

# *Retirement Investment, Fiduciary Obligations, and Socially Responsible Investing*

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In the last thirty years, the face of American retirement has changed dramatically. Previously, the landscape was dominated by traditional “defined benefit plans” (“DB plans”), which most people think of as a “pension”. Such plans still support millions of retirees, especially in government and unionized labor. But today, “defined contribution plans” (“DC plans”) have begun to replace the older system, and 401(k) plans are commonplace – as are IRAs and similar self-directed options. Within the mammoth scope of the retirement investment industry, the question of the permissibility of “socially responsible investing” (SRI) must be addressed with increasing frequency. Whether motivated by the recent corporate scandals, by a desire not to profit from alcohol and tobacco, or by a growing concern for environmental sustainability, more and more plan participants are expressing a desire for a coherent system of selecting investments based on criteria beyond conventional analysis, with a focus on societal goals beyond investment returns. But in what circumstances, and to what extent, might such an investment strategy be permissible? May those charged with making decisions about retirement investments reasonably choose SRI?

Our position in this essay is that consideration of the fiduciary obligations of the trustees of retirement plans shows that SRI investment strategies are not in and of themselves impermissible. On the contrary, in this essay we argue that (A) the farther we move from self-directed plans toward institutionally-invested DB plans the narrower the range of allowable investment options becomes, and yet (B) basic SRI investment strategies are always at least permissible.

## **I: What Is SRI?**

Despite what the media may imply, “socially responsible investing” is neither an asset class of its own nor a simple investment style. Financial reporters have the unfortunate tendency to compare the performance of SRI mutual funds to some basic market index such as the S&P 500, no matter what the fund’s holdings might be. For example, Bloomberg News’s columnist John Wasik recently wrote an article<sup>1</sup> discussing the relative merits of the Domini Social Equity Fund (a large cap index fund), the Sierra Club Stock Fund (large cap growth), the Green Century Balanced Fund (small cap growth and “junk” bonds), the New Alternatives Fund (small cap core), and the Winslow Green Growth Fund (small cap growth) – comparing each of them to the Wilshire 5000 Total Stock Market Index, meaningless as a benchmark for any of these funds.

Services such as Morningstar and Lipper do a better job of providing accurate comparisons for SRI mutual funds, since they look at the fundamental data regarding the portfolio’s contents and performance – but the criteria they use to determine which funds are to count as SRI are at best arcane. On the other hand, this confusion is quite understandable: the concept of socially responsible investing has itself evolved over time, and has suffered somewhat from changing definitions at the hands of both practitioners who are within the industry and others in the “mainstream” who are trying to understand it. For the purposes of this paper, we will use this definition:

Socially responsible investing (SRI) is investing in companies that meet certain baseline standards of social and environmental responsibility; actively engaging those companies to become better, more responsible corporate citizens; and dedicating a portion of assets to community economic development.<sup>2</sup>

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1. John Wasik, “Three Funds That Can Green Your Growth Portfolio”, available online at [http://quote.bloomberg.com/apps/news?pid=10000039&refer=columnist\\_wasik&sid=aLFGI9XpqwU](http://quote.bloomberg.com/apps/news?pid=10000039&refer=columnist_wasik&sid=aLFGI9XpqwU).

2. This definition comes to us courtesy of Joseph F. Keefe, member of the Board of Directors of the Social Investment Forum, an industry association. This definition, and other information, is available online at <http://www.newcirclecom.com/>.

