



Sustainability and the Future of Social Investing

American Accounting Association – May 2, 2008

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Topics

- Sustainability and Social Investing
- The Moskowitz Prize – Recent Winners
- Where We're Going



Sustainability and Social Investing



What is Social Investing?

Social Investing is an investment discipline that enables individuals and institutions to own companies whose philosophies and activities are compatible with their own principles and values. It is also known as...

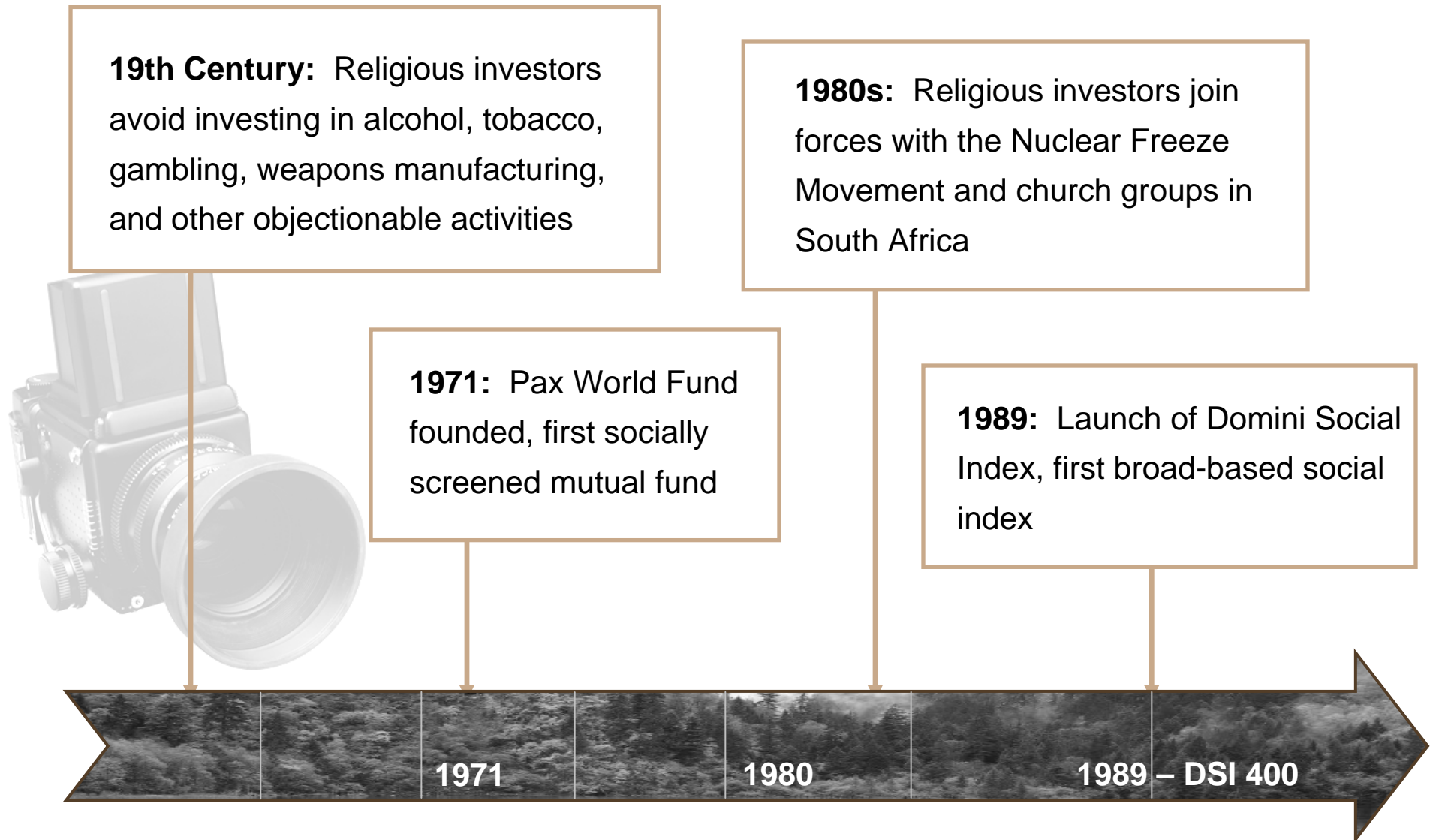
- Sustainable Investing
- Green Investing
- Screened Investing
- Social Investing
- Natural Investing
- Ethical Investing
- Mission-based Investing
- Values-based Investing



Source: Nelson Capital Management

Key Moments in the History of SRI

Socially responsible investing has a long history



Source: Nelson Capital Management

Why It Can't Be Done – ca. 1989

- “It is not possible to do social research on hundreds of companies.”
- “Limiting your investment universe will hurt your returns.”
- “There will never be much demand for these products.”

There Are Many Research Resources Now



One Answer to the Performance Question

Annualized Returns

	Since 5/1/90*
Domini Social Index	+10.83%
S&P 500	+10.33%


Domini Risk Profile:

- Higher beta
- Modest growth bias
- Sector weights
 - Overweighted in Technology, Consumer, Finance
 - Underweighted in Energy, Utilities

Source: KLD Website, as of May 1, 2008. * Data from 5/1/90 inception date of Domini Index.

