation companies with fleets of vehicles, auto and truck manufacturers, and other transportation equipment companies.

***Other Concern.***

## ***NON-U.S. OPERATIONS***

*N.B.: Data for these issues are less complete and more difficult to interpret than the data underlying ratings for U.S. operations.*

### **STRENGTHS**

***Community.*** The company has established substantial, innovative charitable giving programs outside the U.S.

***Indigenous Peoples Relations.*** The company has established relations with indigenous peoples in the areas of its proposed or current operations that respect the sovereignty, land, culture, human rights, and intellectual property of the indigenous peoples.

***Other Strength.*** The company's non-U.S. operations have been praised for their community relations, employee relations, environmental impact, or product innovation.

### **CONCERNS**

***Burma.*** The company has operations in Burma.

***Mexico.*** The company's operations in Mexico have had major recent controversies, especially those related to the treatment of employees or degradation of the environment.

***International Labor.*** The company's non-U.S. operations have been the subject of major recent controversies related to employee relations and labor standards.

***Indigenous Peoples Relations.*** The company has been involved in serious controversies with indigenous peoples that indicate the company has not respected the sovereignty, land, culture, human rights, and intellectual property of indigenous peoples.

***Other Concern.*** The company's non-U.S. operations are subject to controversies related to the community, diversity issues, the environment, product safety, or product quality.

## ***PRODUCT***

### **STRENGTHS**

***Quality.*** The company has a long-term, well-developed, company-wide quality program, or it has a quality program recognized as exceptional in U.S. industry.

***R&D/Innovation.*** The company is a leader in its industry for research and development (R&D), particularly by bringing notably innovative products to market.

***Benefits to Economically Disadvantaged.*** The company has as part of its basic mission the provision of products or services for the economically disadvantaged.

***Other Strength.***

### **CONCERNS**

***Product Safety.*** The company has recently paid substantial fines or civil penalties, or is involved in major recent controversies or regulatory actions, relating to the safety of its products and services.

***Marketing/Contracting Controversy.*** The company has recently been involved in major marketing or contracting controversies, or has paid substantial fines or civil penalties relating to advertising practices, consumer fraud, or government contracting.

***Antitrust.*** The company has recently paid substantial fines or civil penalties for antitrust violations such as price fixing, collusion, or predatory pricing, or is involved in recent major controversies or regulatory actions relating to antitrust allegations.

***Other Concern.***

## ***OTHER***

### **STRENGTHS**

***Limited Compensation.*** The company has recently awarded notably low levels of compensation to its top management or its board members. The limit for a rating is total compensation of less than \$500,000 per year for a CEO or \$30,000 per year for outside directors.

***Ownership Strength.*** The company owns between 20% and 50% of another company to which KLD has assigned a strength rating, or which is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as if it is a division of the first.

***Other Strength.***

### **CONCERNS**

***High Compensation.*** The company has recently awarded notably high levels of compensation to its top management or its board members. The limit for a rating is total compensation of more than \$10 million per year for a CEO or \$100,000 per year for outside directors.

***Tax Disputes.*** The company has recently been involved in major tax disputes involving more than \$100 million with the Federal, state, or local authorities.

***Ownership Concern.*** The company owns between 20% and 50% of another company to which KLD has assigned a concern rating, or which is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as if it is a division of the first.

***Other Concern.***

## ***B. INDUSTRY INVOLVEMENT ISSUES***

### ***ALCOHOL***

***Involvement.*** The company derives revenues from the production or sale of alcoholic beverages.

***Other Concern.***

### ***GAMBLING***

***Involvement.*** The company derives revenues from the gambling industry.

***Other Concern.***

### ***TOBACCO***

***Involvement.*** The company derives revenues from the production of tobacco products.

***Other Concern.***

### ***MILITARY***

***Major Involvement.*** The company derived more than 2% of revenues from the sale of conventional weapons, or earned \$50 million or more from the sale of conventional weapons, or earned \$10 million or more from the sale of nuclear weapons.

