Universal Investors and Socially Responsible Investors: a tale of emerging affinities

Steven Lydenberg*

This paper posits three types of investors in today's financial markets: Universal Investors, Social Investors and Rational Investors. It argues that the Universal and Social Investor are theoretically inclined to seek returns that benefit society and the environment as a whole, while the tenets of modern portfolio theory lead the Rational Investor to seek returns based primarily on market price. Because of the dominance of modern portfolio theory, the actual practices of the Universal and Social Investor reproduce those of the Rational Investor in most regards today. However, Universal and Social Investors are now pioneering at least three investment practices that promote returns to the economy and society. These are engagement with corporate management, investments that benefit underserved communities, and the setting of social and environmental standards in selecting investments. These practices differ from those of the mainstream in that they deliberately take into account more than market price in seeking returns on investments.

This paper argues that measuring the value of corporations to society solely on their stock price and their ability to raise that price is not only a narrow expression of the value of corporations to society, but a potentially dangerous one. It views Universal and Social Investors as having the potential to build on and improve upon the practices of Rational Investors by developing an expanded and more complete conception of investment returns and of corporations' role in providing those returns.

This paper hypothesises that universal investors and socially responsible investors – two classes of investors whose investment practices are increasingly gaining recognition around the world – share a basic affinity for the promotion of a just and sustainable society. Although the two currently differ in certain regards, together they constitute a theoretically coherent model of investment that builds and improves upon the dominant investment theory and practice of rational investors, which focus primarily on market-based returns.

Part One of this paper explores the theoretical affinities between universal and socially responsible investors and highlights their points of departure from certain aspects of modern portfolio theory. Part Two examines the emerging investment practices that characterise these investors and that distinguish them from their mainstream colleagues.

Keywords: Universal investor, social investor, rational investor, socially responsible investing, social returns, modern portfolio theory, corporate social responsibility, community investing, shareholder activism, stock screening

Part one: theoretical framework

Three types of investors

For the purposes of this essay, I will start by positing three types of investors who exist in theory in the marketplace today.

Building on the work of Hawley and Williams (2000), I use the term *Universal Investor* (UI) to refer to investors of such size that their investments are diversified across all asset classes and across investment opportunities within those asset classes, and therefore can be said to be invested in the economy as a whole.

*Address for correspondence: Domini Social Investments, 155 Coolidge Street, Brookline, MA 02446, USA. Tel: 212-217-1113; E-mail: slydenberg@domini.com

© 2007 The Author
Journal compilation © 2007 Blackwell Publishing Ltd, 9600 Garsington Road, Oxford, OX4 2DQ, UK and 350 Main St, Malden, MA, 02148, USA

Consequently economic growth that lifts the value of all investments, as opposed to the appreciation in the price of a particular investment, is of paramount importance to Universal Investors. Because of their size and diversification, public pension funds are examples of Universal Investors.

Building on the work of Domini (2001), Kinder *et al.* (1994) and Lydenberg (2005), I use the term *Social Investor* (SI) to refer to socially responsible investors who explicitly consider the social and environmental implications of their investments in corporations, or other asset classes, as a useful tool to help create a society that is just and sustainable, healthy and wealthy, while still achieving market-rate returns. Various self-identified socially responsible mutual funds in North America and Europe are examples of Social Investors.

Building on the work of Statman (2005), I use the term *Rational Investor* (RI) to refer to the investor postulated by modern portfolio theory, who places concerns such as optimal diversification, risk and return ratios, beta and alpha, the efficient frontier and efficient markets at the forefront of his or her investment philosophy. The Rational Investor is a development of the second half of the 20th century and is particularly concerned with total return consisting, in the case of equity investing, of stock price appreciation plus dividends.

For Statman, the Rational Investor stands in contrast to the "normal", more risk-averse investor of the first half of the century, who invested primarily in bonds and occasionally in dividend-paying blue-chip stocks. The advances that the Rational Investor has brought to investment theory and practice are those of risk management and diversification (Bernstein, 1996). The Rational Investor is the norm in today's institutional investment world.

These three classes of investor exist in theory and can be distinguished. In practice, however, the tenets of Rational Investors tend to dictate the practices of Universal Investors and Social Investors in the current marketplace. Indeed, the fundamentals of modern portfolio theory, the measurement of financial returns against market benchmarks based on stock price, and the fiduciary duties that tie investment practices to these same benchmarks all complicate decisions by institutional investors today to act other than as Rational Investors.

Two types of returns

For the purposes of this essay, I will further posit that investors in the marketplace can seek returns from two distinct sources.

The first I will call *Returns to the Market* (RM). I define Returns to the Market as a zero-sum game in which winners in the market benefit at the expense of losers, creating above average returns by exploiting temporary market inefficiencies. These inefficiencies occur when stocks are mispriced due to asymmetrical distribution of information, irrational market sentiment or faulty market analysis. The markets also create returns that are part of a zero-sum game when individual companies increase their value at the expense of their peers, when new industries grow by taking proportional market share away from the old, or when the private sector can transfer costs to the public sector. RM is measured through changes in stock price because market inefficiencies are defined as the mispricing of equities.