Another Answer on Performance

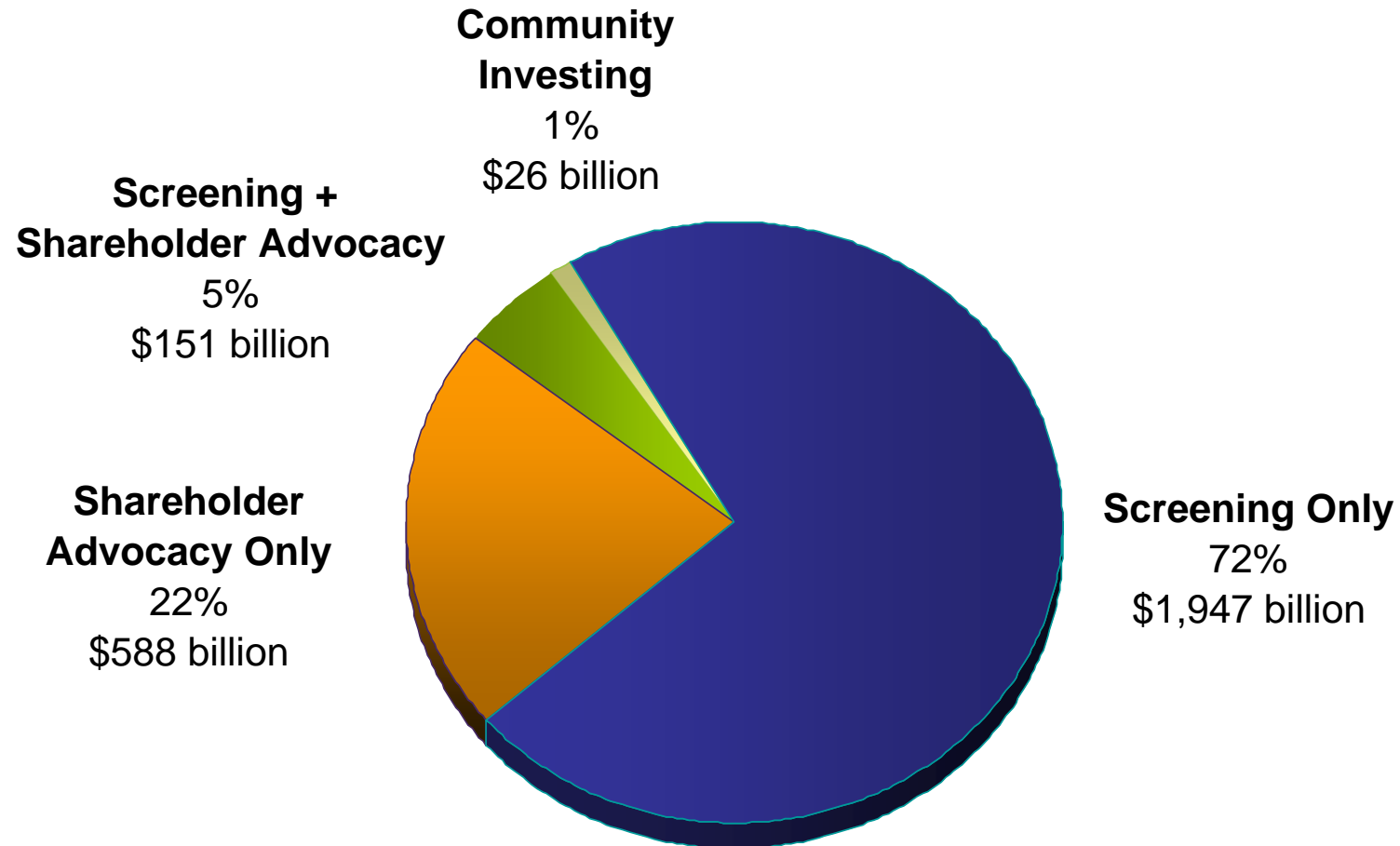
- Equities
 - Kempf and Osthoff (2006)
 - 1992-2004
 - Small Positive SRI effect
 - Geczy (2003)
 - 1963-2006
 - No SRI Effect
 - Bauer, Koedijk, and Otten (2002)
 - 1963-2001
 - No SRI Effect
- Fixed Income
 - Derwall and Koedijk (2006)
 - No SRI Effect



These studies all use the Carhart model, which accounts for style, market capitalization, and momentum effects.

