How Socially Responsible Investment (SRI) Could Redefine Corporate Excellence in the 21st Century

by Masahiko Kawamura
Social Development Research Group

The concept of socially responsible investment (SRI) has recently been gaining prominence. Briefly stated, it refers to the practice among investors of investing in companies that act responsibly with regard to legal compliance, human rights, the environment, and other socially important issues.

This paper describes developments in SRI in Japan and abroad, and examines the possibility that it could actually redefine the criteria of corporate excellence for the 21st century.

1. Interest in SRI Begins to Grow

(1) The Low Awareness of SRI in Japan

One measure of the level of interest in SRI is the number of articles appearing in the four major Nikkei business newspapers. While still small, the number has grown from zero articles up through 1989, to 10 articles from 1990 to 1995, 19 articles from 1996 to 2000, and 14 articles in the first 11 months of 2001 (Figure 1).

This contrasts sharply with the large increase in articles on eco funds (a type of SRI, described below), which were first sold in Japan in 1999. These funds were practically unknown in Japan before then.

The significant difference in level of interest warrants an explanation. Eco funds emerged and drew attention as environmentally responsible financial products (investment funds). On the other hand, very few SRI funds, which have a social and ethical emphasis, have actually been offered in Japan, and the SRI concept itself is also not widely recognized.

However, against the backdrop of recent corporate financial scandals, as well as concerns about returns on the new defined contribution plans (the Japanese-style 401(k) plan), there has been a growing movement to evaluate companies from a social perspective based on sustainability and corporate governance.

Figure 1 Number of Newspaper Articles on SRI and Eco Funds in Japan

Year	SRI	Eco fund
2001 *	14	67
2000	6	85
1999 *	10	82
1998	2	3
1997	1	0
1996	0	0
1990-95 *	10	0
1989 and earlier	0	0

Notes: Valdez Society releases "Green Portfolio" in 1994. Japan's first eco fund is sold in 1999. For 2001, article count covers January to November.
Source: Four major business newspapers published by Nikkei Shimbun.

(2) 100-Year History of SRI in the West

In the West, where a strong concern exists for social issues such as human rights, employment, and the environment, there has long been an investment style that not only seeks monetary returns, but considers the social and ethical implications of such investment. This is what is called socially responsible investment.

SRI has a history of 100 years in the U.S., and total assets currently amount to $2.3 trillion. Its roots can be traced back to the start of the 20th century, when a certain Christian denomination, for religious and ethical reasons, decided not to invest donated assets in companies associated with alcohol, tobacco, and gambling. The first investment fund to adopt a socially responsible investment portfolio was the Pioneer Fund established in 1929. While SRI grew modestly, significant expansion did not occur until the late 1990s, when SRI caught the attention of large institutional investors (investment funds such as the Calvert Group, as well as pension funds such as CalPERS).

In the U.K. as well, SRI began in the 1920s when churches refrained from investing in companies connected with tobacco, alcohol, gambling, and weapons. While other social issues were later added to the investment criteria, not until recently did an SRI approach with environmental criteria become widespread. When the first socially responsible investment trust (ethical fund) was marketed in 1984, analysts estimated the potential SRI market to be £2 million at most. However, by the end of 2000, the market had grown to £3.7 billion, almost 2,000 times greater than the initial estimate.

(3) Backdrop to the Growth of SRI Funds

An important factor behind the rapid expansion of SRI in the U.S. was the growing recognition that SRI does not necessarily entail sacrificing returns. For example, the Domini Social Equity Fund, established in 1991 as a tracking fund for KLD's Domini 400 index of socially responsible companies (a stock index of 400 companies not engaged in defense or nuclear energy, and that meet criteria regarding work, employment, and the environment), was able to outperform the S&P 500 at the time.

SRI investment returns have been debated in the U.S. since the 1970s. Until the 1980s, SRI funds, which mainly focused on Christian ethical values, did not always perform well, and were regarded with skepticism by performance-oriented traditional investors. But during the 1990s, the Domini 400 index on the whole outperformed the S&P 500. According to a study released by the Social Investment Forum (SIF) in November 2001, a larger proportion of social funds earned Morningstar's four-star and five-star ratings than did ordinary funds.

