THE JOURNAL OF
impact&esg
INVESTING

PORTFOLIO
MANAGEMENT
RESEARCH

volume 1
issue 1

JESG.pm-research.com

fall
2020

From SRI to ESG:
The Origins of Socially Responsible and Sustainable Investing

Blaine Townsend

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Blaine Townsend, CIMC®, CIMA®

Executive Vice President & Director, Sustainable, Responsible and Impact Investing
Bailard, Inc.

Blaine joined Bailard in 2016, where he serves as Executive Vice President, the Director of the Sustainable, Responsible and Impact Investing (SRII) group, and portfolio manager of the Small Value ESG Equity Strategy. Blaine is on Bailard's fundamental and SRII investment committees, conducts social research, oversees corporate engagement, and maintains client relationships.

Blaine began researching and writing about corporate social responsibility in the late 1980s. He started his career in Socially Responsible Investing in 1991 at the Muir Investment Trust, the nation's first environmentally-screened bond fund. In 1996, he opened and led the California office for Trillium Asset Management for thirteen years. While at Trillium, Blaine managed socially responsible and sustainably-focused portfolios, served on the investment committee, and conducted corporate engagement on issues from deforestation to media reform. Blaine led the creation of the "Joan Bavaria Awards for Building Sustainability in the Capital Markets" presented yearly at the Ceres annual conference. In 2009, he joined Nelson Capital Management, where he was a partner and portfolio manager. He served on the leadership team, the investment and corporate engagement committees, and the Extraction-Free and Animal-Welfare model teams. Blaine holds a BA from the University of California, Berkeley and CIMC® and CIMA® credentials.

All investments involve the risk of loss.

From SRI to ESG: *The Origins of Socially Responsible and Sustainable Investing*

BLAINE TOWNSEND

BLAINE TOWNSEND is an executive vice president at Bailard, Inc. and the director of Bailard Wealth Management's Sustainable, Responsible and Impact Investing (SRII) group in Foster City, CA.
btownsend@bailard.com

KEY FINDINGS

- SRI and ESG have roots in not only faith-based investing, but also in the civil rights, antiwar, and environmental movements of the 1960s and 1970s.
- The investment risks posed by climate change and poor corporate governance provided a huge catalyst in the growth of ESG investing.
- ESG data is now much more widely available than even 10 years ago, making ESG investing much more viable.

ABSTRACT: *Socially responsible investing. It is a well-worn term that grew in prominence during the 1980s and 1990s, but its roots trace back two millennia, shaped by civil-rights-era thinkers, faith-based organizations, and women. The modern SRI process stands on three pillars:*

1. *Values-based avoidance screens*
2. *Proactive sustainability-focused analytics—colloquially referred to as "ESG investing" and*
3. *Corporate engagement and impact investing.*

In this article, we focus on the origins and continued evolution of the first two pillars, the traditional North American model for socially responsible investing, and ESG, which first took hold in Europe.

TOPICS: ***ESG investing, Portfolio theory, Portfolio construction, Style investing****

*All articles are now categorized by topics and subtopics. **View at PM-Research.com.**

Socially responsible investing (SRI) is a well-worn term that grew in prominence during the 1980s and 1990s, but its roots trace back two millennia. In fact, SRI reflects a set of values that migrated from religious doctrine at the edge of the historical record to a modern landscape challenged by social justice issues, climate change, and concerns about corporate governance. At its inception in North America, civil-rights-era thinkers, faith-based organizations, and women were SRI's most strident evangelists; specifically, women investors, women entrepreneurs, and orders of Catholic Sisters. Today its proponents range from millennial analysts at Wall Street firms to financial engineers, pension trustees, heads of family offices, sovereign wealth funds, and retail investors. From a virtual novelty run out of a few dedicated shops, modern SRI is now a global phenomenon affecting the debate on fossil fuels, fundamental stock research, required disclosures for stock

exchanges, credit ratings, global accounting standards, and multinational cooperation with stakeholders.

SRI has always been rich in nomenclature, and the modern process is no exception. "Sin stocks," "best in class," "community investing," "values-based investing," and "green investing" are now joined in the lexicon by "environmental, social, and governance (ESG)," "impact," "gender lens," "fossil-fuel-free," and a host of other terms. Today, SRI can aptly be described as sustainable, responsible, and impact investing, and is a legitimate influence on the capital markets and financial services. In the traditionally more liquid markets (stocks and bonds), modern SRI falls into two camps: Values-based investing along the lines of traditional socially responsible investing; and more forward-looking ESG analysis, which strives to assess the materiality of nontraditional data to determine which companies are best prepared to compete in a world with dwindling natural resources, higher regulatory burdens, a growing human population, and climate change. According to the 2018 trends report by the United States Social Investment Forum (USSIF), sustainable, responsible, and impact investing now accounts for $12.0 trillion invested in North America, up 38% from 2016. Much of this growth is driven by large-asset owners who now consider ESG criteria across $11.6 trillion in assets, up 44% from $8.1 trillion in 2016 ("US SIF" 2018). As the USSIF data show, it is the growth in ESG investing that makes modern SRI more than just a trickle in the market. ESG has done what traditional socially responsible investing could not: ESG has breached the wall that isolated mainstream investing from socially responsible investing. The modern SRI process stands on three pillars incorporating the old and new:

1. Values-based avoidance screens—akin to traditional North American socially responsible investing
2. Proactive sustainability-focused analytics—"ESG investing" and
3. Corporate engagement and impact investing.

In this piece, we focus on the origins and evolution of the first two pillars, the traditional North American model for responsible investing and ESG, which first took hold in Europe.

SOCIALLY RESPONSIBLE INVESTING

Do no harm. That is the central concept of traditional faith-based investing and, to some degree, the central concept of traditional socially responsible investing: Avoiding products or industries that conflict with a set of moral values. These prescriptive screens, however, don't quite capture the aspirational spirit behind the birth of socially responsible investing in America. Traditional SRI was heavily influenced by the transformative 1960s and 1970s, which saw the rise of the antiwar movement and the maturity of movements on racial equality, women's rights, consumer protection, and the environment. These social and cultural influences are sometimes undersold in the narrative of traditional socially responsible investing. In fact, it was a fusion of the faith-based values with these distinct American progressive values that created the recipe for socially responsible investing in North America. By the early 1970s, this led to the creation of the first mutual funds reflecting faith-based values, civil-rights-era sensibilities, and environmental concerns.