Measuring Returns to the Market and capturing their relationships to the relative risks of markets and to specific investments is a well-established part of modern portfolio management. Because RM is based on the price of investments, which is readily available in honest, liquid markets, its measurement is relatively easy.

The second type of returns I will call *Returns to the Economy and Society* (RES). Positive RES consists of the returns on investments made by corporations, governments or nongovernmental organisations that lead to the creation of a healthy and wealthy society, one that is just and sustainable. Negative RES is also possible, just as is negative RM. It occurs when – through fraud, corruption or lack of management skills – corporations or governments extract value from the economy and society, creating a poorer, less just and sustainable world. Participants in the stock market can benefit from both positive Returns to the Economy and Society – as the value of the market as a whole rises – and from positive Returns to the Market – as they exercise their particular investment skills relative to their peers.

As used here, the term Returns to the Economy and Society refers in general to investments that add to the overall fundamental value of the marketplace and, in particular, to investments that create spillover effects that add value beyond that of the marketplace. Broadly speaking, RES can be generated by, among other things:

- Innovative goods or services that are ultimately shared broadly throughout society, such as technological advances and new management techniques.
- Advances in environmental sustainability that address global challenges of an increasingly populous and prosperous world, such

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

as increases in energy efficiency and development of renewable energy sources.
- Business practices and public goods that assure all levels of society equal access to products and services crucial to economic development, such as microfinance, affordable health care and the diffusion of information technology.

These spillover elements of RES bear a resemblance to what is sometimes referred to as social return on investment (SROI). However, analyses of SROI often focus primarily on the tangible benefits of economic development – such as jobs created, tax dollars generated and social service costs saved – and only secondarily on the creation of less tangible, broader societal goods.[1]

When companies make investments in their stakeholders that have spillover effects, they create RES for their industry, the economy or society more generally. Post *et al.* (2002), for example, have argued that corporations can generate "sustainable wealth" when they invest in their stakeholder relations. Examples of investments in stakeholders that create RES include the following.

- Training programmes for employees.
- Quality manufacturing and customer service investments.
- Fair trade purchasing programmes for vendors.
- Charitable giving programmes for local communities.
- Taxes paid to government.

Examples of governmental investments that result in positive RES include the following:

- Honest and transparent judicial systems.
- Honest and transparent financial markets.
- Fair and consistent regulatory schemes.
- Inexpensive and efficient transportation systems.
- Widely available education systems.
- Local and national security systems.
- Support for basic research and development.

These investments by government are often described as public goods, and can be created at a national or international level (Kaul *et al.*, 1999). They resemble corporate investments that create RES in the sense that they both create goods that, in the vocabulary of economics, are nonrivalrous – that is, can be shared by large numbers of people at little cost beyond that of their original creation.

According to economic theory, public goods are the proper domain of government. Private corporations do not theoretically have a motivation to invest in public goods since they cannot capture the benefits of these goods solely for themselves. In practice, the line between what is and is not a public good – and who should create it – is drawn differently by different societies. For example, many governments provide universal health care insurance, while some choose not to; some local and national governments provide water services, while in other regions private corporations take on this vital service.

Given their concerns for RES, UIs and SIs should also be more inclined than RIs to debate and consider the appropriate relative roles of government and corporations in creating such goods. RIs certainly care about the relative roles of government and business in the sense that they may advocate public policies that enhance their prospects for increasing RM through the externalisation of business costs onto the public, increased public subsidies for particular industries, freeing business from public regulation, and so on. I would argue, however, that the UI and SI have a greater theoretical interest than the RI in finding the optimally efficient means for creating RES through an appropriately balanced allocation of public and private resources.

* * * * *

Having postulated three types of investors and two types of returns, I will now turn to the question of which types of returns are theoretically of greatest interest to which investors.

Return preferences of Rational Investors

Rational Investors (RIs) operate under the strictures of modern portfolio theory and focus on maximising the total returns of their diversified investments at various levels of risk. For equities, total return is made up of stock price appreciation and dividends. RIs are often more concerned with stock price than dividends, since stock price appreciation has the potential to make up the larger proportion of total return.

The RI can add value to the investment process by capturing RM in at least two ways: through active trading that takes advantage of market inefficiencies (by adding alpha, in the language of today's investment community); and through minimising costs – primarily by reducing fees and transaction costs through market-capitalisation-weighted indexing (Bogle, 2005). Market-capitalisation-weighted index investing is often the preferred strategy of the RI because choosing stock price (i.e. market capitalisation) as the only determinant of the size of individual investment holdings allows for substantial reductions in management fees and transac-

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

tion costs (i.e. elimination of stock analysts and reduced trading). The RIs' dedication to capitalising on market inefficiencies and reducing fees is based on their fundamental belief that stock markets are rationally priced, with occasional inefficiencies arbitraged away by vigilant, active investors.