Or, to put this point more succinctly, SRI is “the process of integrating values, societal concerns and/or institutional mission into investment decision-making”.<sup>3</sup>

Just as the basic definition of SRI has continually evolved, the standards for the portfolio screening employed by SRI investment managers have changed, shifting from simple quantitative screens to more complex qualitative screens. For example, not only are companies screened out of portfolios on the basis of the percentage of a company’s revenues that are tobacco-related, but companies can be screened either in or out based on an assessment of a company’s workplace conditions or commitment to sustainable business operations. Screening is, in this sense, a variety of fundamental security analysis – usually a qualitative type of analysis, rather than quantitative. Screening alone, however, is not likely to have a significant impact on corporate behavior – or on an individual company’s share price – until the vast majority of investors are all screening the same group of stocks out of their portfolios. “Shareholder advocacy” is a much more effective strategy for investors who want to see significant changes: companies that might once have simply been screened out of a portfolio are now being held in order to engage corporate management in productive dialogue on topics of vital interest. And community-development investment vehicles have gotten more sophisticated, while consistently proving their impact and value. . It is the prerogatives of ownership, rather than the tool of divestment, that are most likely to raise the bar of corporate responsibility for all companies.

Social investing is almost entirely a financial asset phenomenon. Stocks and intermediate duration U.S. fixed income are relatively well represented among mutual funds and separate account managers. But such things as hedge funds, energy, real estate, precious metals, commodities in general, international fixed income, emerging markets, short or long duration bonds, stable value portfolios and insurance products (beyond variable annuities holding clones of existing SRI funds) are almost entirely unavailable, except in separate account management – and even there they are few and far between.

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3. Steven J. Schueth, “Socially Responsible Investing in the United States”, Colorado Springs: First Affirmative Financial Network, May 2004. Available online at <http://www.firstaffirmative.com>.

While there are quality SRI mutual funds in most of the standard investment style boxes, social screening introduces some biases to investment portfolios, and eliminates or severely reduces some investment options. Social portfolios usually have a smaller market capitalization than their unscreened counterparts. Eliminating General Electric and Exxon Mobil from the top of the S&P 500 drives the average market cap of the Domini Social Index down to \$38.2 billion – much lower than the unscreened index’s \$45.9 billion.<sup>4</sup> Elimination of natural resource extraction, tobacco, and many cyclical manufacturing companies creates a tilt towards growth, and creates challenges for SRI managers trying to work in the value side of the market.

Applying traditional social screening criteria to real estate or precious metals leads to confusion, complex decisions or simple exclusion. Consider the Real Estate Investment Trust that buys an apartment building with the intent of improving the property, increasing rents and selling it at a profit at some point in the future. Evaluate that investment with the common social criterion of providing affordable housing, and you can immediately identify complexities that defy simple include-or-exclude decision processes.

We have argued elsewhere that there is nothing intrinsically contrary to fiduciary duty involved in an investment advisor’s use of SRI investment strategies for those clients who desire it.<sup>5</sup> At the advisor’s level, the key fiduciary duties are procedural: “Simply stated, the role is to set policy, to select appropriate professional money managers (including mutual funds), and to monitor the results”.<sup>6</sup> When assessing the suitability of social investment strategies in retirement plans, the key dividing line seems to be appropriately placed between those situations in which trustees hold a fiduciary duty to make all decisions about the investment management process and those in which plan participants have the ability to make some choices – either on their own or within a scope of choices determined by fiduciary trustees. In other words, we face the following questions: (A) Who selects money

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4. As of April 30, 2004; see [www.morningstar.com](http://www.morningstar.com) analyses for the Domini Social Equity Fund, as a proxy for the Domini Social Index, and the Vanguard 500 Index Fund, as a proxy for the Standard & Poor’s 500 Index.

5. Johann A. Klaassen and George R. Gay, “Fiduciary Duty and Socially Responsible Investing”, *Philosophy in the Contemporary World*, 10 (1), Spring/Summer 2003: 49-54. Available online at <http://www.firstaffirmative.com/media/fafnPieces.htm>.

