



The Next Wave of Socially Responsible Investing May Require Deeper Economic Analysis

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Note: This article is part of a three part series on Socially Responsible Investing (SRI). [Part 2](#) looks at the risk-adjusted returns for SRI mutual funds, and [Part 3](#) looks at SRI investing in the Advisor Perspectives universe.

It's hard to talk about socially responsible investing (SRI) without injecting a tone of judgment and morality. To socially conscious investors there are "good" companies to own and "bad" companies to avoid. The criteria that separate the "good" from the "bad" vary with each investor, but what distinguishes SRI from ordinary investing is its primary focus on what the company does as opposed to how the stock is valued. You might say that socially responsible investors buy *companies* while ordinary investors buy *stocks*.

Anytime you exclude a group of stocks from the universe of available securities -- whether it is through the application of negative screens or positive screens -- you theoretically limit your capacity for diversification. What if your SRI screens eliminate the best-performing stocks? In fact, that's what an aversion to tobacco would have caused from 1957 through 2003 when Philip Morris, now Altria, returned 19.75% versus 10.85% for the S&P 500, and actually outperformed all other stocks in the index over that time period.

On the other hand, limiting your universe of stocks can also be profitable. If you had invested \$1,000 in *only* Philip Morris in 1957, you would have ended up in 2003 with \$4.6 million, compared to about \$124,000 for the S&P 500. The key to SRI, or any other strategy that focuses on a narrow group of stocks, is understanding the economic sensitivities that impact those stocks, says Allen Gillespie, CFA, whose firm, GNI Capital in Greenville, South Carolina, serves as sub-advisor for the Vice Fund. The Vice Fund buys what most SRI investors would call "bad" stocks including alcohol, tobacco, gambling, firearms, and military contractors.

The Vice Fund was not created as a social commentary. Rather, it was designed to focus on a limited universe of stocks to identify and exploit the economic factors impacting that universe. In fact, GNI Capital's approach grew out of its work with individual clients holding concentrated positions of restricted stock. These clients did not have the option of diversification, so GNI Capital was called to fully understand the economic sensitivities impacting their clients' holdings and reduce risk through hedging or other strategies. The idea is that it is possible to achieve above-average risk-adjusted returns with *any* universe of stocks,



whether it is created through SRI screens, so-called "vice" screens, or the rules prohibiting the sale of a single stock.

"One of the biggest mistakes people make," says Gillespie, "is that they'll screen out a universe and not appreciate how that changes the economic sensitivities of the remaining portfolio." So when pursuing an SRI strategy you can't just take out the "bad" stocks and hold what's left. You need to consider the economic factors impacting the universe you're left with and manage the portfolio accordingly. Ideally, you'll want to be long some stocks and short others, Gillespie says. For example, if you're against tobacco, why not short Altria and go long Pfizer, the drug company that helps people stop smoking? If you want to promote green energy, instead of buying all the bio-fuel companies, most of which are unprofitable, why not identify the ones that are most likely to succeed?

Demand for SRI

Since 1995, SRI assets have grown faster than ordinary assets under management, rising to \$2.29 trillion or 9.4% of total assets under management in the U.S., according to the Social Investment Forum's 2005 [report](#). Growth is expected to continue worldwide due in part to changes in regulations regarding the disclosure of social, environmental, and ethical (SEE) information by pension funds and listed companies.

How will the increased demand for socially responsible companies impact the prices of these stocks? Are they already overvalued? Are socially conscious investors paying too high a price for the "good" companies when the bargains are in the "bad" ones? (Over the three year period ending September 30, 2007, the Vice Fund earned an average annual return of 22.38%, versus 13.35% for the S&P. Over that same period, it had a standard deviation of 10.42% (versus 7.52% for the S&P) and a Sharpe ratio of 1.76 (versus 1.22 for the S&P)). Are investors willing to sacrifice returns for the psychic benefits of owning socially responsible companies, or are they asking their advisors to perform a Herculean task: deliver above-average returns from a universe of stocks that may already be overvalued and carry above-average risks?

In the past, socially conscious investors could point to studies confirming market returns, or close to it, to justify their bias. Academic studies comparing SRI portfolios to broad-market indexes have shown mixed results depending on the portfolio in question and the time period being studied. But today's socially conscious investors are not just screening out the classic sin stocks (which tend to do well in a defensive environment as people continue to smoke and drink despite their financial troubles). Rather, they want to help solve the world's problems by investing in companies with sustainable, though unproven,



technologies. Are investors willing to accept the higher risks that come with these emerging 21st Century companies?

Advisors today may be called to do more than simply screen for SRI. In addition to warning clients about the risks of some of the companies their clients want to own, they may need to employ a method of analysis, similar to Allen Gillespie's approach with the Vice Fund, to identify the economic sensitivities of the universe of stocks in question. Gillespie's firm uses [arbitrage pricing theory \(APT\)](#) to measure the impact of a wide range of economic variables on the stocks in his universe. Instead of relying on beta as a single measure of systematic risk, APT decomposes beta into components such as inflation, economic growth rate, investor confidence, and the yield curve, and isolates the effect of each on the risk and return of stocks over a time period. In discussing how APT may be applied to SRI, Gillespie notes as one example the connection between green energy and oil prices. Because alternative energy tends to be more expensive to deliver, you need high oil prices for that strategy to pay off, he says, and APT can determine the extent to which specific stock prices react to changes in oil prices. APT can play a key role in the security selection process of SRI fund managers as they seek to achieve superior risk-adjusted returns and important diversification benefits.

The main thing is not to let clients get so carried away with their commitment to socially responsible investing that they allow it to undermine their financial goals. The answer may be as simple as applying traditional stock analysis -- whichever method you use -- to the universe of stocks you are being asked to manage so that clients won't pay too high a price for investing with their conscience.

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