

*Capitalism's Trojan Horse:
How the "Social Investment" Movement Undermines Stakeholder Relations
and Emboldens the Anti-Free Market Activities of NGOs*

By Jon Entine

According to its advocates, social investing (also known as socially responsible investing (SRI) or ethical investing (EI)) is a fast growing phenomenon that represents “nearly one out of eight dollars under professional management in the United States” and similar percentages in Britain and Australia. Although those investment estimates are wildly exaggerated, the disruptive impact of what is essentially an anti-free market movement with ideological roots shared with anti-business NGOs is all too real and growing.

The central tenet of SRI is that investors can follow their hearts and political whims and make a killing in the stock market at the same time. In the words of the umbrella group for the liberal wing of social investing, the Social Investment Forum, clients can “invest for their own futures and a better world at the same time” (Gravitz, 2002, p. 1) by avoiding companies those that are overtly linked to defense spending, global warming, genetically modified organisms, tobacco, nuclear energy and other litmus issues that are the favorite subjects of NGO hysteria. Truisms of SRI include the embrace of the romantic, anti-science wing of environmentalism, rigid pacificism, animal rights on a par with human rights, and vague notions of social justice that are well beyond the influence of corporations.

So-called “good” companies, their argument goes, perform better financially and on the stock exchanges. Who are these good guys? These are mostly smaller corporations that emerged out of the Sixties counterculture and sell commodity products like toothpaste, yogurt, ice cream and shampoo at premium prices—companies like Tom’s of Maine, Ben & Jerry’s Stonyfield Farms, and The Body Shop. They are distinguished by “good intentions” and their eagerness to make grand pronouncements in support of “sustainability,” “human rights,” and “diversity”—vague principles that no one opposes in theory. The irony is that SRI superstars are often neither progressive nor particularly ethical. Many SRI icons are authoritarian intensely anti-union entrepreneurs who built their business models on social marketing rather than providing quality products or services at reasonable prices. For the most part, their workers are in dead-end jobs and paid near-minimum wage. The two most celebrated ethical superstar corporations, Body Shop and Ben & Jerry’s, are notorious for being operationally dysfunctional and poster companies for exploiting consumer idealism (Entine 1994, 1995b, 1999).

Set against the good guys is the rest of the business world, caricatured by critics as Corporate America, with the phrase used as an epithet. Executive “desperadoes” are ascribed the most selfish of motivations: a commitment to grow their companies by selling desirable products or services. As such, they are dismissed as mere “capitalists,” a characterization that to SRI activists is like being labeled a pro-life activist at a NOW convention. According to consensus, black hat corporations manufacture weapons (which helped topple Saddam Hussein and the Taliban); develop energy (for transportation,

industry, and electricity for second homes in Aspen and Nantucket for these liberal money managers); or the worst of all offenses, develop consumer products or medicines using ingredients tested on animals (according to international standards to ensure safety and efficacy). SRI money managers hold their collective nose and fill their portfolios with large corporations—mostly high tech and financial stocks that were devastated when the bubble burst. But the crown jewels of their portfolios are not led by Lou Gerstner or Jack Welch but Ben Cohen and Anita Roddick. These are the stars of the era of rainforest chic and the vocal leaders of a dangerous alliance that has emerged between NGOs and social investors.

As this analysis demonstrates, although social investing may balm the conscience of ideologues, there is little evidence that it encourages either corporate responsibility or social reforms. In effect, it's guilt free investing, the ultimate politically correct two-for-one sale: Buy shampoo that's not been tested on animals and made from Brazil nuts harvested by Amazon Indians and get social justice for free. The social investment movement elevates a narrow and exclusive social and political agenda that draws on notions of liberal propriety that date to the 1960s. Making profits, growing a company that support jobs and communities, and spreading the wealth—the very reasons behind the success of the capitalist countries of the west—is portrayed as sacrilege. The United States and other western countries are often targets of reflexive criticism.

As an illustration of this anti-business, illiberal sensibility, and the unholy alliance of NGOs and social investors, consider the recent widely circulated letter written by an influential social investment manager.

An Open Letter to the Social Investment Community

Dear Friends and Colleagues:

WE ARE RUNNING OUT OF TIME!

Global corporations are ravaging the natural environment, destroying democratic societies and widening the gap between the rich and the poor.

* Because corporate mergers have consolidated control of the media, agriculture, energy, financial services and other sectors of our economy, competition and fair trade are becoming extinct. Regional wars are being waged for corporate control of natural resources - not to further human rights or democracy.

* Because corporate-paid lobbyists and corporate campaign contributions control politicians, U.S. corporations are free to sell their technology and weapons to authoritarian governments.

* At home, privacy and civil rights are being eroded by corporate control of information technology. Thanks to politicians dedicated to further empowering the wealthy, democracy where it exists is controlled by money.

Corporate governance reform, voluntary codes and watered-down SEC regulations are placebos. It is time that we in the SRI [Socially Responsible Investment] community join together with environmentalists, anti-war, labor and human rights activists, public interest lawyers and social investors to coordinate corporate campaigns to seriously challenge corporate management. We need targeted shareholder resolutions, litigation, mass mailings, demonstrations, legislation, boycotts, citizen referendums and coordinated political action to save our global community.

What do you think? How should the SRI community act to save our global community? Send your thoughts in an email to: reply@harringtoninvestments.com

John C. Harrington, President and CEO

According to the prevailing social investment *Zeitgeist*, corporations are greedy control freaks out to squeeze society. This is the ideology of corporation-as-enemy, which takes the form of paranoia laced with demagoguery. “We expect corporations to act irresponsibly,” writes Peter Kinder, the president of Kinder Lydenberg Domini (KLD) (Kinder, 1997), the premier research organization for the social investment community. “Why? Because corporations have as their explicit purpose the insulation of management and employees and shareholders from responsibility for their actions.”