Of course, by 1970, using any "social" criteria in investing went against conventional wisdom, and traditional socially responsible investing had many more critics than investment vehicles. Famed University of Chicago Economist Milton Friedman offered the most famous soundbite of the era, telling *The New York Times Magazine* in 1970 that "the social responsibility of business is to increase profits" (Friedman 1970, 17). Friedman's comments dovetailed with the Nobel Prize-winning work of fellow University of Chicago economist Harry Markowitz. It was Markowitz's 1952 *Journal of Finance* paper, "Portfolio Selection," that introduced "Modern Portfolio Theory" (MPT) to the world. MPT had as a basic tenet the notion that restricting an investment universe (for any reason) should be anathema in the world of investing. Critics came from outside the financial world, as well. Kennedy Administration National Security Advisor and future Ford Foundation President, McGeorge Bundy (1972, 1), was succinct in expressing his thoughts on the subject when he said, "We don't believe only the virtuous make money."

Nevertheless, in the 1970s the socially responsible investing industry established a pattern that would become very familiar in the decades to come. Despite its conservative biblical influences, socially responsible investing proved nimble with respect to changing

cultural mores and progressive views in society. As society reacted to nuclear energy, sweatshops, Apartheid, GMOs, climate change, human trafficking, the gender wage gap, the LGBTQ movement, and a host of other policy or cultural issues, socially responsible investors followed suit. It has been this way since John Wesley steered Methodists away from the slave trade.

SRI investors push the industry. They are not pulled. Over time, their stances have seldom been judged harshly in the eyes of history. Whether on slavery, Apartheid, tobacco, private prisons, conflict minerals, or coal, these early investors did not require quantitative validation before making their choices. The decision was a matter of principle and very much reflected the aspirational zeitgeist of the 1960s and 1970s. In the same way, Warren Buffett inspired investors with the simple mantra: Don't invest in a company you don't understand. Socially responsible investors have been just as inspirational: Don't invest in a company that conflicts with your values. The birth of the industry coincided with a time when many Americans were challenging which values were most important.

There is usually a catalyst for innovation within the SRI market; Apartheid and climate change are the most recent examples. At the birth of the SRI industry in the 1970s, the most prominent catalyst was the Vietnam War.

Orange is the New Green

By the end of the 1960s, the Vietnam War had grown more complicated for the general population and socially minded investors. The volume of dissent was increasing around the country, and the realization that portfolios may be profiting from the war effort forced the hand of many religious investors. By the 1970s, some in North America began searching for ways to avoid "war profiteering" in their portfolios. The low hanging fruit was Agent Orange—what became identified as a "controversial weapon" in the parlance of SRI.

Over a five-year period, Agent Orange was sprayed over 10% of South Vietnam in a technique, called "herbicidal warfare," developed by the British in the 1950s. This combination of toxins was developed for the United States Department of Defense by Dow Chemical and Monsanto, and its use has been described as "ecocide," an "environmental catastrophe," and a "moral calamity" (Zierler 2011, 161). Agent Orange was designed to defoliate forests and terrorize populations. In 1971, the Pax World Balanced Fund was launched, in large part, to provide an option for largely religious investors looking to avoid direct investments in the supply chains for Agent Orange on moral principles.

The launching of Pax also corresponded with the general awakening of the environmental movement in this country. It occurred less than 10 years after Rachel Carson's (1962) seminal book, *Silent Spring*, gave birth to the modern environmental movement and the idea that toxics, pollution, water, air, plants, people, and animals were all connected. She probably couldn't have imagined how correct she was. In 2016, scientists found tiny crustaceans in some of the deepest, most remote crevices of the ocean—six miles below the surface—contaminated with PCBs and even flame retardant at levels 50 times heavier than crabs living in China's most polluted waters (Carrington 2017). The era also saw protests over nuclear disarmament evolve into concerns over nuclear energy. Friends of the Earth was created in 1969 to carry that mantle. By April 22, 1970, Wisconsin Senator Gaylord Nelson and a Harvard-educated organizer named Denis Hayes mobilized 20 million Americans for the first Earth Day celebration. That same year, the Environmental Protection Agency was created and the Clean Air Act was passed. A cascade of environmental and consumer protection legislation followed, including the Clean Water Act in 1972 followed by the Endangered Species act in 1973, both with bipartisan support. North American socially responsible investing was born against this backdrop. Pax soon had company, and the mission of the other new socially responsible funds reflected this groundswell of aspirational progressive values. The Dreyfus Third Century Fund was launched in 1972 with serious capital, for the time ($25 million), and had some heavy hitters behind it (the presidents of the League of Women Voters and the Rockefeller Foundation, the executive director of the Urban League, a Nobel Prize winner, and the president of Princeton University). The Fund's prospectus stated it was looking for companies that "show evidence in the conduct of their business, relative to other companies in the same industry or industries, of contributing to the enhancement of quality of life in America" (Moskowitz 1973, 15). Novel at the time, this type of analysis would essentially be called "best in class" in socially responsible investing by the 1990s.

Another entry to the fledgling SRI business was the First Spectrum Fund, which started in 1971. Its process also foreshadowed modern SRI techniques, with founders Thomas N. Delany and Royce N. Flippin, Jr. promising that no investment would be made before it analyzed companies' performance in "the environment, civil rights, and the protection of consumers" (as cited in Moskowitz 1973, 15). There was important work being done on specific issues, as well, such as workplace practices and companies' roles in society. The early champion of this work was journalist Milton Moskowitz, a tenacious, business-minded thinker who believed that treating employees well, being transparent, and being a good corporate citizen was a pretty fair investment thesis for a long-term holding. Moskowitz wrote in the Sunday *New York Times* in February of 1973 (15), "I do harbor the suspicion that a socially insensitive management will eventually make enough mistakes to play havoc with the bottom line." Moskowitz wrote a nationally syndicated column three times a week from 1968 to 1986 and published seven books. In 1968, Moskowitz also launched *Business & Society*, the first business newsletter focused on the role companies played in the lives of their employees, in their communities, and in society at large. "The winds of change are blowing vigorously through American society," wrote Moskowitz (1968, preface) in the first issue. "So vigorously are they blowing that the entire posture of US business is undergoing a radical transformation." In 1982, Moskowitz served as senior editor for *Business and Society Review*, a serious academic journal covering the same subject matter. It survives today as an arm of the Center for Business Ethics at Bentley University in Waltham, MA.

