

# Should capital be socially responsible?

Two decades ago, socially motivated investing accounted for a tiny percentage of worldwide capital. Today, U.S.-based socially responsible funds control \$2.7 trillion, and investors representing \$14 trillion have signed on to the UN's Principles for Responsible Investing. What influence are they having?

## Anne Simpson

Executive Director, International Corporate Governance Network;  
Faculty Fellow and Lecturer, Millstein Center for Corporate  
Governance and Performance, Yale School of Management

## Timothy Smith

Director of Socially Responsive Investment, Walden Asset  
Management; Former Executive Director, Interfaith Center  
on Corporate Responsibility

## Anne Kvam

Head of Corporate Governance,  
Norges Bank Investment Management



**Anne Simpson:** I'll start the conversation with a few thoughts and some questions to you both. Tim, you're somebody who has gone from working for an organization coordinating the concerns of religious investors to the mainstream fund-management world. So you've made a journey as this whole movement has grown. Anne, at Norway's sovereign wealth fund, you manage a pool of capital, which I think, depending on the exchange rate of the day, is the single largest pool of savings for retirement in the whole of the global system. You come from different regions and different backgrounds within the investment community. But you're both operating under the proposition that socially responsible investment is a vital part of your strategy.

I recently wrote an article reflecting on what has happened with socially responsible investment since 1991. In 1991, I was writing a book for the *Economist* called *The Greening of Global Investment*. At that point, what was being called socially responsible investment was controversial. It was certainly viewed in London as something rather exotic. It wasn't well understood, but it was clearly growing in size, to the extent that even the *Economist* felt it needed to write a report on what was happening.

The main conclusion that I came to in the article was that, since that time, we've definitely moved away from arguments about whether ethical and social performance is relevant — and even whether it's legal, at least in the UK, for pension funds to address these issues. All of that seems to have moved toward a wider consensus that if you ignore ethics, if you ignore social concerns, if you ignore the environment, you are ignoring something which is very relevant to risk in your portfolio, and which is very relevant to value creation in your portfolio.

So I suppose the story is how socially responsible investment moved from beyond the fringe and into the mainstream. Both of you are good examples of how investors now better understand that the question of ethics and social responsibility is no longer some exotic extra for certain categories of investor who might be inspired by religious or personal or social concerns, but actually is something which is being treated as a fundamental element of performance.

All kinds of interesting approaches have been taken — from those who think the way to influence the agenda is by avoiding owning stock to those who think the way to influence the agenda is by engaging with companies. And for some, these are becoming complementary strategies rather than alternatives. We're seeing big agencies, like the United Nations, saying that getting investors coordinated around these ideas is part of their broader global development agenda. I think it's an extraordinary journey over a fairly short period of time.

Tim, why don't we start with you. Has socially responsible investment gone from beyond the fringe? Is it now a mainstream part of fund management — mission accomplished?



**Tim Smith:** One thing I think it would be important to clarify is that, at this point, many of the institutions that are supporting what they often call ESG [environmental, social, and governance] investing, which is what the UN's Principles for Responsible Investment call it, would probably not describe themselves as "social investors." In the United States, social investors are seen to be people that are imposing a set of social criteria on the investment portfolio that negatively affects financial performance. This is a demonstrably false criticism; you do not lose money when you have social screens in your portfolio. But the vast majority of state and city pension funds, foundations, union pension funds, and others who have embraced the Principles for Responsible Investment, for example — investors with more than \$14 trillion — see themselves as responsible fiduciaries, rather than as investors on a "social mission."

At the same time I very much respect the work that I did for 30 years with religious investors and other investors who are very proud to call themselves socially responsible investors, because indeed they did believe that they had a responsibility to make sure that their investments reflected their values, and their faith if they were a religious group. Further, they believed they had a responsibility to engage with companies on key human rights, environmental, and social issues.

**Simpson:** That's a very interesting point. There is a legal duty on most people putting money into the capital market, because it is other people's money. There is a fiduciary duty of care, duty of prudence, and duty of loyalty. So the big question, then, is whether including concern for environmental, social, ethical, governance, what are traditionally considered nonfinancial issues, is a help or a hindrance?

Anne, the Norwegian fund was set up to provide pensions in perpetuity, channeling your oil revenues into a fund that will provide welfare to the citizens of Norway. Is socially responsible investing something that just seemed to be an obvious, integral part of your strategy from the beginning, or, in Norway, did you go through the same sort of journey that Tim is describing?



**Anne Kvam:** I think we've taken much of the same journey. The fund was established ten years ago, but it's only in the last four or five years that we've had the ethical guidelines and guidelines that encourage us to be active owners; before that we were passive owners.