Despite its dedicated anti-business ideology, the social investment movement and self-proclaimed “socially responsible” businesses are widely portrayed and as a result viewed by much of the public as not only benign but beneficial—honest brokers of stakeholder dialogue and a force for corporate reform. Perhaps because many reporters come from the same ideological and social milieu, the media by and large give social investing a free pass or worse: they echo the anti-free market biases of many social investing leaders.

While activist groups have long existed as corporate gadflies, whose political views were more or less openly stated and argued, the leaders of the social investment movement are an insidious breed. They constitute capitalism’s Trojan horse. Although they purport to support free markets, and in fact attempt to make money playing the world’s stock markets, they are anti-business and interventionist by conceit. While they purport to want to soften the edges of capitalism, their actions are designed to undermine it. Reasonable people should be concerned about the growing influence of the social investment community, and its emerging partnership with NGOs, most of which share a knee jerk demonization of corporations and free markets.

To cite one example of how this synergy works in practice, the Rainforest Action Network, a San Francisco-based environmental group, initiated a campaign against Citigroup about three years ago, blaming the bank for rainforest destruction, climate change, and the disruption of the lives of indigenous peoples. The NGO launched a worldwide campaign, accusing it of “banking on” global warming and forest destruction. It teamed with social investment research groups like KLD and Calvert, which have Citigroup on its taboo list of investments as a result of such controversies. Clearly, this one issue will not bring a multi-faceted company such as Citigroup to its knees. But it is

also more than just a mere annoyance; it's reputation management hell. Moreover, collective attacks on corporations in general feed a growing anti-American, anti-West sentiment in certain countries. On the defensive, and prior to its 2003 annual meeting, Citigroup opened a dialogue with Rainforest Action Network, which planned to introduce shareholder proposals attacking the company's environmental policies. And last week, Citibank was among ten banks from seven countries that announced their adoption of the Equator Principles, a voluntary set of guidelines for promoting social and environmental responsibility in financing development projects, especially in emerging markets.

More and more companies are engaging or being snookered into embracing or at least publicly tolerating fundamentalist critics. Corporations and governments that embrace or even engage this new breed of stakeholder activist, either out of intimidation or misplaced idealism, do so at their own risk. The liberal wing of the social investment community, by and large, is out to destabilize free markets in the name of promoting a faddish, deeply unprogressive agenda. They view global corporations as the implacable enemy.

The Historical Context: The Legacy of Religious-Inspired Social Screens

Social screening has its origins in conservative religious principles. The first known consumer screens date to the 18th century, when Quakers withdrew their business from companies involved in alcohol, tobacco or gambling – so-called sinful behavior. The Quakers also incorporated what is believed to be the first issue-specific screen resulting in boycotts of companies tied to the slave trade. (For historical overview, see Domini, 2001; Waddock 2000; Hutton, D'Antonio, Johnsen, 1998). In what is believed to be the first externally screened US investment, the Pioneer Fund in 1928 incorporated these negative or sin screens, excluding companies involved in tobacco or alcohol. (See SocialFunds.com; <http://www.socialfunds.com/media/index.cgi/screening.htm>)

The social activism of the 1960s spurred the development of additional negative screens based on overtly political sentiments. In 1968, a pension fund in Boston asked a young securities analyst, Alice Tepper Marlin, to compile a "peace portfolio" of corporations with the least involvement in supplying armaments for the war in Vietnam. Hundreds of church and community groups asked for her report. The Interfaith Center on Corporate Responsibility composed of hundreds of religious members from varying faiths was formed in 1971. That same year, a Methodist group launched the Pax World Fund, which included a negative screen on military contracting along with alcohol and gambling.

The 1970s and 80s witnessed the blossoming of a concurrent movement known as green or ethical consumerism. Self-appointed watchdog organizations such as the Council on Economic Priorities (CEP), founded by Tepper Marlin, began rating companies on a variety of hot-button social issues including animal rights, nuclear energy, and gay and feminist issues. In the spirit of the times, many activist consumer groups criticized "multinational" corporations often using the pejorative "Corporate America." (In contrast, entrepreneurial businesses such as Ben & Jerry's and The Body Shop, although beset by ethical and operational problems, were often romanticized as "socially responsible," in part because their founders' anti-corporate rhetoric (Entine, 1995).) The

stated goals of most green consumer groups was not to encourage stakeholder-centric behavior as generally understood by academicians and practitioners but to promote pet social causes and “shop for a better world” (as reflected in the CEP guidebook series “Shopping for a Better World”). Many of social investing’s most prominent researchers, including Steven Lydenberg, a principal at (KLD), cut their eyeteeth as researchers at ideologically-charged CEP.

These two essentially anti-corporate currents – socially conservative “sin” notions promoted by religious-based mutual funds and the vaguely liberal, consumerist brand of Sixties activist ideology – coalesced during the 1980s to form the core of what is today called social investing. The catalyzing event was the boycott of apartheid South Africa, which further politicized corporate critics and tapped into the sentiments of newly affluent baby boomers sympathetic to a “green” romantic, anti-corporate pitch. Portfolio management firms such as Franklin Research and Development (now Trillium Asset Management) and social investment research companies such as KLD and Calvert were formed. By the late 80s, socio-religious screens conflated with populist but shifting activist concerns to form the hodgepodge that today constitutes the principles of the liberal wing of social investing.