In addition, another factor behind the expansion of SRI was the introduction of 401(k) defined contribution plans.

2. Definition of Socially Responsible Investment

(1) Definition of SRI

A textbook definition of SRI might read as follows: it is an investment approach which, in addition to conventional financial criteria, evaluates and selects companies based on social and ethical criteria such as legal compliance, employment practices, human rights, consumer issues, contribution to community, and environmental issues, while seeking stable returns. However, SRI also includes financing motivated by social justice and community contribution, and the exercise of shareholders' rights.

Recently, SRI is being understood as the process of promoting investment in companies that meet some form of criteria for corporate social responsibility (CSR). CSR refers to business practices that are characterized by extensive disclosure and transparency, which companies initiate to fulfill ethical responsibilities toward employees, communities, and the environment. The emphasis is on creating not only sustainable shareholder value but sustainable social value.

From the above definition, Japan's Eco funds, which focus on the environment, are clearly a type of SRI fund. Funds based on environmental criteria are actually quite new in the West, not appearing until the 1990s. We next turn to the present status and changes in investment criteria for SRI.

(2) The Diversity of SRI Investment Criteria

Investors and money managers have a variety of views regarding SRI investment criteria. In particular, the practice of eliminating from consideration companies related to alcohol, tobacco, gambling, weapons and nuclear energy is called negative screening. Another approach called positive screening actively seeks out companies that excel in specific categories such as contribution to society or environmental preservation.

For historical reasons, many funds in the U.S. practice negative screening for tobacco, alcohol and gambling; in particular, almost all funds shun tobacco investments. Moreover, many funds have adopted criteria on the environment, human rights, employment, and weapons, as well as on issues related to labor, animal testing, and community (Figure 2). In actual practice, approximately 90% of funds have adopted criteria in three to four categories, while few have adopted only a single category.

Figure 2 Investment Criteria of SRI Funds in the U.S.

Adopted by at least 50% of funds	Adopted by 30% to 50% of funds	Adopted by less than 30% of funds
Tobacco	Working conditions	Executive compensation
Environment	Use of animals in experiments	Abortion
Human rights	Investment in community	Contraception
Employment	Contribution to community	International labor standards
Gambling		
Alcohol		
Weapons		

Source: Social Investment Forum, *2001 SRI Trends Report.*

In Europe as well, similar investment criteria have been established as in the U.S., though not as broadly. In the U.K., a specified negative screening is combined with several categories of criteria. On the continent, the emphasis on labor issues is somewhat stronger (working conditions, work environment, participation in management, job stability, training & development, etc.), and there is also opposition to recombinant DNA foods and global companies (such as automobiles and aerospace).

Japan's eco funds use only positive screening, presumably based on the rationalization of rewarding pro-environment companies. The avoidance of negative screening reflects the Japanese corporate custom of valuing harmony and avoiding confrontation. However, in the future, to better accommodate investors' diverse social concerns, we expect funds to increasingly reflect the explicit values of Western money managers.

(3) Changes in SRI Investment Criteria

Let us examine changes in SRI investment criteria over the years by looking at the U.S. case. As mentioned earlier, SRI first appeared a century ago when Christian denominations decided to avoid certain industries when investing their assets. While this basic negative screening approach still exists today, investment criteria have changed significantly in response to changes in society. During the Vietnam war in the 1960s, anti-war investors shunned defense industries. The consumer movement of the 1970s stimulated shareholder advocacy and brought attention to shareholder propositions. From the late 1970s to 1980s, companies operating under South Africa’s apartheid regime were spurned. In the 1990s, social criteria for investment broadened to include work conditions, employment issues, animal experiments, deforestation, toxic chemicals, and other issues.

In the late 1990s, distortions cause by globalization in the post-Cold War era became apparent. Global companies that had moved their factories to developing countries were seen as exploiting local workers with deplorable working conditions and cheap wages. Labor unions and human rights groups monitored companies’ activities, and urged consumers to boycott products of offenders. A sensational case was Nike’s use of Vietnamese child labor. This revelation drew protests from members of Congress, and in April 1998 triggered demonstrations in the U.S. and Europe. Seeking to protect its brand image and quell the problem as quickly as possible, Nike was forced to raise the minimum wage and working age of employees in Asia.