6. Donald B. Trone, William R. Allbright, and Philip R. Taylor, *The Management of Investment Decisions* (Chicago: Irwin Professional Publishing, 1996), p. 2.

managers or mutual funds to be among the options for a retirement plan? That is, who develops the short list? And (B) Who is responsible for choosing managers or mutual funds from that list? That is, who makes the final selections? In the case of self-directed retirement plans (“SD plans”) the individual investor uses whatever tools she may have at her own disposal to winnow the thousands of options to a small few, and then she chooses from among them (or she may delegate these decisions to an agent, such as an investment advisor). In the case of DC plans, such as 401(k) and 403(b) plans, plan trustees create short lists of investment managers (usually mutual funds) from which plan participants pick. And in the case of DB plans, the trustees of the plan select the short list, then also choose from that list.<sup>7</sup> It seems clear that different people are responsible for different decisions in these three classes of retirement plan; it is our contention that SRI strategies are not inherently irresponsible choices in any of them.

	<i>Who sets the lists?</i>	
	Self	Plan Trustee
<i>Who chooses from the lists?</i>	Self	SD DC
	Plan Trustee	N/A DB

## **II: Self-Directed Retirement Plans**

The prototypical SD plan is the Individual Retirement Account (IRA). The tax advantages and flexibility that an investor can access through an IRA are purchased at a potentially severe cost: since the responsibility for wisely choosing investments for that account falls entirely on the individual, there is no one to “make good” on catastrophic losses due to unsuitable choices. In the prototypical case, an individual investor scours the financial press for “the best mutual funds” or “the hottest stocks”, investing his \$3,000 contribution for this year – or \$300,000 Rollover IRA – in whatever asset class did best last year. Given that this investor is making his investment decisions by himself, for himself, we think it is clear that there is no reason for him not to choose SRI.

Some brave souls admit their ignorance, and seek an investment advisor. This can be a very difficult decision, because the consumer financial press tends to make advisors look

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7. As far as we know, there are no retirement plans in which the individual selects the investment options from which plan trustees may choose.

unnecessary or worse. But the psychology of the individual investor isn't really our topic – what new wrinkles arise when an investment advisor is added to the picture? Do considerations of fiduciary duty prevent an investment advisor from proposing an SRI strategy for a retirement account? We believe that an advisor can reasonably recommend SRI to any clients who find that strategy compelling, regardless of the tax status of the account in question; we have argued for this view at length elsewhere,<sup>8</sup> but since this is a contentious claim, what follows is a brief sketch of our argument.

In general, two sorts of fiduciary arguments are raised against an advisor's helping a client to pursue an SRI strategy: (A) SRI portfolio managers will necessarily underperform non-SRI managers, because of the limitations on their stock selection universes; therefore recommending SRI is necessarily a breach of fiduciary duty. And (B) It is impossible to construct an adequately diversified portfolio using SRI managers and mutual funds, so an SRI strategy cannot be defensible. We contend that each of these arguments is fundamentally mistaken.

(A) Some recent studies of SRI strategies seem to show evidence of “return drag” caused by the SRI screening processes.<sup>9</sup> However, a quick glance at [SRISTudies.org](http://SRISTudies.org) shows a number of articles, published in reputable journals over the last ten years, showing that SRI strategies either (1) keep pace with non-SRI strategies, or (2) outperform non-SRI strategies by a margin that can be considered statistically significant. For example, at the 2001 “SRI in the Rockies Conference” (the annual conference for SRI investment professionals), two academic papers were specially honored.<sup>10</sup> The essay “Do Corporate Global Environmental Standards Create or Destroy Market Value?” was awarded the Moskowitz Prize for SRI Research; the authors demonstrated that those companies which held themselves to the highest environmental standards had the highest return (when adjusted for other factors).

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8. See Klaassen and Gay, “Fiduciary Duty and Socially Responsible Investing”, 52-53.

9. For two recent examples, see Jon Entine, “The Myth of Social Investing: A Critique of Its Practice and Consequences for Corporate Social Performance Research”, *Organization & Environment* 20 (10) (September 2003): 1-17, and Christopher C. Geczy, Robert F. Stambaugh, and David Levin, “Investing in Socially Responsible Mutual Funds”, Wharton School of Business Working Paper (released May 2003), available online at [http://finance.wharton.upenn.edu/~geczy/Papers/GSL\\_sri\\_paper\\_5\\_26\\_2003.PDF](http://finance.wharton.upenn.edu/~geczy/Papers/GSL_sri_paper_5_26_2003.PDF).

