



The Impact of Your Investments: To Screen or Not to Screen?

By Karen D. Watson, CFA, AIF®
Area Senior Vice President
Institutional Investment & Fiduciary Services

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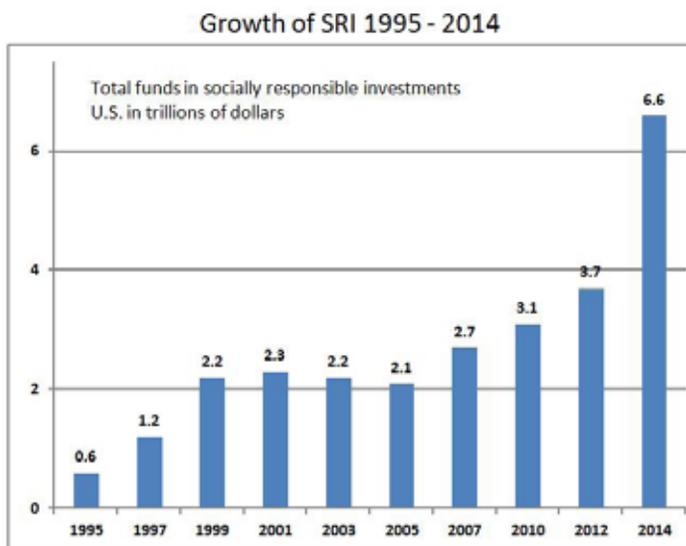
Assets invested in a socially responsible manner increased 76% over the last two years as institutions increasingly seek ways to align their investments with their mission.

The Impact of Your Investments

Sustainable and socially responsible investing mandates continue to expand as more investors factor ethical and moral considerations into the investment process. Typically, these investors do not see social investing as a goal itself. Rather, they are motivated to use their money or resources to make a positive social impact and align the investments of the organization with its values and mission, while not compromising competitive long-term investment returns.

Socially responsible investing (SRI) appeals to a broad variety of institutions. Many institutions, including health associations, religious groups, schools, labor unions, foundations and retirement funds, are called to exercise faithful, competent and socially responsible stewardship in how they manage the organization's financial resources. The increased interest from these institutions in proactive investing has generated a substantial increase in the investment dollars allocated to socially responsive portfolios.

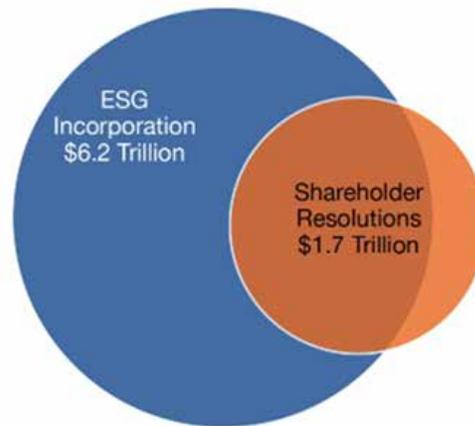
Recent data published by US SIF -The Forum for Sustainable and Responsible Investment indicated that \$6.6 trillion, or more than one out of every six dollars of all assets under professional management in the United States, is invested in a socially responsible manner. These socially responsible assets, as reported in the 2014 Report on Sustainable and Responsible Investing Trends, represented an increase of 76% over the asset level reported two years previously.



Source: US SIF - The Forum for Sustainable and Responsible Investment

As indicated in the chart below, the majority of these dollars are invested through the incorporation of ESG (Environmental, Social and Governance) criteria, yet financial resources are increasingly allocated to shareholder resolutions as well, often in conjunction with the application of ESG criteria. The \$1.7 trillion designated as shareholder resolutions in the chart below represent those assets managed by 202 institutional investors or money managers that filed shareholder resolutions on ESG issues from 2012 to 2014.

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*Source: US SIF - The Forum for Sustainable and Responsible Investment
Note: ESG incorporation assets in this figure include those in Community Investing Institution*

Even as the interest in social investing continues to grow, potential investors might still have concerns whether it is appropriate for an institutional investment portfolio. These may include questions such as:

- How should social restrictions be incorporated into my overall investment strategy?
- What is the potential impact on the investment returns of my investment portfolio?
- Does the inclusion of social restrictions breach my fiduciary duty?
- Does the inclusion of social restrictions limit my access to capable investment managers and asset classes?

Evolution and Approaches to Socially Screened Portfolios

For organizations that wish to invest their financial resources in a proactive manner following socially responsible principles, there are a variety of ways to incorporate that approach into the investment strategy. The traditional method of implementation is through exclusionary or avoidance screens that prohibit investment in securities that conflict with the organization's ESG concerns. Examples of these screens may include the avoidance of tobacco companies in the portfolio of a healthcare organization or the avoidance of gambling companies in the portfolio of a religious organization. The implementation of these types of avoidance screens is accomplished in coordination with the investment managers of the portfolio.

While avoidance screens are still the most utilized approach to social investing, there is a growing trend toward more activist and proactive approaches. For example, some investors have advanced beyond merely using screening in an exclusionary manner to specifically incorporate ESG factors into portfolios in an effort to generate a dynamic impact on social reform. The following lists examples of ESG factors that could be incorporated into investment portfolios.

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Environmental	Social	Governance
Climate change	Consumer rights	Board structure
Environmental policy	Supply chain management	Executive pay
Sustainability best practices	Health and safety	Shareowner rights
Environment management	Product safety	Accounting/audit
Water supply	Labor relationships including relationships with unions	Business ethics
Sustainable transport	Community relations	Conflicts of interest
Waste management	Stakeholder relations	

Two methods that may be used to incorporate these factors are shareholder resolutions and community investing. Shareholder resolutions involve the organization using its proxy rights to vote for a positive change within the company. An example might be to invest in a company perceived as environmentally unfriendly and attempt to make an impact through proxy resolutions that promote positive environmental policies. The community investing approach involves direct investing to support a cause or mission that is consistent with that of the organization. For example, an organization that believes in providing housing and other support for low-income families may invest in a bank that makes affordable loans to lower income families, thereby improving access to capital and supporting job creation, housing and economic development in designated geographical areas.