Fungible Standards of Social Investing

Social investing research has attracted widespread interest among academicians who have been struggling for years to find reliable and objective ways to measure corporate social responsibility (CSR). All social research rating systems rely to some degree on perceptual measures, often translated into numerical rankings. In part because it evaluates thousands of companies including all of the corporations in the S&P 500, the database launched by KLD in 1990 has emerged as a popular and favorite academic benchmark. KLD originally established eight categories, later expanded to ten, constructed around negative or exclusionary screens: nuclear power, alcohol, gambling, tobacco, and military contracting, with other negative attributes such as insensitivity to gays swept into an “other” category. (See www.kld.com/benchmarks/BMSImthd.html) Companies that fail this initial sin screen are designated as not socially responsible and summarily excluded from various social indices that rely on KLD data. After sweeping for “sin” concerns, KLD then evaluates companies in qualitative areas such as community relations, workforce diversity, employee relations, environment, non-US operations, and product safety. Using a process of data collection, analysis, and ranking that it does not explain in detail, KLD staffers assign numerical ratings for each company in each category, which become the basis for its hierarchical rankings. The highest rated companies are included in one or another index, including the Domini Social Index 400. Launched in May 1990, the DSI was the first benchmark for equity portfolios subject to multiple social screens and today remains the most prominent.

Many corporate social performance (CSP) researchers (Rawley and Berman, 2000; Hutton, D’Antonio and Johnsen, 1998; Griffin and Mahon, 1997; Woods and Jones, 1995) including its most fervent advocates (Kurtz, 2000; Waddock and Graves, 1997a, Waddock and Graves, 1997b) have pointed out the methodological and conceptual

problems of linking CSP research to social investment data.¹ Although there is general agreement that CSP is a multidimensional construct, there is no agreed upon standard or theoretical rationale to aggregate and therefore compare multiple dimensions across or within industries. Berman and Wicks (1998) go so far as to argue that CSP is not a theoretically viable construct,” noting that it is a “complex collection of factors that do not maintain the same meaning across contexts” and “must be defined according to social context” (p. 407). Compounding such concerns, researchers often subjectively pick and choose which categories suit their personal notions of CSP and adjust the data using idiosyncratic formulae (Graves and Waddock, 1994; Turban and Greening, 1997). Despite such widespread deficiencies, many academic researchers rely on this data. Among the characterizations: KLD has developed a “consistent, largely objective, set of screening criteria” (Waddock and Graves, 1994, p. 1038); “the database ... objectively rates firms” (Johnson and Greening, 1999, p. 556); and the rating system is “carefully constructed” and reflects “mainstream social concerns” (Sauer, 1997, p. 141). Even some social investing skeptics have referred to the data as “largely objective” (Griffin and Mahon, 1997, p. 10).

Just how objective and carefully constructed are these ratings? Waddock and Graves (1997b) have written that “although the limitations of KLD’s data need to be recognized, these data do represent the only currently-available externally-based assessment of the S&P 500 corporations over a consistent range of stakeholder arenas, over time, by a set of observers with no immediate ‘stake’ in any given company.” This statement ignores the rule of “garbage in, garbage out.” The fact that KLD’s ratings are the “only currently-available” data begs the critical question: is the data reliable and a fair measure of CSP? The quality of conclusions depends upon the credibility of the data.

What are the standards of data collection and analysis? What conceptual and operational definitions are being used? Do social investment data provide a reasonable measure of corporate social responsibility?

- ***Methodological Issues***

CSP research data suffers from a lack of reliability. There are fundamental questions about the quality of the research data. KLD and other research groups review thousands of companies with skimpy resources. Research relies upon often unreliable, anecdotal, and highly interpretable data. Overworked and undertrained junior staffers draw on government data banks, journalistic sources, and information supplied by companies, collating whatever information they deem relevant. The task is daunting and highly subjective. This data are then given a patina of objectivity by being turned into hierarchical numbers or letter grades.

The controversy over the California-based “natural” juice company Odwalla offers a notable anecdotal example of the problematic nature of such data. By 1996, Odwalla was considered a model of social responsibility. Researchers at Adams, Harkness & Hill extolled the company for “respecting the fruit” and for its “intense caring [which]

¹ For one comprehensive bibliography of SRI quantitative studies, see www.sristudies.org/bib_frameset.html.

translate[s] into a superior product.... We believe that no other juice company takes these steps to ensure the quality of its products.” (Patsky, Galle and Negron, 1996, p. 48) At the time, KLD gave it glowing ratings and Domini included Odwalla in its index. Amy Domini, a founder of KLD and president of Domini Investments, orchestrated the appearance of Odwalla founder Greg Steltenpohl at that year’s Social Investment Forum conference, where she lavishly praised his company. One month after the conference, one child died and at least seventy people were injured after drinking Odwalla apple juice tainted by poisonous bacteria. Investigations by *The New York Times* and documents introduced in court cases found Odwalla criminally negligent and derelict for ignoring a known pattern of quality, safety, and health problems, and culpable for withholding that information from the public (Drew and Belluck, 1998). Even after these revelations, Domini showed her emotional attachment to her friend’s company when she wrote: “Odwalla has been compared to Johnson and Johnson (Tylenol) in rapid recall and voluntary assumption of blame, and the reporters give management high marks for action” (Domini, 1998). However, after more embarrassing revelations and adverse court rulings, Steltenpohl was forced to resign and the company, in financial disarray, was acquired (Entine, 1999). As it turns out, Adams, Harkness & Hill and KLD used highly selective data and based their conclusions primarily on company representations. Even after details of its criminal conduct became known, Domini and KLD’s Kinder declined to revise their high ratings of their friend’s company.

The Body Shop case offers another dramatic example of the methodological problems besetting CSP research. In the early 1990s, every social investment company including what was then Franklin Research and Development gave the British cosmetics company high grades. However, after *Business Ethics* magazine published an article that raised sustentative concerns about its performance (Entine, 1994), Franklin did more research (Bavaria, Becker and Billenness, 1994), lowered its ratings across the board, and divested itself of its Body Shop shares. As Franklin’s research director noted, “We learned a hard lesson: never take a company’s representations at face value. This is not a science but an art.”² The Odwalla and Body Shop affairs underscore the personal and ideological biases that challenge the credibility of CSP research.