10. Both of these papers, and many other Moskowitz Prize winners, are available online at [http://www.socialinvest.org/Areas/Research/Moskowitz/winning\\_papers.htm](http://www.socialinvest.org/Areas/Research/Moskowitz/winning_papers.htm).

And the essay “Responsible Investment Screening: No Significant Cost for Actively Managed Portfolios” was awarded an Honorable Mention for the Moskowitz Prize; its authors demonstrated that when portfolios were matched by risk factors, SRI and non-SRI portfolios achieved almost identical performance over time. It seems clear to us that just as a strategy that focused on “high-quality” companies will lead to different results than an indexing strategy – a strategy which led to underperformance in 2003 – so too SRI strategies may lead to different, but not necessarily *inferior*, performance.

While there certainly have been studies showing SRI strategies falling short, there have been many others showing just the opposite. Perhaps the wisest course of action is to suspend judgment on this matter; we doubt very much that any conclusive proof one way or the other is coming any time soon. At the very least, though, we should hold suspect any claim that SRI portfolios will “necessarily” underperform their non-SRI counterparts. If that claim of necessity is suspect, then the claim that SRI is consequently “necessarily” a breach of fiduciary duty is also at least suspect.

(B) The diversification argument is stronger – since there may be certain asset classes that SRI investment managers are precluded from holding, there may be significant gaps in any SRI portfolio, and this could constitute a breach of fiduciary duty. Consider precious metals, for example: some portfolio analysts insist that as much as 5% to 10% of a portfolio should be invested in gold (or perhaps gold-related securities – mining company stocks, futures, derivatives of various sorts). But much of the world’s gold mining is done in conditions that few would consider to be particularly humane, and even the most humane mining operation is at best ecologically risky. Add to that the potential for stunning fraud, as in the case of Bre-X, and SRI-oriented investors have plenty of reasons to be skeptical.

From the standpoint of fiduciary obligations, a strict SRI strategy is still at least defensible. It is possible, by piecing together the asset classes that are well-represented in the SRI universe, to create portfolios on or very near the Efficient Frontier. In fact, given today’s sophisticated computer modeling software packages, it is not particularly difficult to construct an efficient SRI portfolio at a given risk level, and certainly not more difficult than to construct an efficient non-SRI portfolio. This objection might be a hold-over from a

decade ago: the Social Investment Forum, the industry association for SRI investment professionals, counted some 200 SRI mutual funds in 2003, up from only 139 in 1997.<sup>11</sup> With the increase in numbers has come increased diversity of style, and increased pressure to excel. In short, SRI-oriented investors and the professional advisors who serve them need not be overly concerned about the asset-class gaps that result from the application of certain social criteria.

To be blunt, there is no reason for an individual investor not to use SRI strategies to invest her IRA. “Do-it-yourself” investors must take the responsibility for making investment decisions; an investor who decides to hire an advisor to make those decisions on their behalf does not create intractable fiduciary conflicts for the advisor. The options are wide open in both cases – but what of more restricted cases? What about “employer-sponsored plans”?

### **III: Defined Contribution Plans**

According to the Investment Company Institute’s most recent study of the U.S. retirement investment market, as of the end of 2002, approximately 22% of all retirement assets were held in DC plans (up from just over 19% in 1990). While they are still dwarfed by DB plans, at 44% of the retirement market, more and more investors are being offered a DC plan as an alternative.<sup>12</sup> In the prototypical case, a small number of trustees select a short list of mutual funds; from this list, each employee selects the investments and allocations for their contributions (and often their employer’s matching contributions). The plan trustees are in a clear fiduciary role, and are responsible to choose a variety of investment options, sufficient for an informed investor to be able to create an adequately diversified portfolio. Clearly, if there are SRI options on the menu, it is not necessarily irresponsible to select them. But is it responsible for the trustees to put SRI options onto the menu in the first place?