(4) The 3 Types of SRI

While the above discussion has focused on SRI funds, there are actually three categories of SRI. However, the three are mutually related, and cannot always be implemented separately.

1. Screening

This refers to the practice by investment trusts such as mutual funds of selecting companies for investment based on specific social, ethical, or environmental criteria. There are generally two types of screening: positive screening, or actively seeking out companies that are favorable from the perspective of social responsibility as well as expected returns, and negative screening, or deliberately eliminating from consideration companies that, for example, make products or conduct activities that are environmentally damaging.

2. Shareholder advocacy

Shareholder advocacy refers to the exercise of shareholders’ rights to make companies act more socially responsible. More specifically, it means directly confronting management on social or environmental issues, as well as earnings, by applying pressure or support. Voting rights are also exercised at shareholders’ meetings as needed. Shareholder advocacy is increasingly being implemented in conjunction with screening.

3. Community investment

Community investment, also called targeted investment, refers to financing community development in cases where financial institutions would not ordinarily provide any. Investors provide financing at market interest rates or less (or even at zero interest) for improvement projects in these communities. Project objectives can include creating jobs, extending loans to low income households or small businesses, expanding the housing supply, providing child care, and so forth.

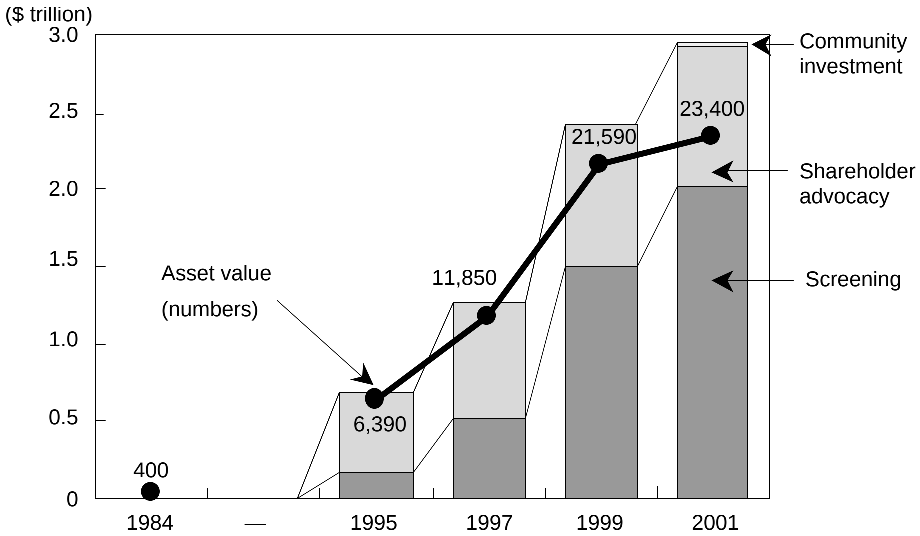
3. The Present Status of SRI in the U.S.

(1) SRI Market Size

The value of SRI assets under management in the U.S. has expanded significantly, particularly in the 1990s. The market grew from $40 billion in 1984 to $639 billion in 1995 — a 16-fold increase in 11 years — before quadrupling over the next six years to $2.34 trillion in 2001. Growth was particularly strong from 1997 to 1999 due to the entry of large institutional investors. The share of SRI assets in total assets under management in the U.S. has gradually increased, and has stayed at 13% since 1999.

While the three SRI categories of screening, shareholder advocacy, and community investment have all grown, the composition has changed significantly due to the pronounced growth of screening: a13-fold increase from $162 billion (comprising 25% of SRI) in 1995 to $2.3 trillion in 2001 (87% of SRI). Screening consists of investment trusts (mutual funds) and separate accounts, both of which have grown at least 10-fold since 1995. Individual accounts, which comprise the majority of screening, grew sharply from 1997 primarily among religious groups, state governments, labor unions, foundations, universities, and insurance companies (Figure 3).

Figure 3 SRI Assets Under Management in the U.S.