RIs have an ambiguous and ambivalent attitude toward RES. RIs care about growth of the economy and often react strongly and rapidly in the marketplace to changes in inputs that affect the economy, such as interest rates or oil prices. RIs' investment skills, however, are measured on their performance relative to the marketplace (that is, on beating stock-price-based benchmarks), not on the performance of the overall economy or other social benefits (that is, not on their contributions to RES).

Modern portfolio theory is essentially agnostic on investment managers' effect on the economy. The factors that promote or hinder economic growth – or RES – are considered by today's investment professionals as essentially exogenous to their particular decisions in the financial marketplaces in which they operate. RIs may react to interest-rate changes or swings on oil prices by bidding the financial markets up or down, but they are doing so essentially in the hope of increasing their RM, not to affect the economy or to enhance RES.

Expressed in terms of risk management and diversification, the tools that RIs have developed provide an excellent means of measuring investors' levels of risk and reward relative to markets and to other investors in those markets, but have not developed equivalent tools to measure the effect of their investments on the economy, the environment, or society more generally.

One consequence of this discontinuity that RIs effectively construct between RM and RES is that RIs often find themselves opposed to investments that corporations might make in stakeholders that would create RES at the expense of short-term RM. For example, they may view with scepticism corporate investments such as contributing profits to support local communities, expenditures on job flexibility for employees' balancing of work and family, or costs incurred to protect endangered species – to the extent that these expenditures produce no immediate, quantifiable effect on stock price.

Similarly, RIs, who should in theory want government to increase its provision of public goods because they will benefit the overall economy and hence stock prices in general, can end up advocating positions such as minimal taxes paid to government, decreased governmental regulation and an increased role of government in dealing with various negative externalities that business would otherwise have to bear – all of which constrain government's resources and its abilities to create positive RES.

This is not to say that RIs don't believe that their pursuit of RM has a positive effect on the economy and therefore creates a form of RES. They frequently cite the action of Adam Smith's invisible hand as supporting the contention that the pursuit of self-interest creates economic benefits through the efficient allocation of capital, the creative destruction of outmoded business models, and the discipline of the marketplace. The allure of this invisible hand – and the reason it is called invisible – is that it absolves them of any responsibility to consider or evaluate the effect of their investment decisions on society and the environment. In effect, for RIs, RES ultimately lies outside of their field of vision and is a factor exogenous to their daily decisions.

Return preferences of Universal Investors

Universal Investors should theoretically have no interest in Returns to the Market. RM derived from exploiting market inefficiencies is of no theoretical use since UIs are invested in all asset classes, all industries and all companies. Because RM is by definition a zero-sum game, gains they make in one part of their portfolios by identifying market inefficiencies will only come at the expense of losses they incur in other parts. In addition, UIs should not theoretically always wish to maximise RM through the reduction of transaction costs if additional fees are incurred for investments that lead to increased RES (see Engagement with Corporations below).

By contrast, UIs should theoretically be interested in RES, since RES will increase the overall value of their portfolios. UIs will see benefit from either corporate investments in stakeholders that create RES or similar investments by government that maximise public goods. Theoretically also, UIs are indifferent as to whether government or corporations make investments that create positive RES, since they benefit in either case. For example, playing what they view as a zero-sum game, RIs might advocate corporations pay as little taxes to government as possible to increase RM. By contrast, with their goal of increasing overall RES, UIs might advocate that corporations pay these same taxes if they felt that government could more efficiently increase that RES. In addition, UIs have no theoretical interest in corporations externalising costs onto government because that will divert government funds from investments that can create positive RES.

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

For at least two reasons, pension fund UIs are naturally inclined to consider matters of RES as endogenous, not exogenous, to their investment practices. First, since pension funds have inherently long investment horizons, they have a natural concern for long-term secular increases in RES and should therefore be led to seek to increase RES through their investments. In addition, to the extent that UIs are public pension funds, they are part of governmental structures whose mission is enhancing economic opportunities and quality of life through RES. Therefore, the concept that there is an obligation to create RES should be more easily incorporated into public pension funds' thinking than into that of RIs.

UIs' practice today, however, generally differs from this theory. Large pension funds tend to pursue RM, just like other market participants. They combine stock indexing to reduce management fees with active management to add alpha, across a diverse set of asset classes. They do so for at least two reasons. First, their performance is almost always measured against market-based benchmarks and the relative returns of their peers, rather than against their ability to assure the opportunity for a high-quality of life for their participants upon retirement. Second, the ability to measure and quantify RES is substantially less well developed than for RM. Without easily quantifiable measurements for RES, it is difficult for UIs to use RES as a benchmark for their management skills.

That said, a number of investment practices recently taken up by UIs reflect their broader concerns with RES. Discussed in Part Two below are examples of these emerging practices, which include locally targeted investments; screening portfolios on issues such as weapons of mass destruction, environmental sustainability and human rights; and engagement with corporations on the quality of their management.

Return preferences of socially responsible investors

Social Investors' preferences are essentially aligned with those of UIs, with some minor exceptions. SIs' concern with the creation of a just and sustainable society aligns them naturally with UIs in their interest in promoting RES. That is to say, they do not view RMs as being the primary means through which such a society can be created. Rather, they view corporate investments in the full spectrum of stakeholders, as well as government investments in public goods, as a means to achieving this goal, and therefore as of primary concern.