**Minor Involvement.** The company derived between \$10 million and \$50 million from the sale of conventional weapons or between \$1 million and \$10 million from the sale of nuclear weapons.

**Major Supplies.** The company received from the U.S. Department of Defense \$50 million or more for fuel or other supplies related to weapons.

**Other Concern.**

## **NUCLEAR POWER**

**Ownership.** The company has an ownership interest in a nuclear power plant.

**Design.** The company derives identifiable revenues from the design of nuclear power plants. This category does not include companies providing construction or maintenance services for nuclear power plants.

**Fuel Cycle/Key Parts.** The company mines, processes, or enriches uranium, or is otherwise involved in the nuclear fuel cycle; or the company derives revenues from the sale of key parts or equipment for generating power through using nuclear fuels.

**Other Concern.**

## II. INDUSTRY INVOLVEMENT REPORT ISSUES

### *ALCOHOL*

***Manufacturers.*** Companies that manufacture alcoholic beverages, including brewers, vintners, distillers, and other alcoholic beverages (e.g., hard cider, sake, etc.).

***Retailers.*** Companies that derive 15% or more of total revenues from the distribution (wholesale or retail) of alcoholic beverages, i.e., supermarkets, convenience stores, liquor stores, bars, pub chains and restaurants that sell alcoholic beverages.

***Manufacturers of Products Necessary for Production of Alcoholic Beverages.*** Companies that derive 15% or more of total revenues from the supply of raw materials and equipment necessary for the production of alcoholic beverages.

***Ownership.*** The company owns between 20% and 50% of another company to which KLD has assigned a concern rating, or is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as a division of the first.

### *GAMBLING*

***Owners and Operators.*** Companies that own and/or operate casinos, racetracks, bingo parlors, or other betting establishments, including casinos; horse, dog, or other race tracks that permit wagering; lottery operations; on-line gambling; pari-mutuel wagering facilities; bingo; Jai-alai; and other sporting events that permit wagering.

***Manufacturers.*** Companies that produce goods used exclusively for gambling, such as slot machines, roulette wheels, or lottery terminals.

***Service Providers.*** Companies that provide services in casinos that are fundamental to gambling operations, such as credit lines.

***Ownership.*** The company owns between 20% and 50% of another company to which KLD has assigned a concern rating, or is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as a division of the first.

## ***TOBACCO***

***Manufacturers.*** Companies that produce tobacco products, including cigarettes cigars, pipe tobacco, and smokeless tobacco products.

***Retailers.*** Companies that derive 15% or more of total revenues from the distribution (wholesale or retail) of tobacco products, i.e., supermarkets, convenience stores, specialty stores, and e-commerce stores that sell tobacco products.

***Manufacturers of Products Necessary for Production of Tobacco Products.*** Companies that derive 15% or more of total revenues from the production and supply of raw materials and other products necessary for the production of tobacco products.

***Ownership.*** The company owns between 20% and 50% of another company to which KLD has assigned a concern rating, or is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as a division of the first.

## ***MILITARY***

***Manufacturers.*** Companies that derive substantial revenues as military contractors or subcontractors for the development or manufacture of military weapons, including armaments and ammunition; components, systems and enabling devices; defense electronics; training and simulation systems and equipment; and air, land-based, and naval combat vehicles.

(Substantial revenues is defined at least \$50 million or 10% of revenues in weapons-related prime contracts from the U.S. Department of Defense (DoD); \$10 million or more from nuclear weapons contracts from the DoD or another U.S. governmental agency; or 5% or more of annual sales from subcontracting from the DoD for military weapons.)



## ***FIREARMS***

***Manufacturers.*** Companies that are engaged in the production of firearms, including, pistols, revolvers, rifles, shotguns, or sub-machine guns.

***Ammunition.*** Companies that produce ammunition for firearms.

***Retailers.*** Companies that derive 15% or more of total revenue from the wholesale or retail distribution of firearms and small arms ammunition.