Now a Major Market Sector

Socially Responsible Investing in the U.S. reached \$2.7 trillion in 2007



Source: Social Investment Forum, SRI Trends Report 2007



The Moskowitz Prize – Recent Winners



The Moskowitz Prize

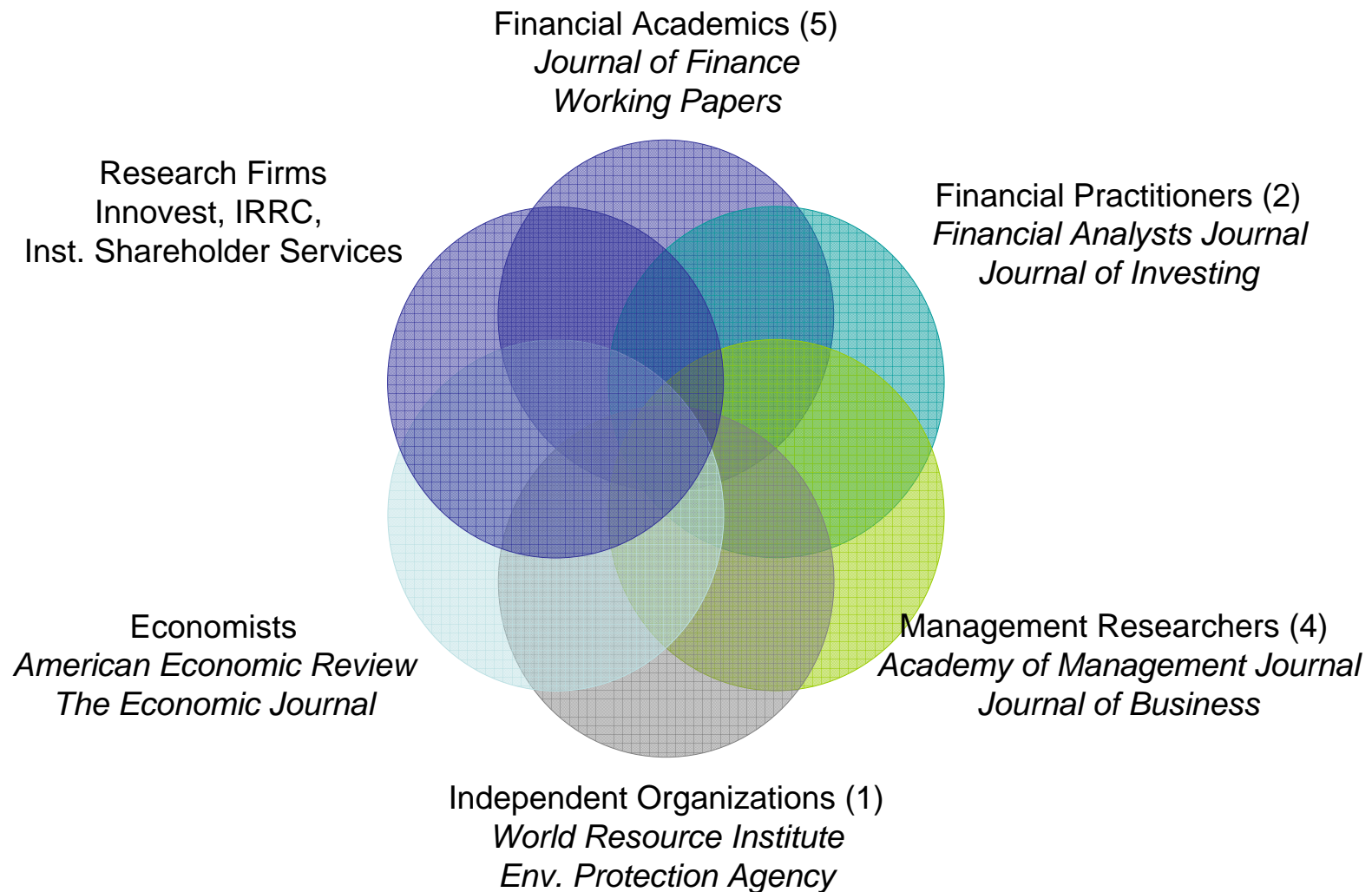
- Global award recognizing outstanding quantitative research in the field of social investing.
- Named for Milton Moskowitz, early investigator and author of *Fortune's* “Best Companies to Work For in America”.
- Independent jury of respected academics and investment practitioners.
- Awarded annually since 1996.

More Information: <http://www.sristudies.org>



University of California
Berkeley
Haas School of Business

The Literature of Social Investing



Numbers in parentheses show # of Moskowitz Prizes and Honorable Mentions

Recent Winners

2004 - Marc Orlitzky, Frank L. Schmidt, and Sara L. Rynes

2005 - Nadja Guenster, Jeroen Derwall, Rob Bauer, and Kees Koedijk

2006 - Brad Barber

2007 - Alex Edmans



Orlitzky et al



Orlitzky's Question

What (if anything) does Corporate Social Performance (CSP) have to do with Corporate Financial Performance (CFP)?