CSP research uses arbitrary standards. Can social performance attributes be measured and compared in a meaningful way, from company to company and across industries? The use of exclusionary screens highlights the subjective and often arbitrary nature of such ratings (Hutton, D’Antonio, Johnsen, 1998). Each fund sets cut-off points to determine whether a company is excluded. For example, Washington Mutual Fund, with \$40 billion in assets, screens out companies that derive 50% or more of revenue from tobacco or alcohol. Why 50%? Beats them. Ethical Funds, a Canadian social research firm, screens out companies that make packaging for the tobacco industry – unless tobacco-related production represents less than 20 percent of business. How does EF verify that figure? It can’t. Why a 20 percent cutoff? “That’s just the percentage we set,” said its founder, David Shuttleworth. (Entine, 1995a, p. 45) KLD screens out companies that derive more than 2% of revenues from weapons sales; 15% of their revenue from adult entertainment; own 20% of another company with abortion involvement; or are

² Billenness interview with Entine, February 1994.

50% owned by a company with alcohol involvement. Putting aside the prickly issue of how it determines such things, what's the meaningfulness of these arbitrary percentages?

CSP research ignores corporate activity that is not easily measurable, and is a priori biased against some industries that are more transparent. In practice, all current social screens eschew complexity. While banks do not release details on their portfolios and the technology industry is notoriously secretive, basic industries churn out reams of environmental data. That makes them easy targets for simplistic screens. Social research rating systems that do not use a “best in sector” approach (KLD does not) severely limit as a matter of principle investments in chemicals, natural resource, energy, and mining – companies and industries with large, negative environmental impacts.

Most research does not extend beyond the first-level of corporate activity, which can result in a distorted picture of company practices. For example, bank portfolios are not screened for relationships with companies involved in tobacco, nuclear power, or weapons production. The loan lists of banks are littered with investments in industries that are taboo according to liberal-oriented sentiments, but are not available for public scrutiny so therefore are not subject to screening. Such superficial standards conveniently allow social investors to screen in fast-growth stocks of banks, financial institutions, communications firms, and technology companies—even though they all do a high percentage of their business with the military and other so-called sin-related businesses. Researchers do not examine layered business models (such as franchising) or the kind of complex business structures increasingly common in modern corporations (such as the dense corporate structure of Enron). Simplistic screens often miss egregious corporate behavior. Consider Microsoft, by far the favorite stock in social portfolios and 6 percent of the Domini Social Index. It has been found guilty of antitrust violations by the federal government and the European Union, and remains embroiled in other consumer antitrust suits. Yet it consistently gets high marks from social researchers because antitrust violations and their impact on stakeholders, most notably consumers, are not screened.

First-level screens make a mockery of the complexity of modern corporations and underscore the methodological limitations of niche CSP research. In their defense, social funds contend they don't have the sophistication to go beyond a superficial analysis. “It's just too complicated, with too many variables,” admits Jerry Dodson, who heads Parnassus, a leading social fund that nonetheless relies on incomplete data to make its investment choices.³ Social researchers pleaded poverty and limited research capabilities when it turned out that many of the recently disgraced companies including Anderson, Enron, WorldCom, Adelphia, Tyco, and Tenet Healthcare were favorites of social funds.

The numerical ratings used by CSP researchers create an illusion of objectivity. Consumer activists such as the Council on Economic Priorities pioneered the rating systems used by social researchers. In its “Shopping for a Better World” guide (now no longer published), CEP graded companies like school children, from A-to-E on a range of social issues. For instance, CEP awarded an A in the category “Women” or “Women's Advancement” if a company had 10 percent or more female representation on the board

³ Dodson interview with Entine, November 1997.

of directors, and lesser grades for lower representation. Did CEP examine the quality or contributions of board members before assigning grades? No. As with many of social ratings, this was purely a litmus test.

KLD adopted this litmus formula. So, for instance, KLD gives high marks to companies in which women, minorities, or the disabled hold four or more board seats. What is the empirical basis for such criteria? There is none and none is offered. Other categories are even more subjective. Companies get high grades for implementing “innovative hiring programs” involving the disabled. What’s innovative? Who crunches subjective perceptions to come up with the hard numbers? Behind KLD’s ratings is a socially responsible Svengali—either an individual or group—who assigns numerical ratings. These numbers represent the perceptions of the ratings makers, colored by personal and ideological biases. The decision about what data to collect and the translation of this information into numbers render social investment data subjective and unreliable. Although numbers do not by themselves confer objectivity or meaningfulness, social researchers often cite these grades as if they represent an objective judgment and incorporate them in elaborate analysis.

- ***Conceptual Issues***

As has been noted, some academic researchers mimic the propaganda line of social investing advocates, who equate aspects of social investing with CSP. This is problematic. While corporate social performance reflects a *substantive* definition of behavior that assumes that some choices are more ethical or socially responsible than others, social investing is burdened by a historical reliance on a client-centered *procedural* definition that requires only that the investor believes he is acting ethically (Mackenzie, 1997).

Social investing advocates have never made the case that buying and selling stocks based on social criteria promotes reform or is more ethical or socially responsible than mainstream investing. In postmodernist fashion, there are no agreed upon standards about what constitutes social responsibility. Each individual gets to decide for herself what is a “better world” and which companies are deemed ethical. “Our common goal,” stated Joan Bavaria of Trillium at a SIF gathering in 1997, “is to give people the information they need to make their own determinations about what they want to invest in.”⁴ According to Cliff Feigenbaum, editor of *Greenmoney Journal*, the movement seeks to “match your capital to the companies that best represent your moral and ethical values.” Social investing is based on investor feelings – the “heart” according to social investor advocates who talk about aligning investments with one’s beliefs – not explicitly on company behavior (Feigenbaum, 2002; Domini, 2001).