However, because they are not driven to favouring RES over RM by their size – as in the case of UIs – they are not indifferent to RM. Pursuit of RM that results from such inefficiencies as mistaken market analysis is a desirable goal for SIs. But SIs are not theoretically disposed to pursue RM obtained at the expense of other market participants in ways that undercut the creation of a just and sustainable society. SIs, for example, will not pursue RM generated by exploitation of indigenous peoples or by causing environmental damage. SIs' pursuit of RM is therefore theoretically of a more limited scope than that of RIs, but broader scope than that of UIs.

It can also be argued that in theory SIs differ from UIs in one aspect of how public goods can best be created by the non-corporate world. SIs may have a greater sensitivity to the role of nongovernmental organisations (NGOs) in creating public goods. To the extent that UIs are part of governments themselves, they may naturally focus on government as a source of public goods. SIs may take a greater interest in the role of NGOs in the creation of public goods and may side with NGOs in their criticisms of government when the latter fails in its role of creating positive RES, as well as in their criticisms of corporations.

SIs' interest in promoting RES through corporate investments in a broad range of stakeholders is aligned with that of UIs in the sense that SIs view such investments as likely to produce RES. SIs are also aligned with UIs in viewing favourably governments' investments in public goods. The public goods that governments create are both generally and specifically crucial to the development of a just and sustainable society.

Put differently, SIs' concern for the creation of a just and sustainable society leads them to consider issues of RES as part of their investment responsibilities – that is, as endogenous, not exogenous, to their daily investment practices and the risks and rewards they entail. Like UIs, however, they are also obligated by today's investment performance benchmarks to pursue the same market-based returns as RIs. Discussed in Part Two below are examples of emerging practices of SIs that demonstrate their commitment to RES, such as engagement with corporations on social and environmental issues, investments in local community development financial institutions, and screening portfolios on multiple social and environmental issues.

Summary of theoretical framework

SIs and UIs theoretically view it as their responsibility to use their influence in the

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

Table 1: Theoretical and practical commitments of rational, universal, and socially responsible investors to returns to the market and returns to the economy and society

	Returns to the Market (RM)	Returns to the Economy and Society (RES)
Rational Investor (RI)	Theoretically and practically committed	Theoretically committed, practically indifferent
Universal Investor (UI)	Theoretically indifferent, practically committed	Theoretically committed, new practices emerging
Socially Responsible Investor (SI)	Theoretically and practically committed within social and environmental limitations	Theoretically committed, new practices emerging

marketplace to encourage corporations, governments and NGOs to promote RES. They view corporations, investors, government and NGOs as part of an interconnected system essential for RES. They view RIs' separation of participants in the market, where RMs can be achieved, from participants exogenous to the market, whose responsibility it is to create RES, as artificial and out of sync with reality. For SIs and UIs, corporations, government, NGOs and investors all have an opportunity to increase RES. Limiting investors' role to that of maximising RMs ignores a crucial part of this opportunity. Therefore, SIs and UIs, as opposed to RIs, have a theoretical interest in managing investment risks with respect to the environment and society, and in reaping the rewards that come from managing these risks.

As Sassenou (2006) has recently pointed out, the concepts of sustainable development and corporate social responsibility – and by extension, those of the UI and SI – have an affinity with economic models that account for growth through endogenous factors – such as investments in innovation, human capital and the environment. By contrast, to the extent that RIs view creating RES as the responsibility of those outside the financial markets in which they operate, they share an affinity with those economists and economic models that have relied upon the exogenous to account for economic growth (Warsh, 2006).

Table 1 gives a matrix summarising the theoretical and practical commitments of Rational Investors, Universal Investors and Social Investors to Returns to the Market and to Returns to the Economy and Society.

Part two: emerging practices

The current practices of the UI and SI reproduce in many, even most, regards those of the RI. It is indeed difficult for today's institutional investor to act otherwise for several reasons. Modern portfolio theory is widely accepted within the financial community. Deviations from its accepted beliefs and implied practices therefore appear radical in nature. The performance of institutional investors is almost universally measured against benchmarks based on the market price of securities. Market price is assumed to be a rational benchmark under the efficient market hypothesis. The incorporation of other factors into performance measurement is therefore a major departure from a performance measurement considered to be rational. Furthermore, by extension, modern portfolio theorists have linked fiduciary duty to the maximisation of returns based on market price. Failure to maximise market-based returns is therefore often portrayed as a dereliction of fiduciary duties.

However, concern with the use of financial assets to help in the creation of a just and sustainable society have led UIs and SIs to pioneer at least three practices that differ from those of the RIs. The specifics of these three emerging practices vary and the vocabulary used to describe them differs, but their goals and broad outlines are clear. These practices are as follows.

