SRI: Definitions, Strategies and Drivers

The Social Investment Forum defines SRI as:

“Integrating personal values and societal concerns with investment decisions. SRI considers both the investor’s financial needs and an investment’s impact on society.”

The Forum considers ‘socially responsible’ investing to be used interchangeably with ‘social investing’, ‘socially aware investing’, ‘ethical investing’ and ‘mission-based investing’. If we consider ‘ethical’ and ‘mission-based’ investing, this covers the niche market of religiously-based investment. Shariah-compliant investment has established itself as a niche market within and alongside the SRI context as there is a fusion\(^8\) between the two concepts. This form of investment stems from the fundamental Islamic beliefs, similar to the establishment of the very first SRIIs (based on Christian beliefs), that emphasise individual decision-making within the gambit of responsible behaviour and accountability.

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Shariah-compliant funds or investments, as the name suggests, comply with the tenets of the Islamic law. Islamic tenets consider the mission of man to be two-fold:

a. Man’s mission as a servant of the Creator
b. Man’s mission as a trustee of the Creator

The first refers to Man’s relationship with his Creator in fulfilling the obligations and acts of worship clearly prescribed.

As a trustee, he is accountable for his actions in managing the trust that he has been made responsible for. This trusteeship considers man as a steward and holds him accountable for the management of his relationship with fellow man, society and the natural environment. Hence the strong base of SRI concepts form the fundamentals of Shariah-compliant investments or Islamic investment.

An academic measure of the consistency between Islamic tenets and the ten SRI principles outlined in the UN Global Compact found that there is convergence between the two.9 In fact, the report states that Islamic tenets often go beyond the requirements of SRIs and have the benefit of providing clearer codification and ethical standards together with mechanisms for implementation that are supervised and reported upon Shariah Supervisory Boards. The report iterates the convergence of values between SRIs and Shariah-compliant fund concepts and highlights the agreements of ethical and social protection.

However, it should be noted that Islamic investment screening criteria applies a more standardised approach of negative screening for industries and businesses that do not comply with the basic Shariah-compliant funds and investments criteria. Whilst there exists diversity in interpretation of appropriate filters in the Islamic investment screening process, the differences are minor and actually harmonising as the market develops. Differences that existed between the two major Islamic investment regions, Malaysia and the GCC (Gulf Co-operative Council) have narrowed significantly since the promulgation of the Islamic Financial Services Act 2013 (Malaysia), promoting a more global-centric set of investment screens that make it easier and simpler to discern Shariah-compliant investments from non-Shariah-compliant investments.

Amidst the globally accepted SRI strategies as defined by Eurosif10 and ALFI11, Shariah-compliant investment falls within the categories of norms-based screening and exclusions (items 3 & 4).

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10 European Social Investment Forum
11 Association of the Luxembourg Fund Industry
### Figure 5: SRI Strategies according to Eurosif

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Description</th>
<th>Link with ALFI’s categorisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>01 Sustainability theme</td>
<td>Investment in themes or assets linked to the development of sustainability. Thematic funds focus on specific or multiple issues related to ESG.</td>
<td>eSg (social) category, Esg (environment) category</td>
</tr>
<tr>
<td>02 Best-in-Class selection</td>
<td>Approach where leading or best-performing investments within a universe, category, or class are selected or weighted based on ESG criteria.</td>
<td>RI positive screening sub-category</td>
</tr>
<tr>
<td>03 Norms-based screening</td>
<td>Screening of investments according to their compliance with international standards and norms.</td>
<td>RI negative screening sub-category, Ethics (cross-sectoral)</td>
</tr>
<tr>
<td>04 Exclusions</td>
<td>An approach that excludes specific investments or classes of investment from the investable universe such as companies, sectors or countries.</td>
<td>RI negative screening sub-category, Ethics (cross-sectoral)</td>
</tr>
<tr>
<td>05 ESG integration</td>
<td>The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.</td>
<td>ESG (cross-sectoral) category</td>
</tr>
<tr>
<td>06 Engagement and voting</td>
<td>Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behaviour or increase disclosure.</td>
<td>esG (governance) category</td>
</tr>
<tr>
<td>07 Impact investing</td>
<td>Impact investments are investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market-to-market rate, depending upon the circumstances.</td>
<td>Social impact sub-category, Microfinance funds sub-category</td>
</tr>
</tbody>
</table>

Source: European SRI Study 2014, Eurosif

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### The New Investor-Driven Standards for Performance

Although there is no consensus to one standard definition of SRIs due to its wide range of screening criteria, according to “The European Sustainable Investment Forum”, the following definition can accommodate most of the SRIs based on their screening and objectives:

“Socially Responsible Investment (SRI) . . . incorporate Environmental, Social and Governance (ESG) issues as well as criteria linked to a values-based approach. For example, it can involve the application of pre-determined social or environmental values to investment selection. Investors may choose to exclude or select particular companies or sectors because of their impact on the environment or stakeholders. Negative screening (such as weapons exclusions) and positive screening (such as best-in-class or thematic approaches) typically fall in the remit of such investments.”