The idea of corporate social responsibility (CSR), much less a dedication to reporting on it, was nearly nonexistent in 1968, when Moskowitz began his career. To be sure, focusing on CSR was not a target-rich environment for a journalist in 1968. As Moskowitz pointed out at the time, Major League Baseball was integrated in 1947, but it took 20 years before there was a single Black board member at a Fortune 500 Company. There were few sources of CSR information readily at hand. In many ways, Moskowitz built a foundation for CSR on which decades of researchers and journalists could build. There is now a cottage industry surrounding CSR that spans consulting, journalism, and publishing. The 500 largest companies in the world now spend over $15 billion per year on CSR efforts (Smith 2014).

Although it would be decades before the academic studies caught up with the growth of the socially responsible investing industry, Moskowitz published a list of "responsible" stocks in *Business & Society* in order to track them against broad market indices and the first socially responsible mutual funds in 1972. His original list included the following "responsible" companies:

- Chase Manhattan
- Dayton Hudson
- First Pennsylvania
- Jewel Companies
- Johnson Products
- Levi Strauss
- M-REIT
- *The New York Times*
- Rouse Company
- Standard Oil (Indiana)
- Syntex
- Weyerhauser
- Whirlpool
- Xerox

In 1973, Moskowitz added new names:

- CNA Financial
- Cummins Engine
- Lowe's
- Quaker Oats
- McGraw-Hill

Moskowitz tracked these "responsible" companies against the broad stock market and went as far as compiling an "irresponsible" list as a further data point to explore the investment thesis of picking the "good guys" (as cited in Moskowitz 1973, 15). These early efforts to evaluate performance started the clock on the academic research dealing with SRI performance. Moskowitz's insights shed additional light on the civil-rights-era sensibilities that influenced early SRI offerings.

For example, Moskowitz included Johnson Products because it was the only Black-owned business listed on the NYSE exchange and M-REIT, which was a real estate investment trust looking to acquire residential properties and racially integrate them. M-REIT sought to make a statement that might still resonate today with millennial investors seeking to avoid for-profit prisons and concerns about growing wealth disparities in this country. M-REIT founder Morris Milgram said at the

time, "Life is too short to do anything but build the kind of world one believes in" (Cromie 1969, 13).

A prominent name on the list was Levi Strauss & Co., a company at the forefront of the early CSR movement, with a suite of business practices that would set the early standard. Levi Strauss was a featured company in the first edition of the best-selling *100 Best Companies to Work for in America*, published by Addison Wesley in 1984 by Moskowitz, Robert Levering, and Michael Katz. The "100 Best" list eventually became an anticipated annual release in *Fortune Magazine* beginning in 1998, and its methodology has spawned numerous other endeavors to rate companies.

The "100 Best" methodology was also applied in real-time as part of the investment thesis for the Parnassus Management's Endeavor Fund (formerly called the Workplace Fund). Launched in 2005, the Endeavor Fund has crested $2.5 billion in assets under management by 2020 and has received Morningstar's highest ratings for its category during different periods.

In 1996, the Moskowitz Prize was established to recognize peer-tested academic research in the area of socially responsible investing. The Prize is hosted and awarded each year by the Kellogg School of Management at Northwestern University. Kellogg is one of the many business schools around the world that now have a focus on CSR and sustainability issues. In fact, today over 88% of students looking for a business school MBA believe learning about social and environmental business impact is critical (*Business as Unusual*, 2014). Many of the companies on Moskowitz's original list (or their successors) still maintain some of the CSR attributes they espoused at the time. Johnson Products was sold to consumer giant Procter and Gamble in 2004 but was then spun out to a group of African American investors in 2009 to reestablish its position as a Black-owned business. And in Ursala Burns, Xerox named the first black woman as CEO, a position she held from 2009–2016. At the time, she was one of only five African American CEOs among the Fortune 500 companies. Burns was also the first woman to succeed another woman as CEO of a Fortune 500 company. In January 2017, Levi Strauss was a lead signatory of a letter to the new Trump administration to support the low carbon economy.

North American SRI in the 1980s

By the 1980s, the socially responsible investment value proposition in North America had been standardized to some extent: Build a portfolio that behaved like the broad market without investing in alcohol, tobacco, weapons, gambling, pornography, and nuclear energy. These are the classic avoidance screens and the backbone of the traditional North America socially responsible investment process.

Beyond the avoidance screens, SRI in North America employed a practice of filling industry sectors with companies regarded as "best in class." The idea was to avoid any company with egregious patterns of behavior around workplace, governance, environment, social justice, and/or other issues that could be quantified or identified. In 1990, the Domini 400 Social Index was launched as the first capitalization-weighted index mutual fund based on this traditional framework—avoidance screens and "best in class." The Domini 400's ability to track the S&P 500 Index over long periods of time with this methodology created a track record that was critical to the growth of the SRI industry.

At the highest level of the SRI practice in North America, firms coupled the use of values-based avoidance screens with a commitment to shareholder activism or engagement—the powerful notion of leveraging ownership in a company to improve its behavior over the long term. Corporate engagement and shareholder activism have been a critical part of traditional socially responsible investing since the start. Leveraging the proxy vote and having access to management have been forceful agents of change that continue today.

The technique of using avoidance screens—the cornerstone of traditional socially responsible investing—is integral to modern SRI/ESG investing, as well. The Fossil Fuel Free movement is perhaps the best example of this. Even though the overarching focus is climate change and shifting capital from traditional fossil fuels to renewables (either as a hedge against a higher price of carbon or to pursue the divest/invest approach), the investment process centers on the exclusion of an industry. Gender Lens investing would be another example of an investment process utilizing avoidance screens—where industries harmful to women and girls might be excluded but companies with corporate practices that offer pay equity or gender diversification on their boards and in corporate suites would be favored. In fact, the majority of the over 500 mutual funds that now fall into the modern SRI and ESG space utilize some avoidance screens, with tobacco and investment in Sudan being the most common. With ESG data

now readily available, the marriage between ESG and traditional socially responsible investing with its values-based screens appears to be a lasting one.