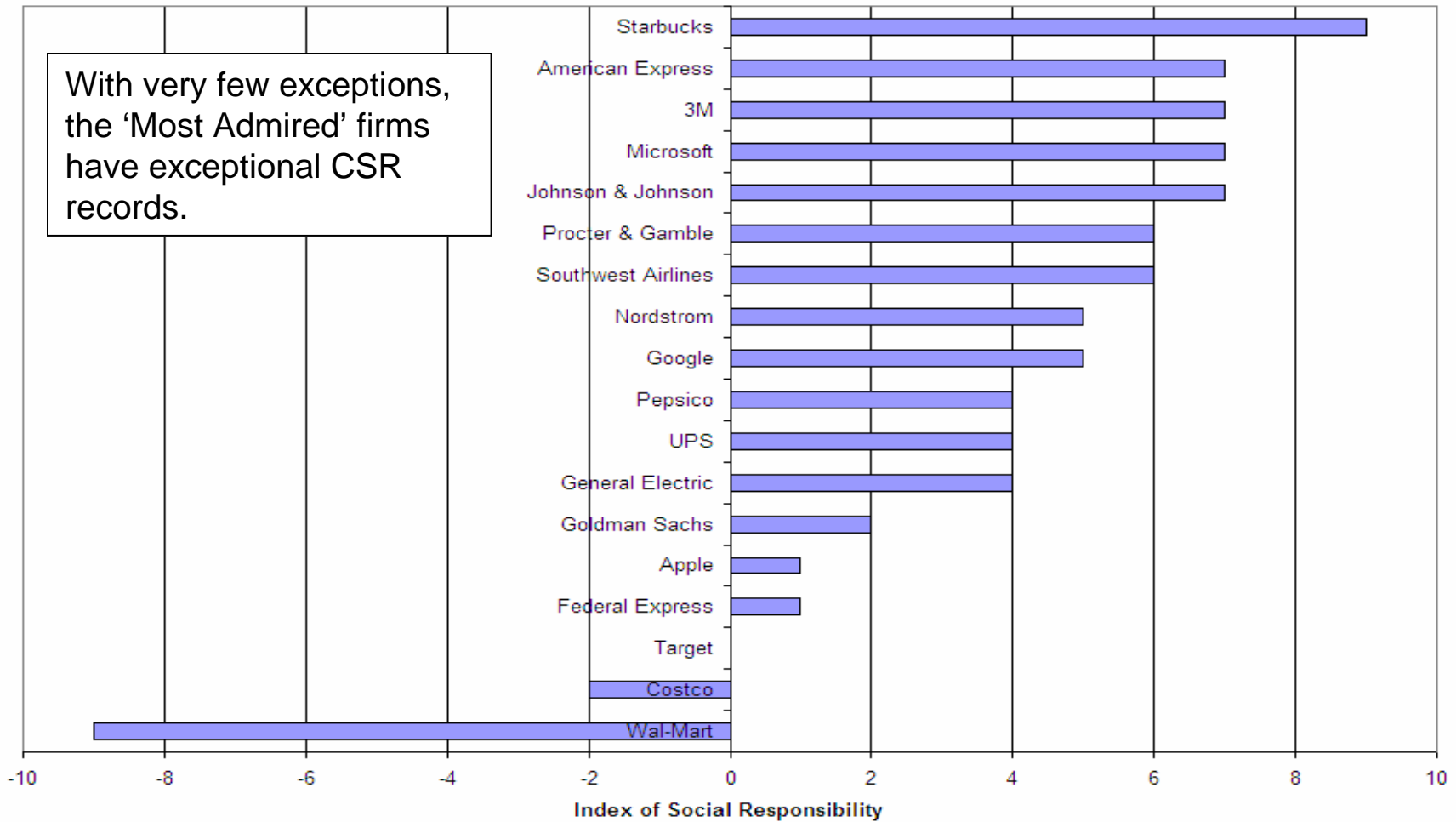
Before Orlitzky: Frustration All Around

- Griffin and Mahon (1997): “25 years of incomparable research”
- Margolis and Walsh (2001): Research is generally weak, but see positive relationship
- Barnett and Salomon (2003): “Despite the intensity of study directed at it, the relationship between CSP and corporate financial performance (CFP) remains in dispute.”

Orlitzky: Findings

- Reviews 52 studies examining the relationship between Corporate Social Performance (CSP) and Corporate Financial Performance (CFP).
- Using meta-analysis statistical techniques, the authors concludes that “there is a positive association between CSP and CFP across industries and across study contexts.”
- “[T]he causation seems to be that CSP and CFP mutually affect each other through a virtuous cycle: financially successful companies spend more because they can afford it, but CSP also helps them become a bit more successful.”
- The relationship was stronger for accounting-based measures of CFP than more market-based ones.