By Category ($ billion)

Year	Screening	Shareholder advocacy	Community investment
1995	162.0	529.0	4.0
1997	529.0	736.0	4.0
1999	1,497.0	922.0	5.4
2001	2,030.0	906.0	8.0

By Screening Type ($ billion)

Year	Screening total	Investment trust	Separate account
1995	162.0	12.0	150.0
1997	529.0	96.0	433.0
1999	1,497.0	154.0	1,343.0
2001	2,030.0	153.0	1,870.0

Note: Total assets are less than the sum of screening and shareholder advocacy due to overlapping.
Note: Separate accounts refer to screening by institutional investors. For all years, numbers represent assets under management as of November.
Source: Social Investment Forum, *2001 SRI Trends Report.*

(2) SRI Case Study: CalPERS

In the U.S., pension funds and other institutional investors have aggressively addressed corporate governance from the perspective of corporate social responsibility. The California Public Employees' Retirement System (CalPERS), which has $158 billion in assets, is famous for being a vocal shareholder in over 1,600 U.S. companies. If a company has corporate governance problems or disappointing stock prices or business results, CalPERS will aggressively seek management reforms. And if the company fails to respond, CalPERS will increase its shareholding to gain a stronger voice in management.

Thus far, most SRI in the U.S. has been limited to U.S. companies. However, last year CalPERS set aside $1.7 billion for the active management of corporate governance investment (bringing the total to $3 billion). Of this, $400 million was allotted for Japan, and since the concept of corporate governance has been spreading in Japan, seeks to increase investment returns while actively participating in corporate management. In the past, CalPERS had managed corporate governance investment passively by tracking stock indexes. With active management, CalPERS is acting as an investor by interacting with management, directors, and shareholders to encourage actions that will boost stock prices.

America’s largest private pension fund, TIAA-CREF (Teachers Insurance and Annuity Association College Retirement Equities Fund, with $300 billion in assets), is another hands-on institutional investor. But due to the fund’s large size, most of its shareholdings — encompassing 4,500 companies in 33 countries — are passively managed. However, at over ten shareholders’ meeting last year, including that of a truck manufacturer, the fund proposed the appointment of outside directors.

In Japan as well, it is hoped that institutional investors come to exercise their influence as shareholders and play a role in corporate governance.

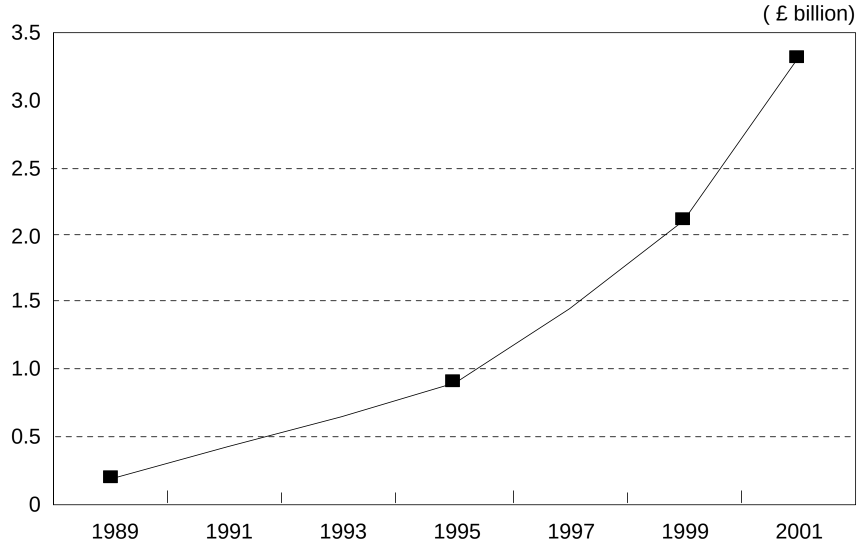
4. Present Status of SRI in Europe

(1) SRI Market Size

Overall, Europe has over 220 SRI screened funds with a total asset value of 11 billion euros. By country, the leading country is England with 54 funds, followed by Sweden with 42 funds, Switzerland with 22 funds, France and Belgium each with 14 funds, and Germany with 11 funds.