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11. Social Investment Forum, *2003 Report on Socially Responsible Investing Trends in the United States* (Washington, DC: Social Investment Forum, 2003), p. 7. Note that Morningstar’s tally is rather different – much smaller, counting only 163 SRI funds as of March 31, 2004. We will return to this issue below.

12. Investment Company Institute, “Mutual Funds and the U.S. Retirement Market in 2002”, Washington, DC, June 2003. Available online at <http://www.ici.org/stats/latest/fm-v12n1.pdf>.

We believe that the trustees of DC plans, including public employee pension funds, have the option and authority to offer investment choices employing social criteria – as long as their selection process follows “prudent process”. Our thinking here is guided by the work of one of the few recognized experts on the special obligations of investment fiduciaries, Donald Trone of the Foundation for Fiduciary Studies (FFS). Trone and his associates at the FFS put it this way:

Fiduciary liability is not determined by investment performance, but rather by whether prudent practices were followed. *It’s not whether you win or lose, it’s how you play the game.*

A fiduciary demonstrates prudence by the process through which investment decisions are managed, rather than by showing that investment products and techniques are chosen because they were labeled as ‘prudent’.<sup>13</sup>

Of course, we have to ask this question: what would a prudent process look like in this sort of situation? How can a DC trustee ensure that their process is prudent?

Fortunately, the FFS has identified ten primary criteria by which we can evaluate the suitability of investment managers. They are:

1. A minimum track record of three years.
2. Assets under management of at least \$75 million.
3. Organizational stability: no perceived organizational problems and portfolio management tenure of at least two years.
4. Holdings are consistent with style: no more than 20% of assets in unrelated asset classes.
5. High correlation with asset class.
6. Expense ratios or fees should not be in the most expensive quartile of the peer group.
7. Risk-adjusted performance (alpha and/or Sharpe ratio) should be in the upper half of its peer group.
8. One-year performance should be in the upper half of its peer group.

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13. Foundation for Fiduciary Studies, *Prudent Investment Practices: A Handbook for Investment Fiduciaries* (Pittsburgh, PA: Foundation for Fiduciary Studies and University of Pittsburgh Katz School of Business, 2003), p. 8. Emphasis in original.

9. Three-year performance should be in the upper half of its peer group.
10. Five-year performance should be in the upper half of its peer group.<sup>14</sup>

The Foundation has evaluated the Morningstar mutual fund universe each quarter since the end of 2000. The “pass rate” – the ratio of funds that meet all ten criteria to the total number of funds evaluated – for the full Morningstar mutual fund universe has fluctuated between 5.34% and 7.04%. And the subset of 163 funds that Morningstar currently identifies as SRI funds? As we indicated earlier, we have some worries about Morningstar’s categorization of SRI funds,<sup>15</sup> and the subset is rather small for statistical purposes, but the pass ratio has varied from 0.69% to 6.90%. Two data points here strike us as particularly important. First, it has long been assumed that SRI funds must be more expensive than non-SRI funds – but of the 163 funds in the Morningstar group, 122 have expense ratios that are not in the most expensive quartile of their asset-class-based peer group. In other words, 25% of SRI mutual funds fall in that most expensive quartile, no better and no worse than similar unscreened funds. Second, most SRI funds are smaller than the FFS standard: only 39 of 163 SRI funds pass this criterion.

In theory, as Trone and his associates at the FFS note, there is no particular reason for trustees to exclude SRI options: “It has become a generally accepted practice to permit the inclusion of an SRI strategy,” the FFS notes. “If there are equally attractive [non-SRI] investment options, then social factors may be considered”.<sup>16</sup> In practice, the decision to

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14. Donald B. Trone, “Debunking Due Diligence”, Foundation for Fiduciary Studies, May 2001. Available online at <http://www.ffstudies.org/articles/debunking.htm>.