This does not mean that values-based or more traditional SRI, with its faith-based or civil-rights-era sensibilities, is moribund or no longer relevant; it is quite the contrary. Depending on the lens with which you view the world, it may be more relevant than ever. The instinct for some investors to fight against the excesses and exploitation inherent in the capital market system is not likely to fade soon. This has been a strong impulse of certain investors since the 1960s' civil rights era inspired the industry. It is very likely that responsible investing will continue to be married to ESG, which represents the sustainable investing framework inherent in modern SRI.

SUSTAINABLE INVESTING

By the mid-2000s in Europe, there were three main catalysts that created the demand for analysis on ESG issues by large investors. The first was a strong intellectual and legal debate on the relationship between fiduciary duty and issues of sustainability. The second was climate change. The third was a capitulation to the thesis that poor corporate governance was harmful to the markets.

Fiduciary Duty

The balance between sustainability issues and fiduciary duty was a focus of the United Nations Environmental Program (UNEP). By 1992, UNEP was working with the financial services sector to support "development that meets the needs of the present without compromising the ability of future generations to meet their own needs" ("UNEP FI Statement" 2020). This idea was decades in the making. In fact, UNEP's mission was an eerie echo of US President Dwight Eisenhower's words from his farewell speech in 1961, "As we peer into society's future, we—you and I, and our government—must avoid the impulse to live only for today, plundering, for our own ease and convenience, the precious resources of tomorrow."

In 2005, UNEP commissioned a landmark report by the London-based law firm Freshfields Bruckhaus Deringer to answer a specific question: "Is the integration of environmental, social, and governance issues into investment policy (including asset allocation, portfolio construction and stock-picking or bond-picking) voluntarily permitted, legally required or hampered by law and regulation; primarily as regards public and private pension funds, secondarily as regards insurance company reserves and mutual funds?"

The report looked at the uniform laws on fiduciary duty in seven major world developed markets including the US, the UK, Germany, and France. With respect to the US, the report looked at the modern prudent investor rule that is the foundation of uniform federal laws like ERISA (the Employee Retirement Income Security Act of 1974, a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans) and its state level counterparts. The report concluded that not only was incorporating ESG consistent with fiduciary duty, but ignoring these long-term risks might in fact be a breach of fiduciary duty (Freshfields Bruckhaus Deringer 2005). Acceptance of this conclusion removed a major hurdle for the growth of ESG.

From the conclusion of the report: "Conventional investment analysis focuses on value, in the sense of financial performance. As we note above, the links between ESG factors and financial performance are increasingly being recognised. On that basis, integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions" (Freshfields Bruckhaus Deringer 2005, 6).

Climate Change

As for the second catalyst—climate change—scrutiny had been building like steam in a kettle for some time as well. As early as the 1980s, climate scientists were concerned by what their models were showing. The InterGovernmental Panel on Climate Change (IPCC) was jointly established in 1988 by the World Meteorological Organization (WMO) and UNEP in response to the growing concerns over the burning of fossil fuels and the rise in global temperatures.

That same year, the US Congress held its first hearing on the subject where NASA scientist James Hansen posited that he was "99% certain" that greenhouse gases were causing global warming (Shabecoff 1988, 1). This was just about a decade before the first

international push for cooperation on global warming—the Kyoto Protocol in 1997—and nearly three decades before the 2015 United Nations Climate Change Conference in Paris, COP 21. It was also one year before the Exxon Valdez oil spill in Prudhoe Bay Alaska in March of 1989. The world was at a crossroads in its relationship with fossil fuels.

The massive Exxon Valdez oil spill galvanized both the environmental community and the social investing community. In the face of the spill (and through sheer will), an SRI evangelist named Joan Bavaria worked with environmental leaders to bring together an unprecedented coalition of institutional investors, environmental organizations, and socially responsible investors to challenge business as usual with respect to large companies' impact on the environment.

Bavaria helped form The Coalition for Environmentally Responsible Economies (CERES), which gave birth to the Valdez Principles—a voluntary set of 10 principles for large companies to sign. Eventually, the acronym was dropped and the coalition and principles both went by the name Ceres. From the start, the Ceres coalition included environmental nongovernmental organizations (NGOs) like the National Wildlife Foundation, religious investors including the Interfaith Center for Corporate Responsibility (ICCR), large-asset owners such as the City of New York Pension Fund, and traditional SRI firms.

The oil industry provided a clear bridge between traditional socially responsible investing in North America and the burgeoning ESG movement in Europe. The Ceres coalition ushered in an era of increased transparency on environmental issues of publicly traded corporations—companies that, at first, bristled at the burden of environmental disclosure. As one-time Ceres CEO Bob Massie put it, "In 1996 the whole idea of having an environmental ethic, or measuring your performance above and beyond your legal requirements was considered completely insane. Sustainability was considered to be a shockingly difficult thing that no company would ever voluntarily take on as a goal" (Ceres 2014b).

Ceres laid the groundwork for the Global Reporting Initiative (GRI) under UNEP, which set the stage for future disclosure frameworks like those launched in 2018 by the Sustainable Accounting Standards Board (SASB). This heightened focus on environmental transparency at large companies was critical to the success of ESG and to understanding the impact of climate change on the markets. Beyond just rewarding transparency, SASB's standards take into account how companies are performing relative to their industry (Townsend 2019). Consultant KPMG reports that, today, 93% of the world's largest 250 companies report on sustainability issues. What can be measured, can improve.

Ceres also specifically helped raise climate change awareness. In August of 2005, Ceres issued the first report on the impact of climate on the insurance industry. In a terrible coincidence, the report was released just as Hurricane Katrina slammed into the US Gulf Coast. The report jibed with the IPCC assessment that the world had two choices: Environmental catastrophe on the one hand or addressing global warming en masse on the other ("IPCC Special Report" 2000).