Fortune 20 Most-Admired Companies, 2007



Sources: Fortune, KLD Research & Analytics, LK analysis



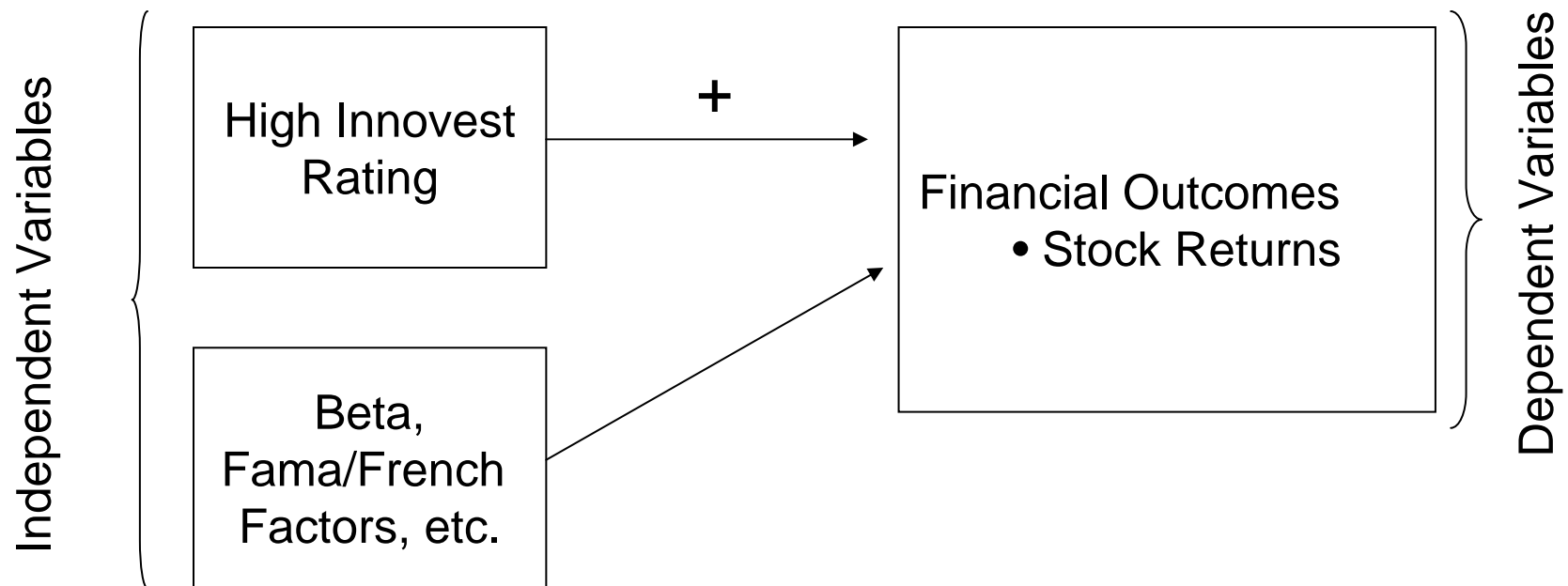
Guenster et al



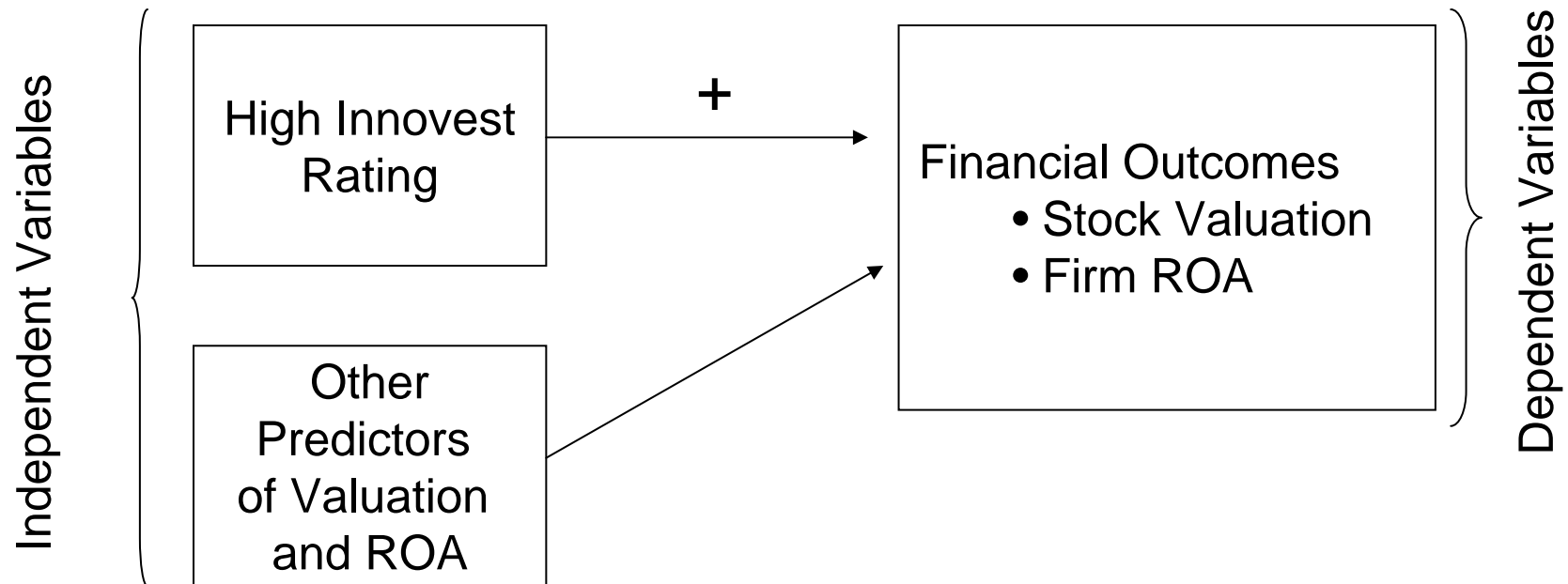
Prelude: Derwall et al

- Backtests an environmentally-based active management strategy.
- Portfolios of 'eco-efficient' companies outperformed portfolios of poor environmental performers.
 - Invest environmental ratings
 - U.S. companies
 - 1995-2003 time period
- Performance was better both in nominal terms and on a risk-adjusted basis.
 - Good environmental portfolio had average annual returns of 12.2% vs. 8.9% for a portfolio of weak performers.
 - CAPM alpha of +1.29% vs. -1.76%
 - 'Four Factor Model' alpha of +3.98% (!) vs. -1.08%

Derwall's Formulation



Guenster's Formulation



- Demonstrates that environmental information is incorporated into the valuation structure of equities (Tobin's Q), and that the 'eco-efficiency premium' has increased over time.
- Also shows that there is a fundamental basis for this, as 'eco-efficient' companies tend to have superior operating performance (measured using ROA).



Barber



Owners vs. Managers

- “The ultimate power in a company must rest with the shareholders.”
 - Jean-Paul Page. *Corporate Governance and Value Creation*, Research Foundation of CFA Institute, 2005.
- “[T]oday shares are held, on average, less than 10 months. Should managers really regard such investors, whose investment horizons are shorter than the most nearsighted of managers, as stakeholders whose value they ought to maximize?”
 - Clayton Christensen and Scott Anthony. “Put Investors in Their Place.” *Business Week*, May 28, 2007.

Financial Claims

A firm may be viewed as a constellation of business relationships with a control group. The control group allocates resources so as to create wealth for the firm, shareholders, and themselves...



Which Leaves a Question...

Who gets what's left?

CalPERS and Corporate Governance

“We believe good corporate governance leads to better investment performance. We seek corporate reforms to protect our investments. The corporate governance team challenges companies and the status quo; we vote our proxies; we work closely with regulatory agencies to strengthen our financial markets; and we invest with partners that use corporate governance strategies to add value to our fund by turning around ailing companies.”