In England, the market size of SRI funds stood at £200 million around 1990, and subsequently surged as in the U.S. to £3.7 billion by the end of 2000, and £5 billion by the end of 2001. However, the share of SRI funds in all investment funds is approximately 1% (Figure 4).

Figure 4 SRI Market Size in the U.K.



Source: Compiled from materials provided by Mr. Eiichiro Adachi

(2) Expansion of SRI Market Due to Pension System Reform

As a result of pension system reforms recently undertaken in Europe, pension fund managers will have to disclose their basic policies toward socially responsible fund management. This requirement reflects the aim of policymakers to ensure the long-term stability of pension fund management.

Under England’s pension law revision of 1995, from July 2000 pension managers must disclose their basic policies on the weight attached to environmental, social, and ethical investment criteria, and on the exercise of voting rights (however, the law does not directly call for SRI).

In support of this measure, the Association of British Insurers (ABI) announced SRI disclosure guidelines to help institutional investors obtain relevant information from listed companies (*Investing in Social Responsibility — Risks and Opportunities*, October 2001). Importantly, the guidelines ask whether companies have “identified and assessed the significant risks to the company’s short and long term value arising from social, environmental and ethical matters, as well as the opportunities to enhance value that may arise from an appropriate response.” The association exercises considerable clout, thanks to its elite membership of approximately 400 major insurers who represent over 20% of the U.K.’s market capitalization.

Specifically, the guidelines call for listed companies to disclose eight items, including the impact of social, environmental, and ethical matters on the company’s value, what risk management systems are in place, and the leadership role taken by the board of directors. Thus aspects previously regarded as peripheral to company value have gained prominence. Morley Fund Management, an affiliate of the

U.K.'s largest insurer, CGNU, basically will not approve annual reports of companies that do not release environmental and human rights reports.

Germany revised its pension system law in July 2001 in an effort to save the troubled pension system. Under the new law, managers of individual and institutional pensions must report how much consideration they give to ethical, social and environmental investment criteria in fund management. Similar developments are occurring in France, Ghana, Australia, and New Zealand.

To promote CSR by integrating the diverse approaches of member countries, the European Commission released a "Green Paper Promoting a European Framework for Corporate Social Responsibility" in July 2001 for public comment.

5. Present Status of SRI in Japan

(1) Initial Stage of Development

The SRI market has just begun in Japan. With almost ten SRI funds — mostly eco funds —now available in Japan, the existence of these funds is significant in itself. While undeveloped compared to the West, the market is expected to grow as products with clearer, more diverse CSR criteria emerge. The growth may also be spurred on the demand side as investors become more familiar with the market.

In this context, it is noteworthy that the research group of Professor Iwao Taka of Reitaku University has announced a corporate evaluation framework focused on corporate integrity called R-BEC001. Evaluation categories include management's stance toward CSR, ethical policies, implementation plans, internal systems, and risk management for legal compliance failure.

(2) Exercise of Voting Rights by Institutional Investors

As mentioned earlier, institutional investors in the West are vocal shareholders, and are increasingly exercising their influence in Japan as well. Last year, CalPERS exercised voting rights at 127 annual shareholders' meetings in Japan. At 60 companies, they voted against items such as the choice of auditors and directors' bonuses, they say, so as to better effect U.S.-style corporate governance and maximize shareholders' interest.

Stimulated by such actions, domestic pension funds have also started to exercise voting rights. The Pension Fund Association released its "Working Guidelines for the Exercise of Voting Rights," which calls for fund managers to actively exercise voting rights as part of their fiduciary duty, and to report such activity. Similarly, the Pension Fund Association for Local Government Officials, a major public pension fund with ¥13 trillion in assets under management, added to its pension management policy statement the exercise of voting rights, and a check list for monitoring such things as profit distributions to shareholders and composition of board of directors.

Other than the exercise of voting rights, there is also a movement among institutional investors to make their investments based on environmental and social considerations. In December 2000, the Tokyo Teachers' Mutual Aid Association began operating its own eco fund as a designated monetary trust (¥1 billion in assets under management), with investment criteria focusing on education and the environment. Moreover, in February 1999, the federation stated in its "Environmental Guidelines" that it will consider investments in eco funds.