There are literally hundreds of funds and investment strategies with different ideological colorings and varying definitions of socially responsible and ethical corporate behavior. Social investing principles run the gamut from ultra liberal to hard conservative, from pacifist to militarist. Perception not ethical performance drives social investing. As a result of this definitional ambiguity, social investing has devolved into an exercise in

⁴ Entine notes from conference.

tactics and liberal sentimentality, focusing on litmus screens and pandering to perceptions, rather than sorting estimable from questionable corporate behavior. Favored investments – consumer products, media, health care, and business services – reflect a consumerist “shopping for a better world” esthete that people’s purchasing habits define strong corporate social performance.

As the controversy over corporate business practices began to build in recent years, social investment leaders have tried to reposition their movement by attempting to equate ideologically based social investing with the very different notion of corporate social responsibility. In its most recent trend report, under the heading “social investing defined,” it often interchangeably refers to SI and CSR as if they are one and the same thing. So, for instance, following a description of social investing practices, it quotes the Prince of Wales Business Leader Forum to the effect that “Corporate Social Responsibility means open and transparent business practices” (SIF Report, 2001, p. 8). It further claims, “Social investment requires investment managers to overlay a qualitative analysis of corporate policies, practices, and impacts onto the traditional quantitative analysis of profit potential.”

In practice, however, the most prominent *social investors generally ignore the impact of most corporate practices on stakeholders*. The single largest social mutual fund company, American, which runs two funds with 40% of all the SRI dollars, does not screen for stakeholder or corporate governance issues at all. It screens only for tobacco and alcohol investments. In fact, not one of the SIF’s 73-member funds screen for the array of corporate practices touted by the SIF in its trend report. As is typical within the industry, its leaders, such as Peter Kinder, have long-standing personal biases against corporate governance related screens. “Focusing on non-issues such as independent boards, transparency and the like makes it easy to avoid taking stands on real issues of corporate accountability,” Kinder has written. He claims that social issues are far better measures of corporate responsibility (Kinder, 1997).

While KLD underplays corporate practice screens, Calvert historically has ignored them altogether. In the wake of recent corporate scandals, Julie Gorte of Calvert was asked why Calvert had never screened for accounting or governance issues. “This is a meteor,” she said, acknowledging that Calvert had long ignored a fundamental measure of corporate responsibility. “We’re still measuring the depth of the crater” (Entine, 2002). Although it has since introduced limited corporate practice screens, Calvert and the rest of the industry pay short shrift to the range of CSP standards that the SIF report claims are the centerpiece of social investing.

Instead of examining corporate practices, social investors favor litmus tests on trendy social issues with an outsized reliance on “sin” screens. Consider the most popular screen, on defense weaponry. KLD’s Kinder hyperbolically brands all military contractors as “merchants of death” and reflexively screens them out as not socially responsible. Many social researchers and academics are so convinced that defense production is a priori not ethical that they do not even attempt to justify this sentiment. “In the view of social investors,” wrote KLD’s Steven Lydenberg and Karen Paul of

Florida International University in a paper and presentation at an annual meeting of the International Association of Business and Society, “full scale nuclear war poses a risk to the survival of life on Earth. Companies that manufacture nuclear weapons increase that risk” (Paul and Lydenberg, 1997). Sandra Waddock and co-author Neil Smith toed this ideological line when they ranted against “...individually harmful products (such as cigarettes, nuclear equipment, or military arms)...” (Waddock and Smith, 2000, p. 78).

By using ambiguously defined and applied sin screens, ideology has replaced analysis. There is no evidence that a ban on military production promotes the presumably desirable goal of preventing war. The screen sidesteps the more important social policy issue of what defense expenditures may be wasteful or unnecessarily provocative. History suggests that absolutist pacifist ideology can have horrific unintended consequences and often leave countries more vulnerable. In the 1930s, ultra-pacifists and Nazi sympathizers formed an alliance in an attempt to keep the US out of World War II. Holocaust survivors or supporters of Israel might find a screen on military production in the name of ethics offensive. It is certainly arguable that military production can act as a deterrent to aggression. Some historians believe that the military escalation undertaken by the US in the 1980s was a key factor in bankrupting the Soviet empire and hastening the end of the Cold War. It’s particularly ironic to note that according to public opinion surveys, the liberal community (and presumably liberal-minded social investors and academicians) has overwhelmingly supported two recent wars: the overthrow of Slobodan Milosevic’s repressive regime to stop genocide and bring Western values to the Balkans, and the military response in Afghanistan in the wake of 9/11, both on humanitarian grounds. It’s hypocritical and logically and morally indefensible for social investors and academic researchers to personally back selective humanitarian military interventions while simultaneously endorsing an exclusionary screen on all military production.

Social screens are based on idiosyncratic biases that differ dramatically in conceit and implementation; in other words, they are arbitrary. As a result of the procedural bias of social investing, there is no unanimity about what values or practices constitute social investing. Some investors focus entirely on one or two issues such as animal rights or tobacco. Many investors and funds are faith-based, drawing on varying Protestant, Catholic, Islamic or Jewish beliefs. Clearly, a religious fundamentalist in Kansas does not share many social and political values with a gay activist in New York. Some funds filter out companies that profess support for abortion rights and others screen-in these same companies. The conservative Timothy Plan excludes Disney, a favorite target of right wing activists, for its allegedly lax moral standards. In the past, Disney has been a favorite investment of more liberal social investment funds such as KLD. Despite the view of most liberal social investors that it’s values are by definition socially responsible, one investor’s taboo is another’s sacred cow.