By 2005, when UNEP released the Freshfields' report, large institutional investors like the $300 billion California Public Employee Retirement Pension Fund (CalPERS) were starting to pay attention to the IPCC conclusions and to external inputs from stakeholder organizations like Ceres. These so-called "universal owners"—large investors like CalPERS, other pension funds, index funds, and insurance companies that own the entire market—were heavily exposed to longer-term risks like climate change and the higher input costs for affected companies. Because the universal owners' returns were heavily correlated to the overall returns of the broad capital markets, they started to take seriously their exposure to these previously underexplored risks, like climate, but also water, access to health care, and other pressing issues. In turn, they started to drive the cottage industry in ESG research so they could begin to assess the materiality of different factors.

To institutional investors, ESG analytics promised to help identify long-term risk factors and/or identify investment opportunities based on these risks. ESG focused on risks that were likely not factored into traditional Wall Street analysis. Tangentially, the ESG scoring framework was also more palatable to mainstream investing because it was compatible with quantitative-driven investing. That compatibility helped fuel its growth.

By 2011, regulators in California, Washington, and New York began to require disclosures on climate risk by insurers operating in their states. The movement started by Ceres and GRI was gaining steam. More required disclosure helped improve ESG data. This push

for transparency on environmental issues was critical in escalating the idea that climate change affected the investment markets. According to Anne Simpson, senior portfolio manager and director of corporate governance at CalPERS, "Making sure that capital markets work is absolutely essential for paying pensions. Close to 70 cents of every dollar we pay for pensions comes from investment returns. We need a physical market that is safe and sound. … If we tip into climate catastrophe, we cannot invest" (Ceres, February 2014).

It stands to reason that North American socially responsible investing and ESG bore a family resemblance from the start. But from the moment the Exxon Valdez struck a reef in Prince William Sound Alaska, both investment disciplines were on a collision course with the fossil fuel industry. To the traditional SRI industry, human rights issues were on par with environmental concerns in the fossil fuel industry, particularly the conduct of western companies operating in environmentally sensitive and unstable countries without democratic governments. With ESG, the scales tipped toward climate change and capturing the data required to make economic arguments to end dependence on fossil fuels. It was a vexing challenge for both traditional and modern SRI to reconcile.

Big Oil always danced around human rights issues in Nigeria, Central America, and other regions with operations plagued by human rights issues. Standard operating procedure was to deflect responsibility to local partners—albeit local partners under their strong influence. With climate change there was not an established playbook. In general, the Big Oil industry utilized a two-pronged strategy to combat the ESG thesis on climate risk. First, they quietly braced for policy changes triggered by concerns over climate change and the burning of fossil fuels (the more forward thinking actually started investing in renewables and alternatives at the same time). Second, they aggressively backed efforts to slow changes in the status quo on the regulatory front and in the court of public opinion. The main focus of this work was the Global Climate Coalition (GCC), which was comprised and funded by fossil fuel companies to promote alternative research to arm the climate skeptics and to lobby strongly against the US ratification of the Kyoto Protocols and subsequent multilateral global efforts to limit the burning of carbon like COP 21.

Although support for the GCC has crumbled, conduct of large oil companies with respect to climate change is still being scrutinized and judged in real time. One of the most symbolic acts in this public debate is the Rockefeller Family Fund's campaign against Exxon Mobil (or Exxon). The Rockefeller family's source of wealth was Standard Oil, Exxon's ancestral corporate parent. It has been a widely followed story alleging that Exxon refused to develop alternative and renewable energy and funded alternative climate science like the GCC even as they knew climate change was real and would have an impact on their future earnings (Wasserman and Kaiser 2016).

Although interest in the Rockefeller family's campaign with Exxon may be more *pique oil* than *peak oil* to some, the tenets are central to the case of materiality in ESG research. Exxon is a case study. Exxon eschewed developing renewables, actively funding the GCC, and, to the chagrin of the New York Attorney General and the SEC, did not write down the financial value of its oil and gas reserves due to climate change issues like most of the industry. The open question is whether their actions conflicted with the interest of shareholders (Olson and Viswanatha 2016).

The SEC first offered guidance on how climate change fits into the existing disclosure framework in 2010. At the time, Chairman Mary Schapiro said, "A company must disclose the significant risks that it faces, whether those risks are due to increased competition or severe weather. These principles of materiality form the bedrock of our disclosure framework. Today's guidance will help to ensure that our disclosure rules are consistently applied, regardless of the political sensitivity of the issue at hand, so that investors get reliable information" (Shapiro 2010).

Of course, the SEC's comments are a reflection of a long and sustained movement by responsible investors who maintain that environmental, social, and governance issues are material to the long-term performance of a stock. By contrast, Wall Street has only recently turned its considerable intellect to this type of analysis. Today, there are efforts on multiple fronts to help bridge the gap between ESG analysis and Wall Street. In fact, SASB worked closely with the SEC, investment, and business communities to help standardize and quantify what environmental and social factors are material to financial performance to help usher in better reporting on these issues.

In any case, the SEC's scrutiny speaks to the accepted materiality of ESG risks. In the case of carbon, the case was built from the IPCC assessments and furthered by issue-specific financial analysis like the Carbon Tracker Initiative (CTI) in London and the work of organizations like Ceres. CTI synthesized for investors the economic impact of a world aligned to prevent the burning of fossil fuels. By the 2010s, CTI had rallied around the concept of a global carbon budget. The premise was simple: If 350 parts per million of greenhouse gases in the atmosphere was the tipping point for an environmental-related crisis, the world would rally to prevent gases from reaching that level. CTI created a list of the 200 largest companies in the world as measured by their proven carbon reserves. This Carbon 200 became the focal point of a growing fossil fuel divestment movement around the world.

For ESG investors, the evidence and support for this thesis was mounting. Unlike the tenor of the debate when Ceres published its first report on climate and the insurance industry at the time of Hurricane Katrina, by the time Hurricane Sandy hit the Atlantic Coast in 2012, the insurance industry was largely on board with the idea that climate-related risks were very real. In the June 13th, 2013 issue of *Insurance Journal*, the industry think tank Geneva Association stated it plainly, "Climate change threatens the insurability of catastrophe" ("Geneva Association" 2013).