- *The practice of targeting investments to promote economic growth in underserved regions.* This practice is usually referred to as community investing by the SIs and as economically targeted investing by the UIs in the United States. The field of microfinance, which is rapidly growing around the world, is also part of this practice. I will use the term *community investing* to refer to this practice here.
- *The practice of setting social and environmental standards as criteria for choosing investments.* This practice goes by many different names – social investing, screening, standards set-

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

ting, best of class investing, triple bottom-line investing, sustainable investing, and so on. Institutional investors in Europe currently favour the vocabulary of sustainability. I will use the term *standards setting* to refer to this practice here.
- *The practice of advocating changes in corporate management's policies and practices.* This practice takes many forms, including filing shareholder resolutions (primarily a North American phenomenon, where such resolutions are both easier to file and nonbinding), voting on shareholder resolutions, informal behind-the-scenes dialogue with management, public confrontations with management, and engagement by coalitions of investors to urge industry-wide changes. This practice is often referred to as shareholder activism in the United States and Canada, and as engagement or responsible engagement in the United Kingdom and Europe. I will use the term *engagement* to refer to this practice here.

The history and current implementation of each of the above practices are varied and complicated. I will examine briefly here their most important aspects, comparing the practices of SIs and of UIs, and contrasting them with the general position of RIs. I will not address here the question of whether these practices entail a give-up of returns as measured in the market price of the securities invested in. This question has been addressed in many other venues (Anderson and Smith (2006), Camejo (2002), Statman (2000, 2006), Margolis and Walsh (2001) among others. See also the compilation of academic articles on this subject on the website http://www.sristudies.org, maintained through the Center for Responsible Business at the Haas School of Business at the University of California, Berkeley.). Suffice it to note here that advocates of SI and UI often assert that these practices do not necessitate a give-up of returns, although increases in volatility may be introduced.

Community investing

Both SIs and UIs engage in community investing from a shared belief that it generates RES. Their approaches can be distinguished, but their goal is essentially the same: to invest in communities that lack access to capital or are underserved by the mainstream financial community.

Generally speaking, it can be said that SIs are primarily concerned with the issue of access to capital and therefore tend to invest in community development financial institutions (CDFIs) that operate in underserved communities, or invest in more traditional vehicles that support affordable and low-income housing.[2] SIs in the United States tend to make community investments through direct deposits with community development banks, credit unions and loan funds, or through the securitised affordable housing and small-business lending securities issued by federal agencies.[3]

US pension funds use the vocabulary of economically targeted investment. These UIs are primarily concerned with local economic development and invest in regions in which their participants are concentrated. Their focus is on creating jobs, investing in local affordable housing and supporting local business development through targeted investments. The California Public Employees Retirement System is one example of a public pension fund in the United States that has a long history of making such investments.[4] Union pension funds in Quebec provide another example of such ongoing activities (Fong *et al.*, 2001).

Because they are concerned with RM, RIs essentially don't speak the language of community investing with its RES implications. They may invest in fixed-income products, especially those issued by governmental agencies, that have community development and RES implications, but they do so in the ordinary course of their investing, giving no particular consideration to community development implications.

Microfinance is a rapidly growing aspect of community investing. SIs clearly view it as an opportunity to serve regions and clients historically ignored by the mainstream investment community. A number of mainstream financial institutions, including the likes of Citigroup and Deutsche Bank, are increasingly looking at this as an investment opportunity.[5] To the extent that community investing and microfinance enter the mainstream, they may be said to have influenced RIs.

Standards setting

Standards setting is the practice most often associated with socially responsible investing in the press and in the public eye. For SIs, this practice takes a variety of forms, including:

- A willingness to forego investments in whole industries (e.g. tobacco).
- A willingness to forego investments in particular companies within an industry (e.g. apparel companies whose subcontractors use child labour).
- A willingness to forego investments in companies involved in certain controversies not related to their industries (e.g. South Africa).

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

- A preference for investing in companies with the most positive social and environmental records in their industry (e.g. sustainability leaders).
- A preference for companies providing solutions to substantial societal challenges (e.g. energy efficiency).

Although these approaches differ, they share a common concern with maximising positive RES and minimising negative RES.

SIs adopt standards setting as a core practice in their equity investments. SIs in the United States are particularly well known for their willingness to avoid entire industries. European investors place more emphasis on investing in selected companies within industries – either companies with the best social, environmental and sustainability records (a methodology adopted by the Dow Jones Sustainability Indexes, for which the Swiss research organisation SAM Group provides research) or choosing those that meet certain basic international standards and norms (a methodology adopted by the FTSE4Good Index global series, for which the British research organisation EIRIS provides research).[6]

UIs have a history of anecdotal application of standards setting. For public pension funds, these standards have historically been set by legislative action, not through voluntary adoption of these policies by the investment professionals involved. For example, the most widespread applications of standards setting among UIs in the 1980s and early 1990s was the South Africa divestment movement driven by legislation at various governmental levels. Currently a number of US public pension funds have divested from companies with operations in Sudan. These divestment policies are driven explicitly by a concern for the creation of just societies. Similarly, certain Swedish and Danish pension funds have investment policies that screen out companies that do not comply with the spirit of international treaties to which their national governments are signatories – indicating a concern by these UIs with widely accepted principles of justice and sustainability.[7]