***Ownership.*** The company owns between 20% and 50% of another company to which KLD has assigned a concern rating, or is more than 20% owned by such a firm. When a company owns more than 50% of another firm, it has a controlling interest, and KLD treats the second firm as a division of the first.

## ***NUCLEAR POWER***

***Ownership.*** Companies that own or operate nuclear power plants.

## ***CONTRACEPTIVES & ABORTION***

***Manufacturers.*** Companies that derive identifiable revenues from the development or manufacture of contraceptives and abortifacients, including cervical caps; condoms; contraceptive implants; contraceptive patches; contraceptive vaccines; diaphragms; intrauterine devices (IUDs); oral contraceptives; spermicides; methotrexate, and misoprostol.

***Ownership and Operation of Medical Facilities.*** Companies that own or operate one or more acute care hospitals or surgical centers that provide general medical services, including abortions and contraceptive surgical procedures.

## Appendix C

### Four Basic Mutual Fund Types Categories & Investment Objectives

- I. EQUITY FUNDS
  - A. Capital Appreciation Funds. Objective: appreciation of capital; dividends not a primary consideration
    - Aggressive growth funds
    - Growth funds
    - Sector funds
  - B. Total Return Funds. Objective: combination of current income and appreciation of capital
    - Growth-and-income funds
    - Income-equity funds (income more than capital appreciation)
  - C. World Equity Funds. Objective: investment in stocks of foreign companies
    - Emerging market funds
    - Global equity funds
    - International equity funds
    - Regional equity funds
  
- II. HYBRID FUNDS
  - A. Asset Allocation Funds. Objective: high total return by maintaining precise weightings in asset classes (equity, fixed-income, and money market)
  - B. Balanced Funds. Objective: conserve principal, provide income, and achieve long-term growth of principal and income by investing in mix of equities and bonds with targeted percentages in asset classes
  - C. Flexible Portfolio Funds. Objective: high total return by investing in stocks, bonds, other debt and money market securities according to changing market conditions
  - D. Income-Mixed Funds. Objective: high level of current income without regard to capital appreciation by investing in income-producing instruments
  
- IIIa. TAXABLE BOND FUNDS
  - A. Corporate Bond Funds. Objective: current income by investing in high-quality debts securities issued by U.S. corporations
    - General corporate bond funds
    - Intermediate-term corporate bond funds (seeks high level of income with less price volatility than longer-term bonds)
    - Short-term corporate bond funds (seeks high level of income with less price volatility than intermediate-term bond funds)
  - B. High-Yield Funds. Objective: higher income with higher risk (two-thirds or more in lower-rated U.S. corporate bonds)
  - C. World Bond Funds. Objective: highest level of current income available worldwide

- General global bond funds
  - Short-term global bond funds
  - Other world bond funds (including emerging and international market debt funds)
- D. Government Bond Funds. Objective: high current income by investing in U.S. government bonds of varying maturities
- General government bond funds
  - Intermediate-term government bond funds
  - Short-term government bond funds
  - Mortgage-backed funds
- E. Strategic Income Funds. Objective: high current income by investing in combination of U.S. fixed-income securities
- IIIb. TAX-FREE BOND FUNDS
- A. State Municipal Bond Funds. Objective: high after-tax income for residents of individual states
- General state municipal bond funds
  - Short-term state municipal bond funds
- B. National Municipal Bond Funds. Objective: high current income free from federal income tax
- General national municipal bond funds
  - Short-term national municipal bond funds
- IV. MONEY MARKET FUNDS
- A. Taxable Money Market Funds. Objective: highest level of income consistent with preservation of capital (by maintaining a stable share price)
- Government taxable money market funds
  - Non-government taxable money market funds
- B. Tax-Exempt Money Market Funds. Objective: highest level of income – free from federal and, in some cases, state and local taxes – consistent with preservation of capital
- National tax-exempt money market funds
  - State tax-exempt money market funds

*Data adapted from Investment Company Institute, Mutual Fund Fact Book 2001 Edition.*