By relying on the above definition, we can differentiate SRIs from traditional investment in at least two ways:

i. Firstly, investors pay attention to all the implications of their investment and not just monetary gains. They achieve this by being environmentally responsible and attaching ethical and societal values to their investment strategies so as to give back to the society they belong to.

ii. Secondly, the objective is to promote long-term sustainable investment that is environmentally friendly and promotes social and ethical values. Hence, it can be argued that socially responsible investors are in for the ‘long-haul’ and short-term gains might not be as attractive to them.

These objectives are critical in driving change in society as global calamities rise in the wake of climate change, human trafficking, unethical labour practice and catastrophic environmental abuse is taking place under the auspices of officials through corruption.
ESG Conscious Trends

The European Sustainable Investment Forum definition brings to light an additional pathway for SRIs that focuses on environmental, social and governance issues or ‘ESG’. ESG investments use specific screening methods to identify corporates with stronger corporate social responsibility (CSR) policies before including them in portfolios whilst others use internally prepared ESG criteria to rank best-in-class corporates for balancing portfolios. More asset managers are actively including ESG criteria for a portion of their portfolio construction in order to contribute indirectly to environmental and social benefits.12

Hence, the increased awareness that ESG filters are not effectively identified or even considered in traditional investment are persuading investors to avoid corporates that have been flagrantly abusing these principles.

However, the challenge in adopting ESG criteria globally has always been the belief that a sacrifice is needed in terms of performance.

Principles of Responsible Investment (PRI)

With almost 1,400 participating institutions/signatories globally, representing approximately $60 trillion in assets under management, or 50 percent of the world’s investable assets, the ‘Principles of Responsible Investment’ project launched by the United Nations in 2006 is representative of the global move towards sustainable consciousness. Assets under management have grown from its humble beginnings ($4 trillion) at a rate of 29% per annum, the vast majority of the signatories being investment managers.

The principles are a set of practice standards that are adopted on a voluntary basis and request signatories to consider the extent to which ESG-compliant companies can be invested in without material loss of overall portfolio performance. This approach strikes a balance between selecting companies that are SRI compliant but loss-making and profit-maximising companies that have no SRI or ESG standards. Analysis therefore considers ESG criteria along with traditional risk indicators to build sustainable portfolios that are attractive and profitable.

Growth of the PRI Initiative

Figure 6: Growth of SRI assets under management between 2006 and 2015\textsuperscript{a}

\textsuperscript{a} UN PRI
The 6 Principles of UN PRI

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

Principle 4: We will promote acceptance and implementation of the Principles within the investment industry.

Principle 5: We will work together to enhance our effectiveness in implementing the Principles.

Principle 6: We will each report on our activities and progress towards implementing the Principles.

Ibid
Supportive Research

Since ESG criteria are fairly inconsistent, reporting and disclosure has been inadequate, resulting in a lack of reliable data for analysis. Moving forward, the approach is geared towards a standardised ESG approach to ensure better reporting that would result in more effective decision-making. This is notwithstanding the fact that an abundance of research exists validating claims that ESG factors are correlated with superior risk-adjusted returns for securities.16

The Deutsche Bank Climate Change Advisors review (2012) of over 100 empirical and academic studies on sustainable investment states that both Corporate Social Responsibility (CSR) and ESG factors contribute to higher returns.

Interestingly, the study revealed that 100% of the research confirmed that companies with higher CSR and ESG ratings actually had a lower cost of capital. Further, the study found that 89% of studies indicated that companies with high ESG ratings demonstrated market-based outperformance whilst 85% showed outperformance from an accounting perspective.

Furthermore, research conducted by Harvard University17 found that the long-term result in considering ESG factors when investing was not well understood. The study compared 180 companies and divided them into categories of ‘high sustainability’ and ‘low sustainability’ (90 per category). The factors considered included issues on governance, performance and corporate culture. Bucking the thought-trend, the study found that high-sustainability firms over a period of 18 years markedly outperformed low-sustainability firms in both ratio analysis, disclosure and accounting measures as well as stock prices.

The overwhelming evidence indicates that investments into ESG-considered corporations are better performing over the long-term, empirically establishing the sustainable investment motive in both ethical and stock market values.