The most ambitious programme of standards settings by a European institutional investor today is that of the large Norwegian state pension fund. Starting in 2005, at the direction of its legislature, the Norway national pension fund began imposing several standards on its equity investments, including what amount to screens on producers of weapons of mass destruction and companies with records of human rights violations. To date, only a relatively limited number of companies have been eliminated by these screens, but the pension plan is nevertheless the largest single pool of assets to which social standards are being applied.[8] In the United States, broad-based standards setting has been incorporated by TIAA-CREF into its CREF Social Choice Account, which as of year-end 2005 had assets of approximately US$7.8 billion. This option is available to interested CREF participants. It represents only a small portion of TIAA-CREFs total of over US$360 billion in assets, but it is nevertheless among the largest investment pools in the US to which social standards are currently systematically applied.[9]

RIs often strongly resist any explicit practice of standards setting based on social or environmental factors. In part they do so because such standards contradict a basic principle of modern portfolio theory – the assertion that limiting the opportunities for diversification will limit the possibilities for maximal risk-adjusted returns. Advocates of SRI may counter that most mainstream investment disciplines – value investing, small-cap investing, investing in emerging markets – inherently limit investment universes, but are still widely accepted investment practices. Nevertheless, RIs often view further social and environmental limitations within these investment styles as limiting managers' abilities to maximise returns in relation to their benchmarks.

RIs also have a philosophical bias against standards setting to the extent that it resembles public policy or politics. For example, state pension fund managers in the United States might well argue that they should be permitted to invest in tobacco companies to maximise RM, although other branches of their government might simultaneously be suing these same tobacco companies for abusive advertising or be conducting smoking cessation programmes. Their responsibility as RIs is to maximise RM, no matter what public policy decisions are being made outside the limits of the financial markets. To the RI, because RES often looks like public policy, it should be avoided – even if there is an obvious cost to society.

This is not to say that RIs are opposed to taking public policy positions when it comes to their interests in the financial marketplace. Like other industries with trade associations, they will advocate legislation and regulation that facilitate their business. They will advocate public policy changes that will allow them to increase RM, if not RES. Nor is it to say that individual members of the mainstream financial community are reluctant to speak out on their political views as individuals, separate from their investment activities. Rather, it is to say, that RIs advocate separating personal political opinions from investment practice

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

because fiduciary duty forbids fiduciaries from using clients' funds for personal purposes. They consequently view with suspicion mixing something that looks like personal politics with investment decisions. In essence, RIs are inclined to equate aspects of RES with personal politics and divorce them from their overall fiduciary duty to enhance clients' returns.

Engagement with corporations

Engagement with corporate management has historically played a crucial role in the investment process for SIs and UIS and continues to do so today. In fact, it can be argued that engagement is the widest spread of the three practices pioneered by SIs and UIs.

As it emerged in the 1970s in the United States, engagement was known as shareholder activism and focused on the filing of shareholder resolutions on social and environmental issues and concurrently on the development of voting policies on these resolutions. Vogel (1978) has provided a detailed account of these early years.

In the United States, and in recent years in Canada as well, filing shareholder resolutions is a relatively simple and straightforward process, with these resolutions being only advisory in nature. Over 100 resolutions on social and environmental issues come to a vote at US corporations each year, and many more on corporate governance issues. Historically, religious organisations, SRI mutual funds, NGOs and concerned individuals have focused their resolutions on social and environmental issues. Large pension funds and trade unions in the United States have concentrated primarily on corporate governance issues, to the extent that they have used the shareholder resolution process.[10]

In the United Kingdom since the late 1990s, engagement through dialogue – as opposed to the more confrontational shareholder resolution process – on sustainability and corporate governance issues has become a core practice for many large money managers. In part because filing shareholder resolutions is more difficult there than in the United States and Canada and in part because large institutional investors in the United Kingdom are more willing to commit themselves to the concept of sustainability, major insurance and money management firms such as F&C Asset Management, HBOS (Insight Investment), and Aviva (Morley Fund Management) are now proactively raising social, environmental and corporate governance issues through dialogue with the management of hundreds of corporations each year.[11] Engagement, in fact, is their primary means of raising these issues, more so than standards setting or community investing.

In contrast to community investing and standards setting, engagement is a tactic that RIs are also increasingly adopting in ways that bear distinct similarities to the practices of UIs and SIs. Until the 1980s, the conventional wisdom was that RIs should practice the Wall Street Walk – if you don't like management, sell the stock. In theory, selling shares sends signals that will communicate to management through the market (exit, in the language of Hirschman (1970)), rather than discussion and dialogue (voice). In practice, however, what is communicated by selling shares is not always clear.

Starting in the 1990s, institutional investors – primarily pension funds, but also increasingly hedge funds – acting in their role as RIs concerned with maximising stock price appreciation, began to take a more active role in raising corporate governance issues. Using the language of RM, they argue that improving corporate governance can improve management and therefore stock price. For example, this form of activism is a core strategy of relationship investing as it has been practised by LENS and Relational Investors. In addition, the Focus List of corporations that are poor financial performers issued by the Council of Institutional Investors each year looks to encourage engagement with these firms in order to improve their stock price.[12]

This form of engagement, however, is not a zero-sum game, because it doesn't follow the usual RI practice of always minimising fees. Engaging with corporations takes extra time and expense. Nor does it follow the usual RI practice of exploiting market inefficiencies. The stocks of these poorly performing companies are presumably priced correctly.