I want to pick up on one of the points that Tim made on how many people don't call themselves socially responsible investors, because that name suggests that you're not concerned about the financial performance, which I agree is a misunderstanding. We prefer to use

the phrase “sustainable development.”

We are a very long-term fund. The purpose of the fund is to secure financial security for future generations in Norway. And we are a large fund, with very universal ownership: we have ownership over almost all the globe. For us, then, the concept of sustainable development — and that encompasses social and environmental issues as well — comes very naturally. So you end up at the same point, though perhaps it’s a different path.

**Simpson:** What does it actually mean to include these issues in your investment strategy? As we were saying, in the early days it was a question of avoiding investments in certain companies. This is the tradition, certainly, in the UK. The Temperance Society, for instance, would be forgiven for not investing in alcohol, even if that meant they got lower returns. But, of course, with investment vehicles that have a wide range of contributors, a wide range of beneficiaries, it’s hard to define your ethical investment strategy by avoiding one thing or another.



**Smith:** Maybe I can help by describing the U.S. context. Different investors operate by somewhat different rules and therefore define their roles and responsibilities a little differently, while often coming to the same place in terms of their actions. I’ll give some examples. Many foundations now are talking about “mission-related investing,” about how to make their investments augment, rather than undercut, their mission and purpose. The American Cancer Society, to use an American example, would not invest in tobacco products. But the vast expansion of support for responsible or ESG investment is occurring with institutional investors and investment managers who see, as the words of the Principles for Responsible Investment remind us, that ESG factors have a direct impact on shareholder value, perhaps because they affect the company’s long-term reputation or risk in the portfolio, and therefore it is our obligation as fiduciaries to take them into account. So the reason that institutions with literally over \$50 trillion have rallied around the Carbon Disclosure Project and have asked for information on greenhouse gas emissions is that they see a very strong business case that climate change is going to affect not just the environment, but our markets and our companies. How a company relates to climate change is a legitimate business question that affects the bottom line, and therefore they say we need information to assess what a company’s role is in terms of climate change.

**Kvam:** One of the areas that the Norwegian fund has chosen to focus on is promoting mechanisms for efficient reduction of greenhouse gases. Exactly as you’re saying, Tim, it is a long-term financial issue for us. The Stern Review calculates that the dangers of unabated climate change would be

equivalent to at least 5%, in the best-case scenario, or up to 20%, in the worst case, of global GDP each year. So with the portfolio that we have, which is a global, very widely spread portfolio, we are bound to lose out if that’s not dealt with now. It will cost us.

**Smith:** On the other hand, in the U.S., there’s tremendous growth in decisions by pension funds to divest from companies that are in the Sudan, because of human rights reasons. The motivating force is not a fiduciary duty. These pension funds are saying that beyond their fiduciary duty they have a moral obligation not to invest in genocide. We are talking about investment portfolios with hundreds of billions of dollars who have made these remarkable decisions in the last three or four years in the United States. So it is a both / and approach.



**Kvam:** There was quite a comprehensive process when the ethical guidelines were established for the Norwegian Fund. We ended up with three different tools that ensure compliance with the ethical guidelines: negative screening, exclusions, and active ownership.

In order to define areas that should be screened out of the portfolio due to ethical concerns, there was a debate to try to find the “overlapping consensus” of the Norwegian people. That’s a quite interesting concept. How do you find that?

For example, we have a negative screening of companies that produce weapons that through normal use may violate fundamental humanitarian principles, such as cluster weapons, nuclear weapons, and anti-personnel landmines. It was agreed that there was an “overlapping consensus” in Norway for this. Tobacco production was also discussed, but the parliament could not agree that there was an “overlapping consensus” in screening these companies out of the portfolio — after all, many people in Norway do smoke, unfortunately.

It was decided that the active ownership of the fund should be exercised in accordance with internationally well-recognized standards such as the UN Global Compact and the OECD [Organisation for Economic Co-operation and Development] Guidelines for Corporate Governance and for Multinational Enterprises. Having a broad, international portfolio, it was important to conduct our ownership in accordance with internationally accepted norms and not a local set of values and standards. Finally, we also established a mechanism by which we can exclude companies if, for example, there is a considerable risk of contributing to gross or systematic violation of human rights, severe environmental degradation, etc., through our investments.

The screening and exclusion of companies are decided by the fund owner, the Ministry of Finance, whereas the active ownership is managed by the fund manager, Norges Bank Investment Management.