The numbers back up this claim. The National Resources Defense Council reported that $139 billion was spent to address the effects of extreme weather in the United States in 2012. This was more than was spent on either education or transportation. Globally, the Oxford Smith School of Enterprise and the Environment concluded that, eventually, climate-change-related events could wipe out $6 trillion per year in agricultural assets.

Even Wall Street icons like Jeremy Grantham and Robert Litterman were embracing this new idea of market risk posed by climate. Grantham, the founder of Wall Street asset management giant GMO and a former Shell Oil economist, stated for the *Guardian's Environmental Blog*, "Those extreme, dangerous, carbon-intensive and polluting resources run the very substantial risk of being stranded assets. … I don't think if you put billions into new tar sands (sic) projects you will see a decent return on it" (Hickman 2013).

Litterman, the former head of risk for Goldman Sachs and the cocreator, along with Fisher Black, of the Black-Litterman asset allocation model, remarked in the *Canadian Investment Review*, "What a risk manager really has to do is figure out whether risk is being priced accordingly. … Climate risk is not being priced right by society. It is a global problem; it requires a global solution" (Blythe 2012). Litterman is a strong advocate of creating market mechanisms to reduce carbon.

Nevertheless, the widespread assessment of climate risk moved the investment world to look at environmental risks as material to outcomes for long-term investors.

This was a huge leap for Wall Street, which was trained to see the world in three-month increments. The SEC voting 3–2 to add global climate change as a material issue—like a plant closing—that companies may have to disclose to investors only underscores this ("Climate Change and the S.E.C." 2010). The evolving view of the materiality of climate change has been a huge driver in the credibility and demand for ESG.

Corporate Governance

Joining climate change in the trifecta of catalysts that bolstered the case for ESG research were the epic corporate governance and ethical failings that defined the subprime mortgage crisis and the subsequent Great Recession. Although there is truth in the idea that good corporate governance should have been central to fundamental investing prior to the subprime crisis or the advent of ESG analytics, it is also true that bad ethical behavior is by definition hidden until it is too late. Unfortunately, changes in the complexity of the capital markets and the speed at which capital flows around the planet have raised the stakes for all investors when bad behavior hits the markets.

By the 2000s, gone were the days of a mortgage being held by the local bank that lent the money and, therefore, knew the client and understood the risk of repayment. By the 2000s, the capital markets were creating staggering, vast, opaque investment pools of mortgages that neither the credit agencies nor the regulators really understood. Subprime players like Countrywide were collaborating with intermediaries like Lehman Brothers and Bear Stearns to create complex mortgage-backed securities without the basic checks and balances you might expect from good stewards of capital. The result was a near-death experience for many investors and an era of unprecedented government intervention

just to keep the markets afloat. Once again, the universal owners took the biggest financial hits. This exacerbated pension fund shortfalls.

As has been the case with each roiled market since the Great Depression, the event came with soul searching and a deconstruction of each incident. With the subprime crisis, as was the case with previous market calamities caused by malfeasance (think Enron and WorldCom), a lack of disclosure, transparency, checks and balances, and good old-fashioned ethics in the financial sector contributed to the havoc and the ultimate cost to investors. In the Global Financial Stability report issued by the International Monetary Fund in April of 2008, the cost in just the real estate and credit markets was nearly $1 trillion (Bianco 2008). By the end of 2008, the Federal Reserve reported that household wealth in the United States had declined by 10 times that much (Bajaj 2009). "Universal owners" were reported to have lost $5.4 trillion as a result of the sub-prime crisis (PRI Association and UNEP Finance Intitiative 2011).

The stock market crash of 1929, which led to the Great Depression in the 1930s, ushered in standardized financial reports. The subprime market crash in 2008–2009 and the subsequent Great Recession made it clear to the largest asset owners that they needed a better framework to assess risks in the market, particularly around complex derivative instruments and the shadow banking system. Suddenly separation of board CEO and chair, board independence, oversight committees on sustainability issues, transparency, political giving, and a host of other issues became material to the long-term performance of a stock. Investors needed a lens through which they could assess risks around climate change, corporate governance, and behavior. Traditional Wall Street analysis did not provide this lens. ESG analysis had come of age.

In the process of reporting and writing this article, the world entered a global pandemic and the global economy came to a screeching halt. The pandemic has again brought to the surface discussions about the roles and responsibilities that companies have to their shareholders, communities, and employees.

Global Problem, Global Solution

As Litterman remarked, risks like climate and poor governance are now global and require a global solution. By the time of the Great Recession in 2008 and corresponding subprime crisis of 2008–2009, the global efforts that would complement the ESG framework were being established. In 2000, the UN Global Compact was created to offer 10 organizing principles for multinational corporations on human rights, labor, anticorruption, and the environment. Nearly 10,000 companies in 168 countries around the world have adopted these principles and released over 40,000 reports on their progress in meeting them.

In early 2005, then UN Secretary General Kofi Annan called on the largest asset owners to help shape something called the United Nations Principles for Responsible Investment (PRI) to create a sustainable financial system. PRI brought some of the largest asset owners in the global markets together around six organizing principles. Under the auspices of the UNEP, PRI was launched at the New York Stock Exchange to create a network of asset owners around the world. The first principle was a commitment to integrate ESG into all investments. As of 2019, 2,300 asset owners representing $80 trillion have become signatories of PRI and ascribed to the following ethos: "As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time)" (*What Are the Principles* 2017).

Today, investors have more robust tools to assess corporate disclosure, corporate governance, and environmental risks. Responding to the incredible growth and demand for ESG funds, Morningstar, the market leading arbiter of mutual fund ratings, announced in 2015 that it was teaming with ESG research leader Sustainalytics to offer ESG ratings of mutual funds.

Morningstar will utilize a holdings-based analysis to derive a fund's score. According to Morningstar, "providing fund scores on environmental, social, and governance factors is a natural extension of our work. We want to bring even greater transparency and accountability to the investment industry with ESG research, data, and tools, while helping investors to put their money to work in ways that are meaningful to them" (Benjamin 2015).

In fact, the current surge in socially responsible investing and ESG would not have been possible without the type of research now available to Morningstar,

Bloomberg, and individual investors. Amsterdam-based Sustainalytics, for instance, has hundreds of analysts around the globe and scores over 11,000 companies on ESG criteria.