CalPERS Corporate Governance Program

- Identifies long-term underperformers with entrenched/unresponsive management teams.
- Each year, CalPERS constructs a Focus List of these companies, and engages with them to promote change.

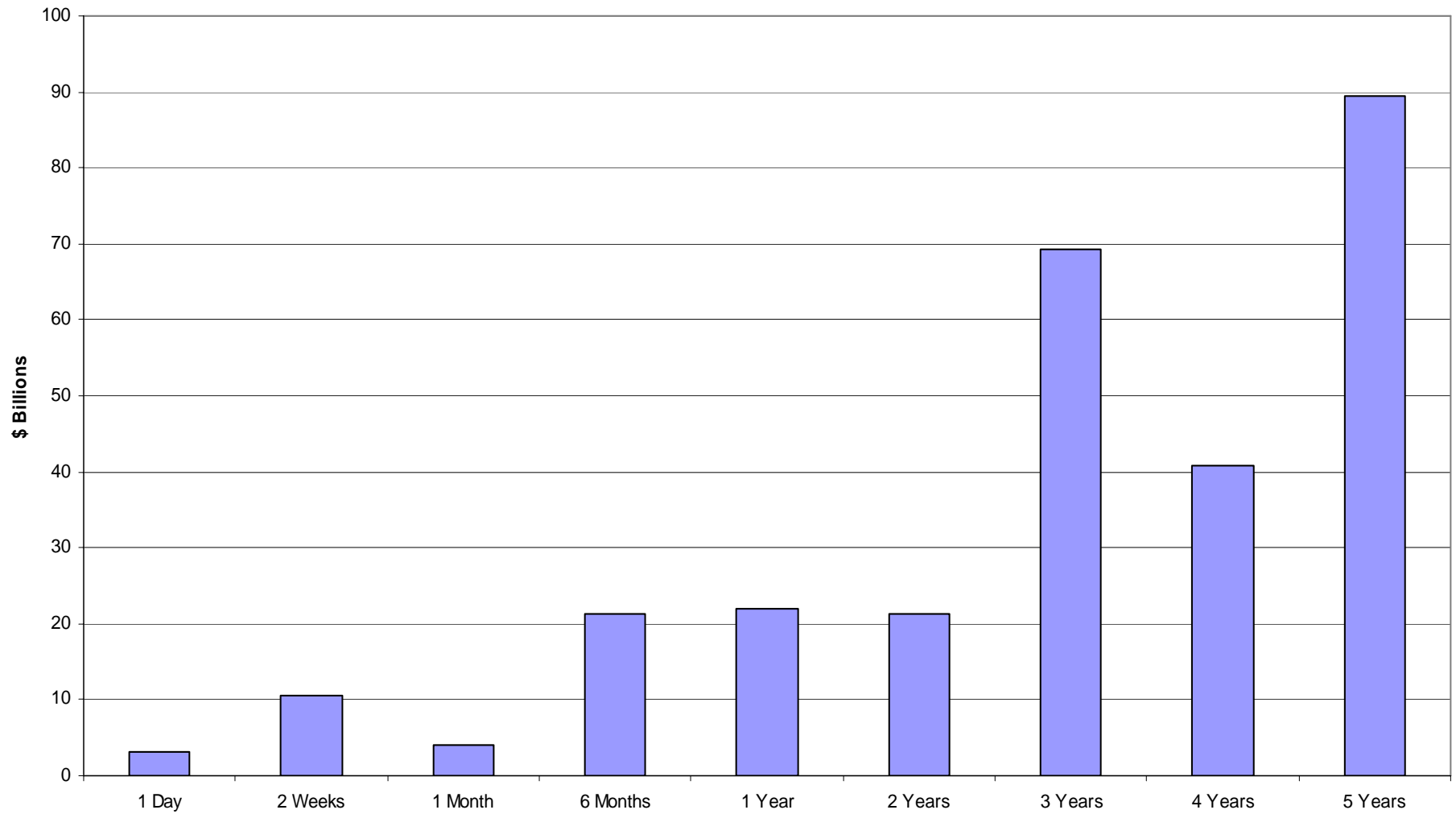
Does It Work?

- Nesbitt, Steven. “Long Term Rewards from Shareholder Activism: A Study of the CalPERS Effect.” *Journal of Applied Corporate Finance*, Winter 1994.
- English, Philip, Thomas Smythe, and Chris McNeil. “The ‘CalPERS effect’ revisited.” *Journal of Corporate Finance*. January 2004.
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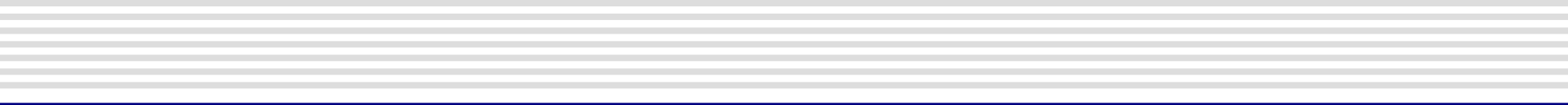
Short-Term Impact

- Barber finds a “small, but reliably positive” +0.25% effect on announcement date.
- “My best estimate, based on conservative short-term market reactions, indicates CalPERS activism has resulted in total wealth creation of \$3.1 billion between 1992 and 2005.”