**Simpson:** That leads nicely to the next thing I wanted to ask you both about. For whatever reason, an investor has a concern about what companies are doing in terms of environmental, human rights, ethical issues, whether there's a fiduciary reason or an issue of conscience. The question, then, is what do you do?

In the case of Sudan, one thing people have noted is that because some of the active, responsible investors said, "We're pulling out of those companies," the only route left for influence was calling on government to pressure the Chinese, who were selling arms to the regime. The question is what it's been from the beginning: if you want to do something, do you avoid investment in order not to be morally tainted — or to be trapped in risks if you're a fiduciary — or is the responsible investor somebody who keeps their stake and engages and tries to have influence?

**Kvam:** I think you are spot-on regarding the difficult issues. What does the responsible investor do? Do you stay or do you sell? In some ways, you try to find the perfect balance: staying and exercising your influence, but showing that you are willing to exit a company if you feel that you're not achieving anything or if the company's practices are unacceptable. But that's a tricky balance to reach. It is important to always bear in mind that the intention of the funds is to create financial value, and not to act as a foreign policy tool.

**Simpson:** Sudan, of course, is a very extreme situation. Maybe you can talk us through Wal-Mart.

**Kvam:** As mentioned earlier, the Ministry of Finance can decide to exclude companies. This has happened in only 27 instances. Twenty of these have been in connection with negative screening, so there are only seven companies that have been excluded from the portfolio due to their behavior. Wal-Mart is one of those cases; it was excluded due to violations of international human rights and labor standards. Now, seven companies out of about seven and a half thousand listed companies in the portfolio is not a large number, but the process that we've established around those issues is such that they do get a lot of attention.



**Simpson:** With Wal-Mart, the process you followed was closely watched by a lot of other investors. And when you decided to call it a day and to pull out, others followed. But I wonder, and maybe Tim can comment on this: Did that leave other investors wishing that Norway had stayed in, or did it add something? It's an interesting case to look at in terms of exclusion and activism, and whether they complement each other.

**“The responsible investor no longer defines their investing simply as, what am I screening out? They also ask, how do I take my responsibility of ownership seriously?”**



**Smith:** I think you put your finger on it with the last comment you made, that sometimes these efforts complement each other. Here's a quick historical note: I was at the shareholder meetings back in 1970 and 1971 when General Motors received the first resolutions on social issues. Right from the very beginning, when religious groups got involved in ethical investing, they did both: Many groups decided not to invest in alcohol, tobacco, gambling, or major companies that made weapons of war. But at the same time, they were very engaged as shareholders.

The responsible investor, then and today, no longer defines their investing simply as, what am I screening out? They also ask, how do I take my responsibility of ownership seriously? How do I vote my proxies? How do I voice my concerns to management? And with an increasing number of institutional investors, how do I sponsor shareholder resolutions for a debate at the stockholder meetings? At least this is common in the United States, and somewhat in Canada now.

So we see some investors deciding not to invest in Wal-Mart because they're concerned with the lack of responsiveness on specific issues, while others have been knocking on their door, filing resolutions for the last 15 years. We can debate it if you wish, but I think Wal-Mart is a company that's very much in the midst of change on the environment and vendor standards and diversity issues. I think they were not happy to see the Norwegian fund sell its shares, and neither are they complacent when the Sisters of Charity or United Methodist Church Pension Board or other groups file shareholder resolutions with them.

Some institutions, by virtue of their mission, are forced — I used the American Cancer Society as an example — not to own certain things. On the other hand, New York City's pension funds, as I understand it, have absolutely no screens. There is \$100 billion in New York City's pension funds, and they are one of the most active, engaged shareholder voices in the country. Many institutional investors define their responsibility not as what they're going to avoid, but how they engage companies as long-term owners and push the companies to change.

Finally, the context for our discussion today is very different from 20 years ago on this point: We no longer are talking just about the mainstreaming of responsible investing. We also are talking about the mainstreaming of corporate social responsibility by the corporate community. We are seeing companies by the thousands who are making our case for us: that being a good corporate citizen is a part of their business responsibility. And they describe the business case for taking climate change and diversity issues and supply-chain vendor standards issues seriously. Twenty years ago, we had to make that case to the business community. Today there are many CEOs who make the case to their peers.

**Simpson:** I think it's really where Milton Friedman went wrong, when he said in his article "The Social Responsibility of Business Is to Increase its Profits" that social responsibilities are properly the realm of governments and NGOs, and if you start distracting companies from making profits, all will be lost for capitalism. To be fair, a bit later in that same article, he acknowledged that actually making profits probably means that you have to pay attention to things like what society expects of you, and you must always behave legally. But I think you're right that the whole concept of corporate performance and corporate purpose has developed beyond the mantra of shareholder value to an understanding that shareholder value must include and encompass society's values, and the two cannot be held separate from each other. There isn't something called corporate performance and something called social welfare. At the end of the day the two things are all connected up in subtle and sophisticated ways over the long term.