Compounding these differences, social researchers with similar ideologies often apply different conceits or methodologies. As a result, those screening for the same issue and with the same purported social goal may sometimes reach differing conclusions. For example, while Boston-based US Trust was praising Gillette in the early 1990s for being “extremely proactive in disclosing...its animal testing policies,” concluding that it is

“quiet about its corporate social responsibility achievements and forthcoming in areas of social controversy,” Gillette was screened out of numerous funds including Domini Social Equity because it engaged in animal testing (Entine, 1997).

KLD, as other CSP research organizations, offers little explanation as to why certain categories are selected and others excluded. Indefinable “social justice” issues take precedence over classic stakeholders. Investors, vendors and franchisees are given second-class citizenship in comparison to ambiguous ideals like “peace” and “fighting oppressive regimes.” Companies that create high-paying jobs, for example, get few of the social credits of companies that pass flowery social mission or ethic statements—like Enron. Oddly, there is little focus on a company’s responsiveness to its customers, arguably its most important stakeholder. Although KLD developed a category called “product quality,” the use of that screen as a surrogate for customer relations by Waddock and Graves (2003) is dubious at best.

By elevating trendy social issues, mission statements, and sin screens over broader stakeholder measures, liberal social investors often ignore behavior with significant social and financial implications. As an example, Levi Strauss, the jeans and clothing company, basked in a tremendous amount of good press in the 1980s and 90s because of its ethical pronouncements on a variety of trendy issues. Yet it made increasingly shoddy products, treated piece workers poorly, and eventually saw its CEO mismanage the company into the ground. It was ultimately forced to retrench, shutter its American facilities and flee to low-wage havens. Thousands of its employees no longer have jobs and the company still has not recovered. In essence, Levi Strauss’ high-minded ethical stands – the actual operating centerpiece of liberal social investing – proved worthless in real terms.

The arbitrary nature of the categories used by social researchers can be illustrated by comparing the dominant liberal social investing model with the rating system developed for black trade unions in South Africa in the early 1990s. Consultants Richard Adams and Jayanti Durai surveyed members about how to invest their pension fund, which then totaled \$175 million (Adams and Durai, 1995). Rather than relying on the socio-religious criteria popular in North America and the UK, the workers devised their own guidelines. Litmus-test social sin issues such as armaments manufacturing and alcohol production were scrapped. Union members focused on product quality, working conditions, benefits, safety, and equal opportunity as weighted measures of CSP. Worker-related issues represented more than 75 percent of the screening criteria.

South Africa’s Community Growth Fund

(In order of importance based on 100 points)

Job creation policy	14
Industrial relations	14
Conditions of employment	13
Training	7
Equal opportunity for women	7
Health and safety	6

Type of product	5
Privatization	5
Profit retention	5
Affirmative action	5
Location (share of foreign assets)	4
Environmental management	4
Disclosure	4
Worker participating	4
Political profile	2
Social spending	1

Unlike the liberal model with its procedural focus on perception and its reliance on exclusionary screens, the workers' model focuses on behavior and stakeholder rights.

The Financial Footprint of Social Investing

Every two years since 1995, the Social Investment Forum (Key members include KLD and its sibling Domini Investments, Calvert Group, Parnassus, and Citizens) has issued a report on industry trends including estimates of the assets of investors who use social screens and shareholder advocacy. According to the SIF's most recent report, as of June 30, 2001 "nearly one out of eight dollars under professional management in the United States is involved in socially responsible investing"; \$2.03 trillion, 12 percent of the \$19.9 trillion in investment assets under management, are socially screened; these assets "grew 1.5 times faster than all U.S. managed portfolio assets" over the previous two years; and "socially screened separate accounts grew by nearly 40 percent" (SIF Report 2001, pp.4-5). Citing the spate of corporate scandals, Citizens Advisor, Inc. founder Sophia Collier claimed, "Socially responsible investing is about to come into fashion," predicting it will double in three to five years (Ackermann, 2002). Academic researchers and journalists credulously report these purported trends, often reproducing SIF statistics and news releases almost verbatim (Waddock, Bodwell and Graves, 2002; Sauer, 1997). These are certainly astounding statistics, worthy of academic study if they accurate and in context. Are they? How does the SIF define social responsibility and thereby determine which assets are considered socially responsible?

The SIF counts all assets that by its definition are "screened, involved in shareholder advocacy, or are directed to community investing." Under the heading "What Was Counted," the study notes that "an institution was considered to engage in socially responsible investing" if it "utilizes *one or more social screens*" or if the institution sponsors or co-sponsors shareholder resolutions *on issues the SIF considers socially responsible* [emphasis added] – even if the client or investment manager does not consider those investments social investments (SIF Report, p. 31-32). What does this mean in practice? Any institution, investment manager, or investor that screens on almost any issue as part of a "formal" policy is by SIF definition engaging in social investing. This definition is problematic. Consider the recent proliferation of governance screens on such things as accounting issues, board makeup, and pension fund liabilities. Under SIF criteria, a pension fund that screens for a majority independent board or the compensation of executives has that investment counted as a "social investment." Yet almost every

responsible investment advisor now reviews corporate governance issues as a matter of course. According to SIF's boundary-less policy, their investments could be counted as social investments – if the screening is deemed formal. With such ambiguous standards, there are almost no barriers to entry into the SIF's social investment club.