Consequently, activist RIs find themselves riding that same uncomfortable line that UIs and SIs often find themselves on – that of benefiting others at their own expense. This "free rider" dilemma is often brought up with regard to the activist UI and SI because their engagement practices imply a willingness to incur expenses to enhance RES that benefits society as a whole, which represents a huge number of free riders. Activist RIs increasingly appear willing to adopt a similar tactic with individual poorly performing corporations, although their free riders are confined to other owners of a company's stock.

Institutional investors working with the environmental advocacy group CERES and the Investor Network on Climate Risk (INCR) are also blurring the line between RES and RM. The state and local pension funds that

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

form the core of the INCR membership are raising questions with energy companies and utility companies about the financial implications of climate risk. To the extent that these initiatives result in better company practices and improved stock price, this is an activity of the RI seeking RM. However, to the extent that broader issues about the environment and society are being raised, it is the activity of the UI seeking to effect RES.

Future implications

Although modern portfolio theory has brought major advances to measuring of risks and rewards relative to the financial marketplace, it has not developed similarly sophisticated tools to measure the risks and rewards of investment decisions beyond that marketplace. The focus on returns to the marketplace creates an elegant, self-enclosed and mechanical system based on a readily available and measurable metric – stock price. In their pursuit of maximising returns relative to benchmarks based on stock price, however, Rational Investors appear to ignore the benefits of making investments that help create a just and sustainable world.

The measurement of the value of corporations to society solely on their stock price and their ability to raise that price is not only a narrow expression of the value of corporations to society, but a potentially dangerous one, as the seemingly endless string of recent corporate scandals triggered by the pursuit of stock-price maximisation has shown.

The theory and practice of Universal Investors and Social Investors provide a more robust and vital means of assessing the range of values of contemporary corporations to society. I view Universal Investors and Social Investors as aligned in their concern for this more complete and organic means of assessment and propose categorising them both as Complete Investors (CIs). The strength of CIs is their willingness to evaluate Returns to the Economy and Society, along with Returns to the Market when appropriate. However, their ability to effect these evaluations is currently limited in that Returns to the Economy and Society are difficult to measure and to capture.

That stock price alone is not an adequate measurement of the value of corporations to society today is an assertion increasingly finding its way into the mainstream. The recent proposals by Arnott *et al.* (2005) to create what they call fundamental indexes based on valuations that incorporate more than just stock price indicate one level of discomfort with the excessive weight given today to stock price as a means of valuing corporations.

If Complete Investors are to build on and improve upon the practices of Rational Investors, however, they must supplement their current practices of standards setting, engagement and community investing with the development of a sophisticated and robust set of measurement tools for Returns to the Economy and Society.

Conclusion

Universal Investors and Social Investors are sufficiently similar in theory and practice to describe them as embodying a single style of investor, the Complete Investor. As these two practitioners continue to evolve their theory and practice, they are likely to lend greater legitimacy to Returns to the Economy and Society within the mainstream investment community. As Returns to the Economy and Society become more thoroughly incorporated into the mainstream in the first half of the 21st century, Universal and Social Investors will provide an important amplification of the theory and practice of Rational Investors, which have come to play such a dominant role during the last half of the 20th century.

Notes

1. See REDF's website for a discussion of social returns on investment (http://www.redf.org/results-sroi.htm). See also Jed Emerson's website on blended value for an elaboration of this concept (http://www.blendedvalue.org) (accessed March 2007).
2. See the US Treasury's website (http://www.cdfifund.gov) for a definition of community development financial institutions and programmes that support them.
3. See the website of the US Social Investment Forum for details on its 1 per cent for Community Investing program (http://www.socialinvest.org) (accessed March 2007).
4. See the website of the California Treasurer's Office for details on its Green Wave programme that integrates environmental considerations into its investments across multiple asset classes (http://www.treasurer.ca.gov/greenwave/020304_enviro.pdf) (accessed March 2007).
5. For further details, see the websites of Citigroup and Deutsch Bank (http://www.citigroup.com/citigroup/citizen/microfinance/index.htm and http://www.deutsche-bank.de/csr/en/index_3247.html) (accessed March 2007).
6. See the website of SAM Group (http://www.sam-group.com/htmle/research/philosophy.cfm) for a discussion of its research philosophy and best-of-class approach. See the website