Impact on Investment Returns

Of the different approaches to social investing (avoidance screening, shareholder resolutions and community investing), the easiest one to assess in terms of its direct performance impact on an investment portfolio is avoidance screening. There is numerous academic research available on the impact of social screening on investment returns. One of these studies, completed by GMI Ratings in 2011, reviewed academic literature on the topic and found that “the general consensus is that on average, responsible investment methods perform on par with conventional techniques, neither outperforming nor underperforming them on a regular and reliable basis.”

This assessment is supported by a direct comparison of recent performance of screened versus unscreened benchmarks. The table below compares the performance of a global screened index, the MSCI ACWI ESG Index, to that of an unscreened index, the MSCI ACWI Index, through the period ending December 31, 2014. The MSCI ACWI ESG Index consists of both large-cap and mid-cap sized companies in both developed and emerging market countries that have high ESG scores based on data from MSCI ESG Research.

	One-Year	Three-Year	Five-Year
MSCI ACWI ESG	5.4%	15.2%	10.3%
MSCI ACWI	4.7%	14.7%	9.7%

Note: Gross Returns. Returns greater than one year are annualized.

Source: www.MSCI.com

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As seen, the return of the MSCI ACWI ESG Index has been slightly better than that of the unscreened MSCI ACWI Index over different time periods, indicating that the ultimate impact of social screening on a portfolio's investment returns may be immaterial over a long period of time.

Of course, it is important to note that different investment styles have positive and negative periods of investment performance depending on the market environment, and that anomaly is evident with social screens as well. Consider again the healthcare organization that eliminates the securities of tobacco companies from its investment portfolio or the religious organization that excludes securities of the gambling companies. The table below compares the investment returns of the tobacco industry and the casinos and gaming industry within the S&P 500 Index to that of the broad domestic equity market (S&P 500 Index) over the last five calendar years:

	2010	2011	2012	2013	2014
Tobacco Industry	21.0%	30.1%	5.7%	11.8%	8.7%
Casinos and Gaming Industry	35.6%	5.1%	-1.0%	62.0%	-25.9%
S&P 500 Index	15.1%	2.1%	13.4%	29.6%	11.4%

Source: Standard & Poor's S&P 500 GICS Sector Scorecard

Even though the above table only illustrates two industries during a specific time period, it is used to demonstrate the potential volatility of socially-screened sectors compared to the broad investment universe. During those calendar years in which the performance of the screened industries lagged that of the S&P 500 Index, the organization eliminating these companies from its investment portfolio may have experienced a positive performance differential in its account compared to the broad market index.

For organizations or investors that seek to incorporate some form of social screening in the investment portfolio, they need to weigh the potential return impact to the portfolio against the desire to align the organization's investments with its values.

Implementation and Governance

Given that the implementation of social restrictions may narrow the investment universe, some investment committees may be concerned that such an approach breaches their fiduciary duties. However, fiduciary standards allow for the implementation of SRI where the purpose and mission of the organization are considered and its social and fiduciary responsibilities are aligned through proper implementation and monitoring.

A critical aspect of this phase is the articulation of the social guidelines in the investment policy statement (IPS). For avoidance screening, the screens should reflect the social concerns and beliefs of the organization, but should also be refined to a point that they are neither too strict nor too loose. It is important to restrict investment in those social issues that are important to the organization, but at the same time provide the investment managers with sufficient latitude and opportunity to identify and select securities in an effort to add value over the designated benchmark index.

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One way to refine the guidelines is to assign a constraint to a specific issue as opposed to eliminating all companies with any exposure to that issue or industry. For example, instead of prohibiting all companies that are involved in a specific industry, specify in the investment guidelines that only those companies that have revenues that exceed a specific amount (typically 5-10%) in that industry would be eliminated. As further clarification of the guidelines for the investment managers, we also recommend that a list of prohibited securities is developed based on the approved social investing criteria and attached to the IPS.

Once the social guidelines are incorporated into the IPS, the next consideration is identifying money managers that have the capability and experience necessary to manage a social portfolio. This often falls under the expertise of a consulting organization, whose knowledge, experience and qualitative tools allow it to identify those managers who advance socially responsible portfolios for those clients for whom investing is an ethical and moral decision. As the global assets invested in a socially responsible manner continue to grow, there has been a corresponding growth in the number of capable managers and mandates. This growth has even expanded into alternative investments where there are now socially responsible hedge fund portfolios available for investment.

Regardless of the form of socially responsible approach implemented in a portfolio, it is essential that it be monitored for compliance and reviewed periodically to be certain the holdings still reflect the direction of the guidelines. Institutions implementing avoidance screens, along with their advisors, should regularly review the holdings in the investment manager accounts to ensure that no prohibited securities are being held. Another necessary review might be that of the proxy voting guidelines to ensure that they remain consistent with the social investment criteria.

Conclusion

As the list of screens increases, and public interest in those screens escalates, fiduciaries have become increasingly more cognizant of social issues, along with corporate citizenship and governance. This increased interest has generated more investors seeking to incorporate their institutions' values into the investment process, as evident by the 76% growth in socially responsible assets over the last two years.

In response, Gallagher continues its efforts to identify investment products and managers appropriate for socially screened portfolios and adding value to our clients' portfolios by balancing social objectives with long-term performance objectives.