There are also glaring computational mistakes in the SIF report. It stated that “assets in socially screened mutual funds stayed steady from 1999 to 2001, despite a substantial market downturn,” and set the total at \$153 billion (2001 SIF Report, p. 12). That is inaccurate. Socially screened mutual fund investments totaled only \$144.5 billion. SIF misstated the Calvert Large Cap Growth Fund by a factor of ten – an \$8.5 billion error.⁵ Using the corrected figure, the 1% drop in mutual fund social investments turns out to be a 6.2% fall off. According to the Investment Company Institute, (www.ici.org/facts_figures/historical_trends.html), the mutual fund market grew by 14.36 percent over that over two year period. So while the amount of money being invested overall in mutual funds was soaring, dollars were being drained from the most prominent social investment funds. It is disconcerting to note that these erroneous data have already been incorporated in academic research papers, including the winner of the 2002 SIF Moskowitz Prize, “Evidence on Ethical Mutual Fund Performance and Investment Style” (Bauer, Otten and Koadijk, 2002), which was also published by the *Journal of Investing*.

How large is the financial footprint of the liberal wing of the social investment movement, which garners most of the media attention? If the mutual fund market is the measure, it is tiny. Of the 73 SIF member funds, only 16 broadly screen for social issues and hold assets over \$100 million, accounting for less than \$8 billion. The 73 liberal-minded funds in total hold only \$10.11 billion in total investments, or .16% of the \$6,555.1 billion mutual fund market.

Since the puncture of the market and technology bubble, tech-weighted funds including most liberal focused social funds that placed outsized sector bets on technology have cratered and continue to underperform. While there has been an overall rise in mutual fund investments of 2.5% over the two-year period, Domini Social Equity, the largest SI fund with \$1.296 billion in assets as of December 31, 2002 has shrunk by 22%; Pax World has dropped 14%; and Calvert, the third largest fund, is off 25%. Not one of the largest social funds tracked by the SIF showed an increase, with the overall drop approximately 20%.

We are faced with the apparent anomaly that while social investing advocates claim dramatic growth, investments in socially focused mutual funds are contracting relative to the overall size of the mutual fund pie. It seems counterintuitive to claim that interest in social investing by individuals is soaring while social investment dollars in mutual funds, which are generally believed to reflect individual investment interests rather than institutional sentiment, now represent the tiniest fraction of fund investments.

This pattern of applying an ideological filter on data also extends to performance analyses. For example, John Guerard, Jr.'s “Is Socially Responsible Investing Too

⁵ Confirmed in conversation with SIF public relations spokesperson Todd Larsen, 1/21/2003.

Costly” asserts “there is a growing literature in academic and professional investment journals that suggests socially responsible investing might produce higher risk-adjusted portfolio returns than merely using all available stocks in the equity universe” (Guerard, Jr., 1997, p. 26). However, the data does not support that sweeping conclusion—as he himself notes further along in his article. Guerard cites studies that mostly show either no statistical difference or relative underperformance by social funds. Similarly, Waddock, Bodwell and Graves (2002) have written that “significant evidence from a large and growing body of academic research suggests at a minimum a neutral, and quite likely a positive, relationship between responsible corporate practices and corporate financial performance.” Yet, those who have reviewed the performance analysis literature, including Waddock, find no such consistent evidence that socially screened companies and funds outperform (Waddock, 2000; Sauer, 1997; Griffin and Mahon, 1997).

The few studies that purport to show either a neutral or positive social investing or financial performance tout the KLD data as a reliable measure of CSP practices (see Waddock and Graves, 2003; Waddock and Graves, 1997a; Waddock and Graves, 1997b; Guerard, Jr., 1997; Kurtz, 1997). Also, many studies and popular articles have favorably compared the performance of the KLD-linked Domini Social Index (DSI) or the Domini Social Equity Fund with the S&P 500 (Feigenbaum 2002; Guerard, Jr. and Stone, 2002; Waddock, 2002; Sauer, 1997; Young, 1996). There are significant problems with this assumption. Although the DSI counts as its benchmark the S&P 500, it is not a passive large cap index fund and is not optimized to any broader benchmark. The DSI only includes about half of the top 500 stocks and weights them as it chooses and arbitrarily. While some academic researchers incorrectly state that Domini maintains a “passive fund” (see “How We Did the Study” in Waddock and Graves, 2003, p. 8), like all social investing funds, it is actively managed.

Researchers also often overlook that there are a variety of factors that can convincingly explain the competitive performance of social investments, most notably: (1) the concentration of investments in a narrow range of formerly high growth sectors; and (2) the time frames that these researchers arbitrarily select to compare social investment funds with mainstream funds. The KLD database (and as a result the DSI) is biased towards larger growth companies concentrated in a few key sectors—technology and financials most prominently. While the S&P has 20.5% of its holdings in financials, KLD/DSI hold more than 25%; S&P holds 14.3% in technology stocks while KLD/DSI hold 18.75%⁶ (and as much as a third of its portfolio in recent years). KLD/DSI underweight as a matter of principle infrastructure, manufacturing and energy companies claiming these are more likely to have adverse environmental impacts.

Almost every academic study that purports to show a neutral or positive correlation pre-dates the current bear market during which large growth stocks and technology companies outperformed. For example, Guerard, Jr. has used various time frames between 1984-1997 (Guerard, Jr., 1997; Guerard, Jr. and Stone, 2002). Waddock’s social investment study covered a ten-year period from 1986-1996 (Waddock, 2000). The 2002 Moskowitz Prize paper by a team of Dutch researchers incorporates data through 2000

⁶ As of December 31, 2002.

(Bauer, Otten and Koadijk, 2002). These time frames are never theoretically defended; in fact, they present a very distorted picture of social performance. Even a minor change in dates selected for market analysis can significantly alter the results. For example, in the early 1990s, when sin stocks including military companies outperformed, a sin portfolio yielded a significantly higher return than screened funds (Naber, 2001). Later in the decade, KLD and other social funds prospered with sizable bets in financials, technology, health care and communications.