Bloomberg, the ubiquitous and robust ecosystem for professional investors, also has ESG data available via a few keystrokes utilizing the Sustainalytics universe and information from data provider RobecoSAM, which focuses on identifying ESG risks material to investment performance by industry sector. Bloomberg also provides its own scores on governance risk and disclosure.

With this kind of data readily available to investors, professional investors can make a call on which environmental, social, and governance factors might be material to financial performance. That gives modern SRI a much broader appeal. Research vendors can provide not just scoring on ESG metrics but also on revenue derived from a range of specific products from embryonic stem cell research (critical for many faith-based investors) to controversial weapons, animal testing, or involvement in countries with severe human rights abuses (e.g., Sudan). There are also providers of research and ratings in many specific areas, including carbon intensity, gender wage gap, animal welfare, life ethics, toxics, and LGBTQ issues.

At the center of this process is information being provided by the companies themselves through greater required disclosure on ESG issues. One year after SASB launched its 77 industry-specific reporting standards, the nonprofit said 120 companies are now using the standards in their ESG reporting (Ashwell 2019). Some of this transparency has come easily and some has been hard fought—the result of pressure from stakeholders and a push for global reporting standards. All of this has made the markets more transparent and has helped investors be more informed. What is measured can improve.

PERFORMANCE

For some reason, the aspiration to build an investment portfolio aligned with an investor's moral or environmental values was formerly an affront to the traditional investing mentality. There seemed to be an unwritten law that said a person should solely focus on making as much money as possible (by whatever legal means necessary) and then give away the excess to charity. Externalities or the negative social or environmental outcomes of the investment were conveniently ignored.

Most dedicated socially responsible investing firms realized early on that, to gain acceptance, strategies needed to be evaluated against conventional market benchmarks for both risk and return.

The skeptics greatly outnumbered the optimists on whether that balance could be achieved, and there was white-hot scrutiny on performance from day one. It could be argued that new and much more complex financial instruments based on the promise of a pure financial return faced much less skepticism and resistance to adoption than an SRI portfolio benchmarked against the well-known and understood S&P 500 Index. There apparently was something unsettling about considering environmental or social criteria in investing. The professionals who bore witness to the first decades of socially responsible investing can attest to this: If bull markets were built on a war of worry, SRI was built in an avalanche of arrows. The mantra from Wall Street was simple: If you do socially responsible investing, you will lose money. This was always the first question asked in the early days of professionally managed SRI strategies. Over half a century later, there is now a body of serious academic work focused on that question.

The conclusions of the academic literature on traditional SRI and ESG over the past two decades range from showing some cost, to little cost, to some benefit for SRI (Fulton et al. 2012). In 2014, a TIAA-CREF analysis showed that, over the long term, the leading SRI equity indices saw no material difference in performance versus broad market indices, "suggesting the absence of any systematic penalty" (O'Brien et al. 2017). More emphatically, a meta-analysis of 2000 empirical studies from 1970–2014 published in the December 2015 *Journal of Sustainable Finance and Investing* issue (Friede et al. 2015, 210) confirmed the *de minimis* impact of SRI and ESG screening on investment returns or risk: "The results show that the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–CFP (corporate financial performance) relation. More importantly, the large majority of studies reports positive findings."

To many, the benefits may lie more in reducing risk versus adding return. In 2012, for example, Nofsinger and Varma (from Washington State University and University of Illinois law schools, respectively)

concluded that SRI funds do worse in up markets but better in times of crisis (Varma and Nofsinger 2012). Academia has found positive correlations with sustainable business practices, as well. A Harvard Business School study (Eccles et al. 2011) found that companies with more sustainable business traits outperform their peers over the long term. With such a rapidly evolving field, it should come as no surprise that much of the academic focus is driven by the era in which the study is conducted. For example, early studies focused on divestment issues while more recent studies focused on climate change.

Lloyd Kurtz, a black belt in SRI performance studies, is the head of Social Impact Investing at Wells Fargo and a lecturer at the Haas School of Business, University of California Berkeley Center for Responsible Business. He breaks down SRI and ESG academic studies into four eras. In his review of SRI/ESG studies, *Looking Forward Looking Back: A Hitchhiker's Guide to Research on Social and Sustainable Investment* (2013), Kurtz summarizes the eras in the following manner:

- **Pioneering Efforts (1970s and 1980s):** This era was highlighted by studies by Rudd (1979) and Grossman and Sharpe (1986) which used factor-based analysis to explain variances in South Africa-free equity portfolios.
- **Sustained Attention (1990s):** This period showed strong nominal performance of social investment benchmarks. The first notable study in this era by Hamilton et al. (1993) concluded the use of negative screens did not have a major impact on performance.
- **Sustainability, Stakeholder, and the Search for Alpha (2000s):** This period offered papers like Derwall et al. (2005) and Edmans (2011) that demonstrated that superior sustainability and stakeholder performance improved both firm-level and stock performance.
- **Modern Era (2009–present):** This period responded to the global financial crisis with dozens of papers covering a wide range of topics from fixed income by Bauer and Hahn (2010) to the impact of shareholder engagement on the market by Dimson et al. (2012).

Academic studies seem to consistently support the notion that financial factors drive performance more than any social criteria. That stands to reason. With modern investment and portfolio construction techniques, modern SRI portfolios can be constructed with very similar characteristics as their benchmarks, which should result in an expectation of similar risk and return behavior.

For example, Bailard Wealth Management's Sustainable, Responsible and Impact (SRII) large-cap equity strategies are all benchmarked to the S&P 500 Index. Despite having different criteria, the financial characteristics of each of these dedicated strategies bear a family resemblance to each other and the benchmark. Exhibit 1 shows a characteristic comparison among these SRII strategies against the benchmark, illustrating a similar risk and return profile.

