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# Socially Responsible Investing and Active Management

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Socially responsible investing (SRI) has received significant attention during the past several years, driven by a growing desire among investors to have their portfolios reflect their personal values. Over the last nine years ended 2003, assets managed in socially responsible strategies grew 40% faster than all other professionally managed assets<sup>1</sup>. To that same point, roughly one out of every nine dollars under professional management in the U.S. is invested in a socially responsible manner<sup>2</sup>. This surge of socially responsible inflows has not been unique to the U.S., with the number of SRI funds in Europe having grown nearly eighty-fold within the last two decades<sup>3</sup>. Despite the increased hype around SRI of late, many still may be unclear on the premise around SRI, benefits of such investing, and/or perceived disadvantages of the same.

Put simply, SRI is the process of investing that is based upon personal values and societal concerns surrounding social, environmental, and corporate morals. The allure of SRI stems from the opportunity it provides investors to incorporate personal values in investment decisions, while indirectly promoting corporate responsibility among companies and heightening competition for excess returns within the marketplace.

There are three leading strategies used within the SRI framework—*Screening*, *Shareholder Advocacy*, and *Community Investing*—all of which are dynamically employed, often simultaneously, as investment tools for diversifying portfolio compositions.

**Screening** is the most common method to practice SRI through which individual securities are evaluated on their financial stability and their positive contributions to society and/or the environment. The use of a ‘negative’ or ‘exclusionary’ screening process targets the omission of those companies not aligned with designated societal values. Companies in the tobacco, firearm, and incineration industries are typical issues excluded from many SRI portfolios. Conversely, those companies that display, strong environmental-friendly practices, respect for human rights, and/or produce ‘safe’ products above and beyond their peers are often incorporated into SRI portfolios via a ‘positive’ screening strategy.

**Shareholder Advocacy** is typically led by institutional investors such as trusts, foundations, pension funds, and investment pools with the intention of influencing Corporate America to improve its level of corporate citizenship and responsibilities to stakeholders. These advocacy practices can range from simple dialogues with targeted companies or industries to filing and voting on specific proxy resolutions.

**Community Investing** involves placing capital in local, entrepreneurial businesses or investments as a means to help provide them with access to credit, equity, and additional resources. In many cases, the capital provided to certain institutions, community loans funds, or regional development bonds fosters sponsorship for low-income individuals, community childcare facilities, affordable housing, and healthcare.

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<sup>1</sup> Social Investment Forum, Trends Report 2003.

<sup>2</sup> Social Investment Forum, Trends Report 2003.

<sup>3</sup> Socially Responsible Investing For European Private Clients, June 2003.

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THE PRACTICE OF SOCIALLY RESPONSIBLE INVESTING

Many investors elect to invest passively to build their socially responsible portfolios. Passive portfolios are typically modeled after popular socially responsible benchmarks such as the KLD Domini 400 Social Index. As demonstrated below, a passive investor in the KLD Index would have achieved a superior return versus the S&P 500 Index for both the three- and ten-year periods ended September 30, 2004.

<b>As of September 30, 2004</b>	<b>KLD Domini 400 Social Index</b>	<b>S&amp;P 500 Index</b>
<b>One Year</b>	12.25%	13.87%
<b>Three Year</b>	4.45%	4.05%
<b>Five Year</b>	-1.68%	-1.29%
<b>Ten Year</b>	11.88%	11.09%

Source: KLD Research & Analytics Inc.

*Indices illustrated are unmanaged. You cannot invest in an index. The returns do not reflect management fees, transaction costs or expenses. Past performance is no guarantee of future results.*

In the past, some have argued that the aforementioned outperformance was driven by advantageous factor exposures relative to the S&P 500 Index. More specifically, higher exposure to the growth factor as well as higher beta were the leading positions cited in the 1990s. However through his research, Kurtz [1997] illustrated that the return of the Domini 400 Social Index surpassed that of the S&P 500 Index even after adjusting for factor exposures. This is also consistent with a recent paper written by Geczy and Stambaugh [2003], which argues that passive socially responsible investing has little cost to the investor.

Other investors have chosen to invest in active managers that specialize in socially responsible investing, typically through mutual fund vehicles. These managers seek to achieve returns in excess of the socially responsible index by selecting securities which they believe offer significant return advantages. However, Geczy and Stambaugh contend that actively investing in social responsible mutual funds can have significant costs. Perhaps though, this is reflective of the specific level of manager skill actively managing social responsible mutual funds rather than an inherent characteristic of social responsible active management. For example, following their analysis in replicating active management by forecasting security returns from 1984-1997, Stone, Guerard, Gultekin and Adams [2001] assert that social screening resulted in no significant cost in risk-adjusted performance for actively managed portfolios.

In order to better understand whether active management can be successful in social responsible investing, SEI Investments has conducted a research project using our proprietary manager holding database.

SEI has explored the negative effects a variety of social responsible screens have had on active management. We chose 39 large cap products in which we had monthly holdings from 1997-2002. The time period was chosen to ensure the study reflected varied market environments—notably the growth-favored bull market from 1997-1999 and the small-value favored market in the subsequent three years.

The large cap products were represented by 14 large cap growth, 12 large cap value and 13 large cap core managers. SEI classified these managers based upon analysis of their holdings and conference calls to review their respective investment processes. Each product's holdings were screened on a monthly basis using eight individual social screens: abortion, alcohol, contraception, gambling, firearms, military, nuclear and tobacco, plus a screen comprised of each of the aforesaid. Thus, each original product was assessed on nine different levels.