The period beginning in the early 1980s and ending in 2000 corresponds to a historically unprecedented extended bull market in which growth companies and sector investments favored by social funds outperformed. It is no wonder that tech-heavy social funds performed competitively during this period; according to Morningstar, with the bubble at its largest during 2000, more than 90% of tech mutual funds rated five stars (McDonald, 2003). During the 1970s and early 1980s large company growth stocks including technology companies that are prominent in the DSI performed relatively poorly for an extended period. Neither the DSI, nor academic studies using DSI data, have backtested for this period to fairly evaluate performance in varying investment climates.

The mediocre performance by social funds during the current bear market, when many of social investing's favorite sectors were out of favor, underscores the limited value of academic studies using narrow and arbitrary time periods. The Domini Social Equity Fund (DSEF), which is based on KLD's ratings, has been a notable recent laggard. It rates a below average "2" in Morningstar's Ratings and a "C" over 3 years by Lipper.⁷ It trails the S&P 500 index funds that it claims in its prospectus to track over the 3- and 5-year periods. However, comparing it to the S&P 500, which many social investing advocates and academic researchers choose to do, understates its even poorer performance relative to its peers. According to the Domini Fund's web page, the DSEF is a large blend (Morningstar) or large-cap core (Lipper) fund. Against these indices, Domini underperforms by about 15% over three years independent of fees, which would increase the disparity.

The KLD/DSI stock mix would have significantly underperformed the market even during the go-go 1990s if they had screened these once outperforming stocks for key stakeholder issues such as corporate ethics. If only one stock, Microsoft, which represents more than 6% of the indices, had been screened out because of alleged consumer anti-trust violations, the performance data would have looked markedly less robust. Entire groups of questionable stocks were screened in only because their problem area – pension fund shenanigans and shifty accounting – are too arcane for the social investment community's porous screens. For example, Verizon, the US's largest local phone company and the DSI's seventh largest holding at 2.4%, reported a strong fiscal 2002 with profits of \$389 million. Only those investors who dug into the small print at the back of the document learned that Verizon's reported earnings included \$2.7 billion in gains from its pension fund investments. One problem: as Verizon knew and the KLD/DSI research did not pick up, those profits did not really exist. The company pension fund actually lost \$3.1 billion, a footnote on page 58 of the 68-page report revealed, and \$15

⁷ As of December 31, 2002.

billion since 2000. These are not just abstract accounting issues. Verizon's pension fund fiasco has vaporized more than 30,000 jobs including 25% of the union workforce. Even today, with the full details of the misrepresentations (that has so devastated key stakeholders including investors, workers and local communities) public knowledge, Verizon remains a KLD/DSI favorite. Numerous other companies considered favorites by social researchers including Cummins Engine, American Airlines and Delphi Automotive face a raft of ethical questions about underfunding of their pension funds or unilaterally trying to change their pension fund schemes.

There is no evidence to believe that the principles of social investing, rather than active-fund portfolio management and sector bets, explain the competitive (though eroding) performance of some social investments during the late bull market. Although it is certainly possible and even intuitively likely that CSP is positively correlated with both stock performance and financial performance, the data generated by social researchers is too methodologically flawed and theoretically suspect to be of serious use for academic research. There is absolutely no convincing evidence that social investing principles help identify ethical high fliers, profit stars, or stock market winners.

Discussion

While social investment advocates claim that “social investors [are] consciously ... working to build a more just and sustainable economy” (SIF Report, 2001, p. 8), there is an unbridgeable gap between rhetoric and reality. As with most NGOs, perception and anti-corporate ideology, not corporate reform, drive the movement. The rating systems that have evolved are based on superficial litmus screens judging social propriety and social conventions. They lack a coherent moral or ethical perspective. They confuse social liberalism with ethical behavior. They systematically underplay key aspects of corporate behavior including corporate governance and transparency and overplay facile moral notions. They reflect the personal ideologies of those who conceived the ratings and collect the data. Social investing remains trapped in an anachronistic paradigm based on a bouillabaisse of problematic conservative religious principles and dated liberal social notions.

Despite these intrinsic limitations, social researchers convert this ideological stew into so-called objective ratings. They commit what is called the fallacy of reification – the conversion of a complex and multi-faceted concept, in this case corporate social responsibility, into a putative real entity – a number or rating. This is pseudo-science, on the level of astrological research. Social researchers who rely on this data caricature the complexity of business to suit their ideological beliefs. Business ethics requires decision-makers to weigh the impact of their ethical choices on a number of stakeholders. Such decisions do not lend themselves to litmus tests or reductionist numerical ratings.

As currently practiced, social investing principles and databases are hopelessly flawed proxies of corporate social responsibility. Although social investing has demonstrated that it can be an effective brand marketing strategy, it does not fulfill its stated rationale of promoting systematic investment in “good” companies and effecting positive change –

to “do good”. Moreover, by implicitly encouraging the belief that the intentions of a business can be judged distinct from the economic impact of a company, social investing may promote corporate behavior that is neither socially progressive nor ethical and may result in adverse consequences to stakeholders.

To date social investing has drawn modest but increasing interest from institutions and mutual funds that view it as a potential brand with appeal to niche investors. Nonetheless, it continues to draw outsized and consistently positive media coverage, and is increasingly being characterized and often perceived as a proxy for good corporate citizenship. Its influence, and therefore its potential for mischief, dramatically exceeds its small financial imprint. Anti-free market NGOs under the guise of corporate reform are extending their reach into the boardrooms of corporations. In many cases, naïve corporate reformers, within corporations and in government, are welcoming them. This is an unsettling trend: As practiced, social investing is a wolf in sheep’s clothing.

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