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007

of FTSE4Good (http://www.ftse.com/Indices/FTSE4Good_Index_Series/Index_Rules.jsp) (accessed March 2007) for a discussion of the rules by which it maintains its indexes.
7. See the website of the Swedish AP1 fund (http://www.ap1.se/templates/AP1_Normal.asp?id=2368) for a discussion of its social and environmental standards. See the website of EIRIS (http://www.eiris.org/files/press%20releases/atppensamapr05.pdf) (accessed March 2007) for a description of the Danish initiatives.
8. See the website of Norges Bank Investment Management (http://www.norges-bank.no/nbim/corporate/article-afteposten-january2006.html) (accessed March 2007) for a discussion of this initiative.
9. See TIAA-CREF's 2005 Annual Report (http://www.tiaa-cref.org/pdf/annual_reports/annualreport.pdf) (accessed March 2007).
10. See the website of the Interfaith Center on Corporate Responsibility at (http://www.iccr.org/shareholder/proxy_book06/06statuschart.php) (accessed March 2007) for details on its coordination of the filing of shareholder resolutions and its Ethvest database that provides historical data on these resolutions.
11. See the websites of F&C Asset Management (http://www.fandc.com/new/aboutus/Default.aspx?id=63796) and HBOS' Insight Investment (http://www.insightinvestment.com/responsibility/investor_responsibility_home.asp) (accessed March 2007) for links to their comprehensive reports on their engagement activities.
12. Members of the Council of Institutional Investors may have access to this Focus List (http://members.cii.org/dcwascii/web.nsf/doc/2006_focus_list.cm) (accessed March 2007).

References

Anderson, J. and Smith, G. (2006) A Great Company Can Be a Great Investment, *Financial Analysts Journal*, 62, 86–93.

Arnott, R. D., Hsu, J. and Moore, P. (2005) Fundamental Indexation, *Financial Analysts Journal*, 61, 83–99.

Bernstein, P. L. (1996) *Against the Gods: The Remarkable Story of Risk*. New York: John Wiley & Sons, Inc.

Bogle, J. C. (2005) *The Battle for the Soul of Capitalism*. New Haven, CT: Yale University Press.

Camejo, P. (2002) *The SRI Advantage: Why Socially Responsible Investing Has Outperformed Financially*. Gabriola Island, British Columbia: New Society Publishers.

Domini, A. (2001) *Socially Responsible Investing: Making a Difference While Making Money*. Chicago, IL: Kaplan Publishing.

Fong, A., Hebb, T. and Rogers, J. (ed.) (2001) *Working Capital: The Power of Labor's Pensions*. Ithaca, NY: Cornell University Press.

Hawley, J. and Williams, A. (2000) *The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic*. Philadelphia, PA: University of Pennsylvania Press.

Hirschman, A. O. (1970) *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations and States*. Cambridge, MA: Harvard University Press.

Kaul, I., Grunberg, I. and Stern, M. A. (1999) Defining Global Public Goods. In I. Kaul, I. Grunberg and M. A. Stern (eds) *Global Public Goods: International Cooperation in the 21st Century*. Oxford: Oxford University Press.

Kinder, P., Lydenberg, S. D. and Domini, A. L. (1994) *Investing for Good: Making Money While Being Socially Responsible*. New York: HarperBusiness.

Lydenberg, S. (2005) *Corporations and the Public Interest: Guiding the Invisible Hand*. San Francisco, CA: Berrett-Koehler.

Margolis, J. D. and Walsh, J. P. (2001) *People and Profits? The Search for a Link Between a Company's Social and Financial Performance*. Hillsdale, NJ: Erlbaum.

Post, J. E., Preston, L. E. and Sachs, S. (2002) *Redefining the Corporation: Stakeholder Management and Organizational Wealth*. Stanford, CA: Stanford Business Books.

Sassenou, N. (2006) Développement Durable et Responsabilité Sociétale de l'Entreprise: Apport de la Théorie Économique, *Revue d'Économie Financière*, 85, 49–62.

Statman, M. (2000) Socially Responsible Mutual Funds, *Financial Analysts Journal*, 56, 30–39.

Statman, M. (2005) Normal Investors, Then and Now, *Financial Analysts Journal*, 61, 31–37.

Statman, M. (2006) Socially Responsible Indexes: Composition, Performance, and Tracking Error, *The Journal of Portfolio Management*, Spring, 100–109.

Vogel, D. (1978) *Lobbying the Corporation*. New York: Basic Books.

Warsh, D. (2006) *Knowledge and the Wealth of Nations: A Story of Economic Discovery*. New York: W.W. Norton & Co.

Steven Lydenberg is Chief Investment Officer for Domini Social Investments LLC. He has been active in social investing for 30 years as Director of Corporate Accountability Research with the Council on Economic Priorities, Investment Associate with Franklin Research and Development Corporation (now Trillium Asset Management), and Director of Research with Kinder, Lydenberg, Domini & Co. (now KLD Research & Analytics). Mr Lydenberg is the co-author of *Rating America's Corporate Conscience* (Addison-Wesley Publishing, 1986) and *Investing for Good* (Harper Collins, 1993), a guide for socially responsible investors, and co-editor of *The Social Investment Almanac* (Henry Holt & Co., 1992). He is the author of *Corporations and the Public Interest: Guiding the Invisible Hand* (Berrett-Koehler, 2005). He holds degrees from Columbia College and Cornell University and is a Chartered Financial Analyst (CFA).

© 2007 The Author
Journal compilation © Blackwell Publishing Ltd. 2007