Long-Term Impact



Source: Barber (2006)



Edmans



The 100 Best Companies List

- **Pros**

- Same people have been doing it since 1984
- Uses non-public employee survey data
- Candidate companies self-select

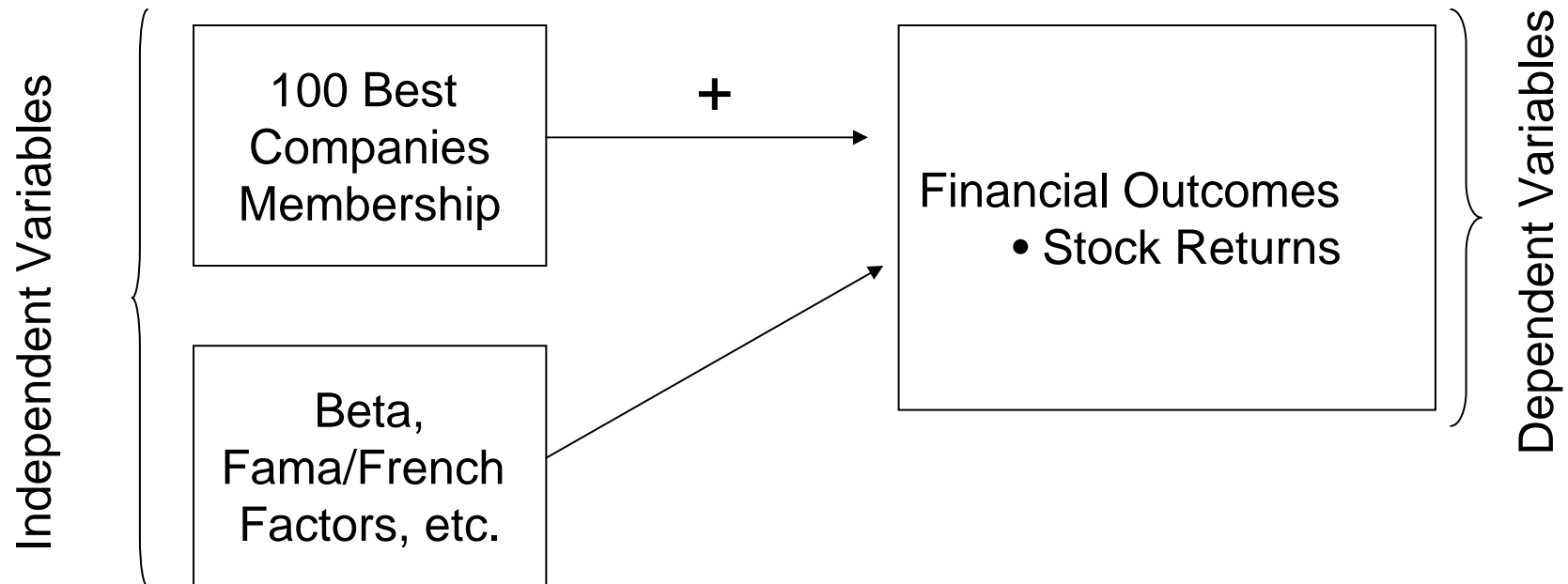
- **Cons**

- Many potentially qualified companies not considered because they did not volunteer
 - Methodology has evolved over time
-

The 100 Best Companies List

- 1st Hardcover Edition
 - March 1984
 - Paperback (minor revisions) 1985
 - 2nd Hardcover Edition
 - February 1993
 - Paperback (minor revisions) January 1994
 - *Fortune* Magazine
 - January 1998
 - January 1999
 - January 2000
 - January 2001
 - January 2002
 - January 2003
 - January 2004
 - January 2005
 - January 2006
 - January 2007
- Kurtz and Luck (2002)
- Edmans' (2007) primary analysis
-

Edmans' Formulation



Edmans: Key Findings

- After many checks for robustness, “the Best Companies variable is statistically and economically significant.”
 - The effect on investment returns has been positive, with statistically significant alpha relative to industry-matched and characteristics-matched portfolios.
 - “Employee satisfaction improves corporate performance rather than representing inefficiently excessive non-pecuniary compensation.”
 - “The stock market does not fully value intangibles, even when they are made visible by a publicly-available survey.”
- 



Where We're Going



Three Trends

- Recent research suggests variables social investors care about could matter for investment returns.
 - But current practice doesn't emphasize these variables. Many social investors have experience disappointing returns in recent years.
 - As investors – social and otherwise – assimilate these findings, some aspects of social investing are finding their way into mainstream securities research.
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Perhaps Some of These Things *Do* Matter