Shareholder Activism

Shareholder advocacy has been used successfully over the last few decades to highlight critical issues stemming from sustainable and responsible business activity. The impact has been significant. For example, between 2010 and the first 2 quarters of 2012, over 200 institutional investors and asset managers filed resolutions relating to ethics, sustainability, governance and corporate social responsibility.

The US Securities & Exchange Commission issued guidelines in 2010 requiring the disclosure of information related to climate risk for public companies. Shareholders are now arguing that this disclosure should include material corporate exposure to ESG factors and other non-financial data that relates to sustainable investing to provide stakeholders with superior information for a more effective decision-making process.

Regulators have also entered the foray by emphasising a move towards sustainable investing. For example, the Sustainability Accounting Standards Board (SASB) is also developing industry-specific sustainability accounting standards that public companies can use to report on ESG issues when providing statutory filing with the authorities.

In the UK, the Pensions Act (2000) requires that pension funds disclose the manner in which they have considered sustainability components during the process of portfolio construction.

South Africa requires that institutional investors consider any factors that “may materially affect the sustainable long-term performance of the investment, including those of an environmental, social and governance character”.18

In Australia, retirement funds and mutual funds are required to disclose the scope of ESG factors that have been considered in the selection of investment.19

More than 200 institutional investors or money managers that held assets worth $1.54 trillion, filed or co-filed shareholder resolutions on ESG issues at publicly traded companies between 2010 and 2012 in the US alone. International shareholder activism is gaining momentum as regulators heed investor sentiment towards sustainable, responsible and impact investing. A brief review of shareholder resolutions filed in 2014 in the US show a significant awareness of corporate governance issues, environmentally safe investment and political lobbying.

In the forthcoming section, we will consider the advantages that SC investments bring to portfolios and the trends in the growth of SRI and Islamic/Ethical funds globally.
An Investment is a planned activity to generate the maximum rewards from every unit of resource used within a set level of risk and investment horizon. The greater the risks assumed and the longer the investment horizon, the more rewards are expected by investors. This basic premise of investment is universal, irrespective of whether the investments are generated within a conventional, Ethical, Socially Responsible or a Shariah-compliant (SC) system. The only difference is that different systems have their own modus-operandi and constraints based on the philosophy or belief-system they profess.

Social advocates often argue that conventional investment activity is focused on ‘profit-maximization’ without due ethical and/or socially responsible consideration. The profit motive dominates and if there is any consideration for social responsibility, it is often in support of a profit objective (for example, receiving tax advantages for their socially responsible activities or a public relations exercise in displaying their generosity). For business entities that believe and profess the idea of well-being of the society in which they are engaged, profitability is achieved in harmony with the core values of society thereby positively impacting on growth and sustainability for the long-term.

The traditional view of an SRI or sustainable, responsible and impactful investment is that it refers to non-financial criteria that are integrated into investment decisions, encompassing ethical concepts or systems that promote social and environmental stability and sustainability. Focus has changed over time though, and depending on the types of investors and their motivation, impetus is accorded to establishing a variety of investment options that fall within the ambit of SRIs. Since churches in the US and UK in 1900s played an important role in introducing the concept of SRIs to the markets, SRIs have been driven by faith-based objectives, universally-accepted ethical values and sustainable development. Some notable beginnings of SRIs are usually traced to religious groups like the Quakers that started in the 18th century to exclude companies from their business dealings that were involved in the slave trade, alcohol, tobacco and gambling. One of the first modern SRI funds was initiated by the Methodists in 1971 that excluded arms producers as a reaction to the Vietnam War. Despite being historically rooted with religious groups, modern SRI activists emerged as part of the political climate of the 1960s and 1970s and as a result of the rise in human rights awareness, anti-war activism namely against the Vietnam War and opposition against apartheid. Companies benefiting from South African investment were excluded as part of international sanctions, giving rise to the first funds that screened company activities in banned countries. In the 1980s and the 1990s, SRIs evolved further to include positive screening by focusing on industries that promote alternative energy sources, equal employment opportunities and those who adopt sound corporate governance among other non-profit considerations. A total of 60 mutual funds were based on SRI principles managing $640 billion in assets.

In the last decade, a number of new threats and challenges have been facing the global populace, from climate change to corporate fraud and large-scale wars. Hence a new age of SRIs developed, focusing on ethics and beliefs and often opposing the industry focused on profits first.

The concept of SRIs is consistently evolving to dispense appropriate policies depending on the changing environment. In its most recent adaptation, SRIs are moving from negative screening to include positive screening to promote positive innovations and contributions to society, no longer simply to reduce the negative impact of business and industrial practices on man and his environment.

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