Table I displays a summary of the results. The impact of these screens was fairly distributed, with 46% of the 39 managers positively affected by the screens. The median manager's return was negatively impacted by 13 basis points per annum. The most positively influenced manager's return was advanced by 233 basis points. The worst that a manager's return was impacted was by 226 basis points. Additionally, screens associated with abortion and contraceptive resulted in the largest negative impact to manager total return. This is consistent with the strong relative return large pharmaceuticals had during this time period; however, we do not view this as a systematic result. Overall, military screens led to the largest increase in portfolio returns.

**Table I. Impact of Select Social Screens 1997-2002 (basis points)**

Percentiles	Tobacco	Abortion	Alcohol	Contraceptive	Gambling	Firearms	Military	Nuclear	Total
Max	1.01	0.98	0.90	0.67	1.47	0.88	0.82	0.92	2.33
95th Percentile	0.41	0.39	0.39	0.23	0.49	0.03	0.64	0.31	0.94
75th Percentile	0.14	0.00	0.09	(0.11)	0.01	0.00	0.32	0.10	0.25
50th Percentile	0.00	(0.12)	(0.04)	(0.24)	(0.08)	0.00	0.15	0.00	(0.13)
25th Percentile	(0.07)	(0.31)	(0.14)	(0.40)	(0.21)	(0.02)	(0.01)	0.00	(0.63)
5th Percentile	(0.29)	(0.82)	(0.73)	(1.13)	(0.51)	(0.14)	(0.36)	(0.20)	(1.51)
Min	(0.64)	(1.63)	(1.19)	(1.52)	(1.18)	(1.16)	(1.32)	(1.10)	(2.26)

Table II illustrates the effects of these social responsible screens by manager style. The median large cap growth manager was the most negatively impacted by the screens. Analysis of the manager's holdings demonstrated that the impact on the portfolio resulted from a lower weight to pharmaceuticals and a greater weight to technology. Although these positions hindered returns for the period, again we do not believe this is a systematic outcome. The median large cap value and large cap core managers were positively affected by the screens.

**Table II Impact of Select Social Screens by Investment Process 1997-2002 (basis points)**

	Tobacco	Abortion	Alcohol	Contraceptive	Gambling	Firearms	Military	Nuclear	Total
Average Large Cap Growth	0.03	(0.41)	0.03	(0.45)	(0.18)	(0.01)	(0.03)	0.01	(0.71)
Average Large Cap Value	0.11	0.13	0.00	(0.10)	(0.00)	0.06	0.21	0.10	0.06
Average Large Cap	(0.00)	(0.14)	(0.19)	(0.29)	0.00	(0.11)	0.21	(0.01)	0.08

Finally in Table III we show the impact these social responsible screens had on the managers' abilities to outperform their respective benchmarks. We calculated each manager's realized alpha using the appropriate benchmark for their process (Russell 1000 Growth Index, Russell 1000 Value Index and Russell 1000 Index). Given SEI's dedication to identifying the highest-quality managers, it is not surprising to see 230 basis points of alpha registered by the median manager before social screening. However, this manager's alpha *after* screening for all eight factors was

only two basis points lower. This supports the notion that manager skill is not necessarily impacted by social screens.

**Table III Portfolio Alphas by Social Screen 1997-2002 (basis points)**

Percentiles	Realized Alpha	Tobacco	Abortion	Alcohol	Contraceptive	Gambling	Firearms	Military	Nuclear	Total
Max	8.56	8.41	7.76	8.41	8.29	8.73	8.56	8.63	8.56	8.59
95th Percentile	7.41	7.45	7.20	7.41	7.20	7.44	7.40	7.54	7.41	7.69
75th Percentile	5.01	5.15	4.97	4.85	4.99	4.93	5.04	5.14	5.11	5.24
50th Percentile	2.30	2.36	2.23	2.11	2.00	2.12	2.16	2.78	2.51	2.28
25th Percentile	0.38	0.36	0.32	0.30	0.22	0.24	0.36	0.57	0.30	0.14
5th Percentile	(4.13)	(4.14)	(4.43)	(4.19)	(5.01)	(4.60)	(4.13)	(4.46)	(4.13)	(5.59)
Min	(7.72)	(7.72)	(6.94)	(7.30)	(7.75)	(7.72)	(7.72)	(7.72)	(7.72)	(7.79)

#### IMPLICATIONS

We have seen that there is research to support both the notion that there are significant costs associated with social responsible investing, as well as the contention that there is no meaningful risk in social responsible investing. SEI has extended this research using our proprietary holdings database and has found the latter to hold true in our results. Consequently, the quality of active management is a stronger contributor to total return than social screening as an investment strategy. A discipline process is therefore needed to select and continually monitor high-quality managers with sustainable skill. Our research also shows that social screening can have negative or positive effects on managers' alpha. The impact is unpredictable and therefore should be mitigated by diversifying across multiple managers.

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John is a Client Portfolio Manager focused on SEI's institutional clients. Specific responsibility is focused on advice relating to our client's investment strategy and investment product research and development. John began his career as an Investment Analyst on SEI's Global Fixed Income Team working with non-investment grade and international products. He then joined SEI's US Equity Team where he was a Senior Analyst responsible for manager research and portfolio monitoring of SEI's US Large Cap portfolios. John graduated from Babson College where he holds a B.S. in Finance and Accounting.

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