2004 – Orlitzky et al → Overall Corporate Social Responsibility

2005 – Guenster et al → Environment / Sustainability

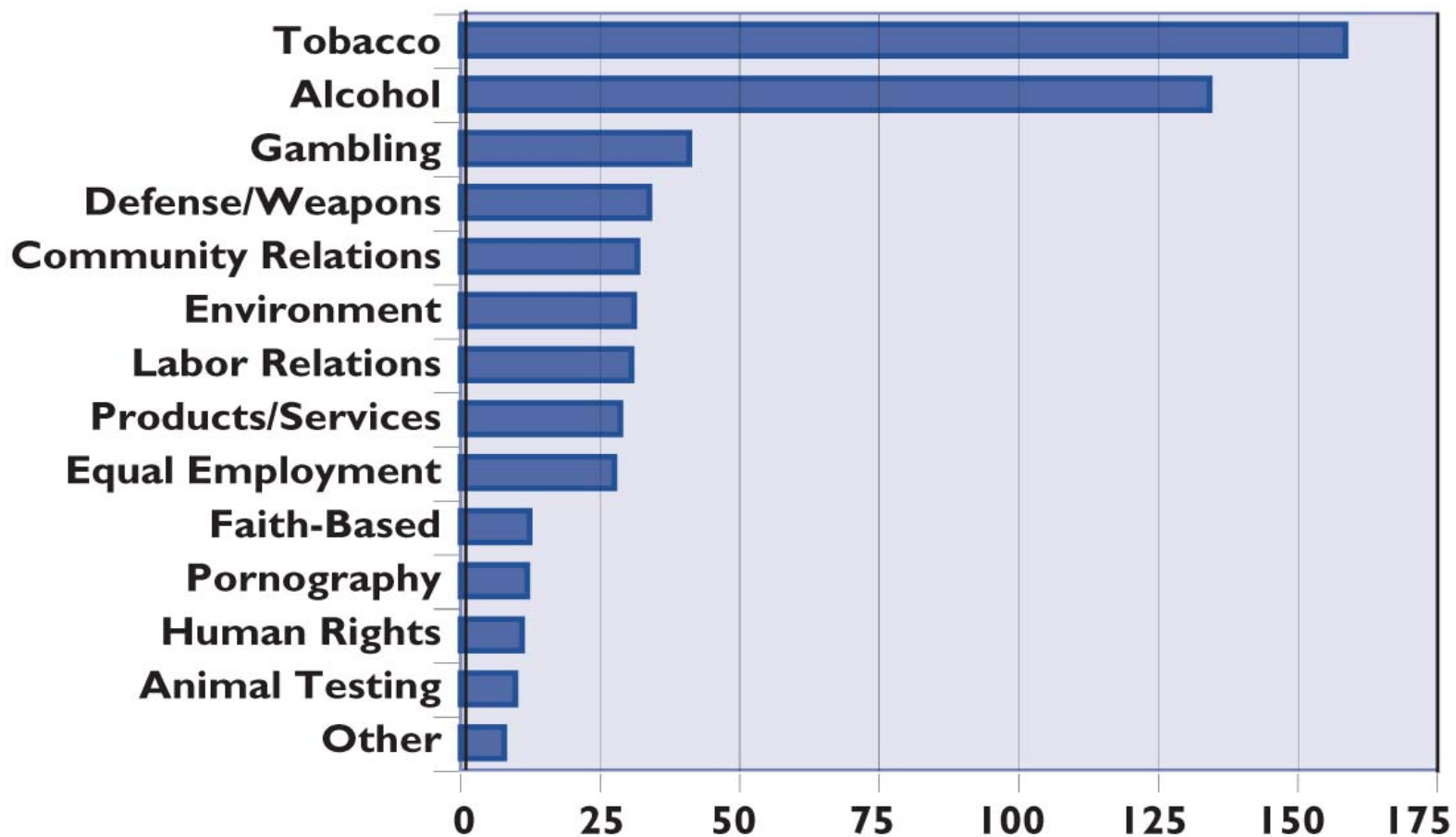
2006 - Brad Barber → Corporate Governance

2007 - Alex Edmans → Employee Relations

But Social Investors Don't Feature Those Factors

FIGURE 2.5

Mutual Fund Assets by Screen Types 2005



SOURCE: Social Investment Forum Foundation

Total Net Assets (\$Billions)

And Recent Social Index Performance Has Been Disappointing

Annualized Returns, Three Years Ended 3/31/08

Domini Social Index	+4.7%
Calvert Social Index	+4.3%
S&P 500	+5.9%

Key Drivers:

- Both indexes underweight energy
- Both indexes underweight Utilities
- Both indexes overweight Finance

Some New Social Investment Researchers

- Citigroup
- Goldman Sachs
- JP Morgan
- Societe Generale
- UBS

Studies

- Barber, Brad M. "Monitoring the Monitor: Evaluating CalPERS' Shareholder Activism." Working Paper, Graduate School of Management, UC Davis. March, 2006.
- Barnett, Michael L. and Robert M. Salomon. "Porous, Pious, and Prosperous: The Curvilinear Relationship Between Social Responsibility and Financial Performance." Working Paper, November 2003.
- Bauer, Rob, Kees Koedijk, and Roger Otten. "International Evidence on Ethical Mutual Fund Performance and Investment Style." Working Paper, January 2002.
- Derwall, Jeroen, Nadja Guenster, Rob Bauer, and Kees Koedijk. "The Eco-Efficiency Premium Puzzle." *Financial Analysts Journal*, March/April 2005.
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- Geczy, Christopher C., Robert F. Stambaugh, and David Levin. "Investing in Socially Responsible Mutual Funds." Wharton School, Working Paper, May 2003.
- Griffin and Mahon. "The Corporate Social Performance and Corporate Financial Performance Debate: Twenty-Five Years of Incomparable Research." *Business & Society*, March 1997.
- Guenster, Nadja, Jeroen Derwall, Rob Bauer, and Kees Koedijk. "The Economic Value of Corporate Eco-Efficiency." Working Paper, Erasmus University, July 25, 2005.
- Kempf, Alexander and Peer Osthoff. "The Effect of Socially Responsible Investing on Financial Performance." Working Paper, University of Cologne, Germany. June, 2006.
- Orlitzky, Marc, Frank L. Schmidt, and Sara L. Rynes. "Corporate social and financial performance: A meta-analysis." *Organization Studies*, 24, 2003.