EXHIBIT 1

Bailard Wealth Management ESG and SRI Portfolio Model Characteristics as of 12/31/2019

Characteristic	SRI Model	ESG Model	SPDR S&P 500 ETF Trust
Dividend yield	1.8%	1.8%	1.8%
Price-to-earnings ratio (P/E)	21.2	20.7	21.6
Return on equity (ROE)	18.4	19.2	14.5
LT debt/equity	81.0	81.0	90.1
BEst LTG EPS	9.0%	9.0%	10.6%

Sources: Bailard, Bloomberg. Data regarding holdings reflect ownership information as of December 31, 2019 and are not intended to represent any past, present, or future investment recommendations. Holdings are subject to change. The Bailard SRI and environmental, social, and governance (ESG) model portfolios are actively managed domestic equity model portfolios benchmarked against the S&P 500 Index, with a similar risk/return profile. The portfolios typically hold between 40–60 stocks on average. The model portfolios seek to invest in companies with above-average ESG characteristics.

There are now multiple global ESG indices supporting even more growth in mutual fund or exchange traded investment vehicles focused on sustainable, responsible, and impact investing. Dow Jones, FTSE, MSCI, NASDAQ, OMX, Bloomberg, NYSE, and the S&P all have ESG-focused indices. In 2016, the UN launched the Sustainable Stock Exchange Initiative (SSE) to close the reporting gap on ESG issues on stock exchanges. The SSE now includes over 100 stock exchanges and four out of the top five in the world (SSE 2020). According to Gwen Le Berre, Vice President of Corporate Governance and Responsible Investment at the world's largest asset manager, BlackRock, "Cross-border collaboration by stock exchanges will

help shift public companies toward more comparable and meaningful disclosure of ESG (environmental, social and governance) risk factors. This will enable investors to more accurately value companies and make better informed investment decisions" (Ceres 2014c).

CONCLUSION

Markets change. Often rapidly. The Pony Express cut the time for transcontinental mail delivery from three weeks to ten days. It lasted only 19 months before it was replaced by the telegraph. The first retail mutual funds went public in 1928. Against the regulatory backdrop of the Investment Company Act of 1940, these funds saw unfettered dominance as the pooled vehicle of choice for retail investors for 75 years until the advent of the exchange-traded fund (ETF) in the 1990s. Mutual fund hegemony is now seriously threatened by ETFs. In December 2019, there were roughly 1,700 ETFs with assets over $4.3 trillion listed in the US Since 2010, ETFs have accounted for 25% of the trading activity on Wall Street (Turner 2017; Li 2019).

Sustainable and responsible investing represents both rapid and gradual change in the investment world. SRI has persisted through each innovation, trend, fad, and delivery system created. Whether applied to stocks, bonds, mutual funds, ETFs, or private equity, SRI represents a process, not an asset class. What began as a way to align portfolios with faith-based and progressive values has evolved to help Wall Street account for previously overlooked global risks and has influenced everything from accounting practices to listing requirements on public exchanges. Wall Street firms have progressed from staunch critics of SRI to participants as they enter this ever-growing market. SRI has grown from a niche within the North American financial service industry to a global phenomenon. Built on conviction, SRI now flourishes because of its relevance.

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To order reprints of this article, please contact David Rowe at d.rowe@pageantmedia.com or 646-891-2157.

ADDITIONAL READING

A Morality Tale of ESG: *Assessing Socially Responsible Investing*

Edward N.W. Aw, Stephen J. LaPerla, and Gregory Y. Sivin

The Journal of Wealth Management

https://jwm.pm-research.com/content/19/4/14

ABSTRACT: *A review of academic literature suggests a lack of consensus on positive and negative abnormal returns associated with*

socially responsible investing/environmental, social, and governance (SRI/ESG) factors. This article examines the benefit of incorporating ESG factors during a more recent period to acknowledge the ongoing investment trend toward ESG. The authors find that the top-quintile (most compliant) stocks ranked by ESG score underperform the out-sample research universe. They present evidence that indicates incorporating ESG into a robust quantitative investment process can mitigate the adverse effect, however, thus providing investors with a portfolio that outperforms a benchmark while allowing investors to embrace ESG.

The Benefits of Socially Responsible Investing: *An Active Manager's Perspective*

Indrani De and Michelle R. Clayman

The Journal of Investing
https://joi.pm-research.com/content/24/4/49

ABSTRACT: *There has been a lot of research on the predictive power of environmental, social, and governance (ESG) ratings, the relationship between ESG ratings and subsequent stock performance, and whether using ESG data in stock analysis and portfolio management was value-additive or valuedetracting. In this article, the authors examine the relationship between the ESG ratings of a company and its stock returns, volatility, and risk-adjusted returns in the post-2008 financial crisis era. They explore the negative relationship between ESG and volatility in greater depth, given the well-documented low-volatility anomaly (outperformance of low-volatility stocks). Both (high) ESG rating and (low) volatility positively impact stock returns, but the ESG effect is independent of the low-volatility effect, and ESG is a positive contributor in its own right. Given the controversy surrounding the effect of ESG-based investment restrictions, the authors test the effect of restricting the investible universe by deleting the lower tail of ESG companies on portfolio performance. Asset managers can thus actively use the association between corporate ESG ratings and stock return, volatility, and risk-adjusted return to enhance their stock-picking and portfolio-construction abilities.*

An Empirical Examination of the Dynamic Linkages of Faith-Based Socially Responsible Investing

Akash Dania and D.K. Malhotra

The Journal of Wealth Management
https://jwm.pm-research.com/content/16/1/65

ABSTRACT: *A fundamental tenet of the investment management process is portfolio construction to maximize wealth creation through investment in efficient portfolios. Faith-based, socially responsible investments (SRI), on the other hand, place importance on investors' concern with the religious and faith-based consequences of investment decisions. This study examines dynamic linkages among four major Islamic indexes and their corresponding "conventional" indexes of North America, European Union, Far East, and Pacific nation markets. Contrary to the widely held assumption that faith-based SRI involve a selective portfolio selection process due to faith-based screening, and are likely to have low correlation with the set of counterpart conventional investments, we find evidence of a positive and significant spillover from conventional market indexes on their corresponding faith-based SRI returns. Results from impulse response analysis show that innovations in conventional indexes have significant and positive impact on their corresponding Islamic indexes. Regarding the nature of volatility spillover, we find evidence of a positive and significant spillover from conventional indexes on their corresponding Islamic indexes. We also find evidence of an asymmetric news effects.*