**Smith:** The contradiction, of course, in what we have been saying is that you can act as a scoundrel — acting legally, but acting in an unethical way — and still make a lot of money for shareholders. But companies understand that, long-term, not to pay attention to environmental and social responsibility is to shoot themselves in the foot. BP uses the term that their "license to operate" is under question if they don't act responsibly.



**Simpson:** I'd like to talk about one more issue, which is the question of information and reporting and assurance. I was at a lecture last week and Sir Adrian Cadbury was there, and he was telling me a tale about a controversy reported in the press to do with West African cocoa pickers and the use of child labor. A story had been circulating that the company had been making use of labor delivered by more or less a slave ship. This story, apparently, was not true. But other than in the *Economist*, the claims and the counterclaims were not properly recorded.

So he really put in my mind one dimension to information flow, which is how investors get information that they can trust and rely upon. In this case, the media picked up on a story which wasn't accurate and was quite damaging, he felt. And he was upset about it.

But there are much deeper problems about verification and standards. I was on the board of a group called Accountability, and it's of great interest to me, this whole question of how we develop a set of standards so that when investors are looking at companies, they're not just looking at the window dressing of the corporate responsibility statement or even the very persuasive speech of the CEO. How do you match up the reporting from the social, ethical, and environmental side with the audited financial statements that we're looking at? How do you actually know what to believe and what to factor in

as material? Anne, with a portfolio of 7,000 companies, how do you find out what's really going on?



Kvam: In the more well-established markets, it's generally easier to trust the financial figures and reports and to get the information that is available from companies. But when you're moving into the developing and emerging markets this is not so easy. We have investments in China, India, and other countries where you have the whole issue of language in addition to access to information. So where do you get the information? One source is the company and the official corporate documentation, but there is also the issue of finding trustworthy sources for reliable outside information about what's actually going on. You can get information from a stakeholder, an NGO, the media, and you try to follow up on that. Often you end up in a kind of a loop on the internet, where one source is based on the other. So this is truly a difficult area.

One of the traditional corporate governance issues that we have chosen to focus on is access to information, because we see that as vital for everything that we're doing. We pursue this focus area through company engagement, through voting, when we approach regulators, and when we interact with other investors.

**Simpson:** Is the logical end of what you are saying that investors need to be calling for these issues to be part of the audited financial statement and subject to the same standards of quality and third-party assurance as we would expect for the financials?

Kvam: I know that, for example, the International Corporate Governance Network, which you lead, Anne, is developing proposals and principles regarding this. We very much support those initiatives.

**Smith:** One way for a company to pursue that goal is to utilize the Global Reporting Initiative and follow the set of high-quality standards listing items for disclosure. In the United States there is presently a request to the Securities and Exchange Commission asking for expanded regulations on what should be required as disclosure. A number of investors are asking that the SEC mandate that environmental and social issues be disclosed by companies. It's terribly important to have that information.

As an investment firm, we manage around \$4 billion for our clients. We go to multiple sources, as Anne does. Of course we study what the companies say and do. We go to government. We go to research advisory services that sell you information. We look at what NGOs and the press say, but we have to evaluate it. As Anne said, just because it's on the internet doesn't mean it's true.

One other point: when we're looking at shareholder advocacy efforts and we're asking companies to either report information, or change policies or practices, which we often do, it's not something that usually has immediate results — it's a process.

Often you might be talking to a company for 5 years or 15 years about an ongoing issue. The question of vendor standards and making sure your factories in China and Guatemala are run responsibly is not something you solve in a day, where you snap your fingers and it's done. Likewise, work on the environment requires continuous improvement.



**Simpson:** I'll come back to the opening comment: Is it mission accomplished? Do we want to get to the point where socially responsible investment no longer exists as a subject because corporate responsibility is simply understood and investors are doing the right thing? Where it would no longer be considered a style of investment; it would just be what investing is all about. Do you think that's where we're heading?

Kvam: I think we're well along. I don't think that the mission is accomplished. I don't think you do it and then you put it aside and you're done with it. When you're talking about the financial interest in investments, you don't reach a point where you're done and you don't have to talk about it anymore. These issues need to become a part of investment as natural to relate to and assess as financial issues. It's an ongoing effort.

**Smith:** Very well said. It will never be a finished job, just as we're always going to be urging our governments and our institutions to be living up to higher standards. ●