6. Conclusion

(1) SRI Will Alter the Flow of Funds in Society

Regardless of the particular form, SRI offers a way for investors to express their own social priorities — whether for social justice, economic development, world peace, or environmental preservation — based on how they invest. By changing where funds are invested and altering the condition of companies, SRI can transform markets and the flow of funds in society.

(2) SRI and Corporate Excellence in the 21st Century

In the past, corporate excellence has been defined in terms of product quality, price, delivery time, and profitability. However, this definition will no longer suffice in the 21st century; excellent companies not only must pursue economic rationality, but social and environmental rationality. Stated differently, market valuation will reflect the relationship of companies to society, as well as their underlying integrity and ethical values. In this sense, SRI promises to be a powerful tool for redefining excellent companies in the context of their social existence.

In Japan, the SRI era has just begun. Due to poor management transparency, more time will be needed for it to become entrenched. However, as SRI grows, funds with clearly stated investment criteria and superior disclosure will have a competitive advantage. The investment sense of investors will also be tested.

(3) SRI Criteria Unique to Japan

While we have primarily discussed the long-established SRI of the West, perspectives on corporate social responsibility and contribution to society — the basis of SRI criteria — clearly vary considerably depending on a country or region's history, culture, religion and other factors. Although some values are shared, others cannot be directly introduced into Japan. Thus for SRI to spread in Japan, CSR concepts unique to Japan need to be formulated. Several such efforts are already underway, including the R-BEC001 approach described earlier.

It may be instructive to refer to SRI criteria from Hong Kong. To better promote the growth of SRI, Kingsway Fund Management's SRI Value Screen only contains criteria that are acceptable to society in general. For example, alcoholic beverage companies are not ruled out, but tobacco companies are. With respect to gambling, privately operated casinos are ruled out, but company-operated ones that have mass appeal and engage in donations and charity work are ruled in.

The U.S. has been called an economy that invests, and Japan an economy that saves. When people in Japan save money in Postal Savings or banks, few probably ever wonder how their funds are invested. But as underscored by the introduction of 401(k) defined contribution plans, now is an era where the investment of personal assets entails individual responsibility.

For this reason, there is nothing wrong with self expression when it comes to how one's money is being used. It does not mean becoming some kind of social activist-investor. SRI represents an ideal opportunity for individuals to participate in the flow of funds in society. Of course, the same applies to companies as well.

Figure 5 Evaluation Categories for Corporate Social Responsibility

CEP (U.S.)	KLD (U.S.)	ACOM (Germany)
1. Employment of women	1. Contributions	1. Management system
2. Employment of minorities	2. Diversity of employment	2. Labor relations
3. Charitable activities, contributions	3. Labor relations	3. Health
4. Contribution to community	4. Operations outside the U.S.	4. Social welfare
5. Support for employees & their families	5. Product considerations	5. Socially disadvantaged persons
6. Work environment	6. Executive compensation	6. Supplier relationships
7. Prevention of cruelty to animals	7. Excluded items (alcohol, tobacco, gambling, defense, nuclear power)	7. Customer relationships
8. Defense contracting		8. Community relationships
9. Homosexuality		9. Operations in developing countries
		10. Fair trade
EIRIS (U.K.)	**Asahi Shimbun Foundation (Japan)**	**Sustainable Management Forum of Japan**
1. Corporate ethical guidelines	1. Consideration toward employees	1. Organizational ethical guidelines
2. Customer/supplier relationships	2. Emphasis on families	2. Supply chain
3. Workplace safety/cleanliness	3. Ease of work for women	3. Guidelines to eliminate competition
4. Workers' rights	4. Employment of physically disabled	4. Equal opportunity employment
5. Equal opportunity/diversity in employment	5. Globalization of employment	5. Human rights issues
6. Employee compensation	6. Consumer orientation	6. Labor safety and cleanliness
7. Training & development of employees	7. Harmony with community	7. Employment issues overseas
8. Job creation & security	8. Support for society	8. Customer relations
9. Community service activities	9. Environmental preservation	9. Contribution to society
10. Supply chain	10. Disclosure	10. NPO relationships
11. Human rights at overseas operations	11. Corporate ethics	11. Charitable activities, contributions

Source: Compiled from various sources.