15. Of the 163 funds identified by Morningstar as SRI funds as of March 31, 2004: (A) Several Rydex funds are listed; Rydex makes no claim of social responsibility and is not included in any other statistical compilation of SRI products. (B) Several funds that do use social criteria are not identified as SRI funds by Morningstar. And (C) Morningstar lists separately each share class of funds that have multiple classes – so, for example, the new Morgan Stanley KLD Index funds are each listed four separate times (since each has A, B, C, and D class shares). By comparison, the Social Investment Forum identifies 200 unique funds using social screens, including many not listed by Morningstar, and is careful to point out that they *do not* count multiple share classes of a single fund – see the *2003 Trends Report*, pp. 7-11.

16. *Prudent Investment Practices*, p. 31. This quotation is from the “practical application” discussion of “Practice 3.7”: “The investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable).” The FFS supplies a list of the substantiating codes, regulations, and case law, including the relevant sections of the *Employee Retirement Income Security Act of 1974*, the *Uniform Prudent Investor Act*, and the *Management of Public Employee Retirement Systems Act*, all three of the key pieces of legislation regarding retirement investing. In addition, the FFS refers to the Department of Labor’s *ERISA Opinion Letter No. 98-04A* (May 28, 1998), which explicitly justifies the inclusion of SRI options in qualified retirement plans.

include an SRI option in a DC plan has not only been made, but has been welcomed by participants. TIAA-CREF, one of the nation's largest pension plans, offers an SRI option to its retirement annuity participants, primarily educators. Approximately \$6.2 billion, representing 4.1% of TIAA-CREF's plan assets, is invested in the "Social Choice Account", a portfolio applying social and environmental screens. Among public pension funds already including such options are New York City, Chicago, San Francisco, King County, Washington, the states of Alaska, California, Colorado, Illinois, Indiana, Tennessee, Vermont, Washington, Wisconsin, and the Commonwealth of Massachusetts.<sup>17</sup> And H.R. 4140, the "Federal Employee Responsible Investing Act", has been introduced in the U.S. Congress by James Langevin of Rhode Island; if enacted, it would add a "Corporate Responsibility" choice to the Federal Employees Thrift Plan.

However, we note that there are three large practical problems to consider when planning to add new funds or managers to the approved list. First, several recent studies have shown that when people have more choices in any area, whether it be shopping in the supermarket or making investments in their 401(k) plan, they are less, rather than more, likely to make use of the extra choices. Having too many options to choose from tends to lead to inactivity and unwillingness to choose, rather than to the creation of a diversified investment portfolio – in fact, as the number of options increases, the percentage of eligible employees who participate in the plan at all drops significantly.<sup>18</sup> Second, adding a single SRI fund to a DC plan could lead to undesirable outcomes. Many investors who choose investments based on social impact goals are liable to put 100% of their money into the social choice, leaving them insufficiently diversified and dependent on only one investment style. A retirement plan that offers one social choice, most commonly large capitalization U.S. stocks, can lead a participant to ignore bonds, international stocks or smaller companies. At present, there are no SRI funds that adequately diversify investors among multiple asset classes in a single

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17. Joseph F. Keefe and Steven D. Lydenberg, "Corporate Governance, Social Responsibility, and Obligations of Ownership: Background Paper for State Treasurers and Legislators" (New York: Domini Social Investments, LLC, September 2003): p. 21. Available online at [http://www.socialinvest.org/areas/research/other/012004\\_treasurers.pdf](http://www.socialinvest.org/areas/research/other/012004_treasurers.pdf).

18. For a digest of this research, see Gary R. Mottola and Stephen P. Utkus, "Can There Be Too Much Choice in a Retirement Savings Plan?" (Vanguard Center for Retirement Research: June 2003), available online at <http://institutional.vanguard.com>.

fund choice. To avoid a participant concentrating solely in one SRI fund, a plan must offer a responsible alternative in every category, potentially doubling the number of funds in the plan. And third, in a similar way, to add one SRI fund that addresses the values of one segment of the population, without adding another, different option addressing the values of another segment could be politically unpalatable. Adding multiple choices increases cost and complexity, while quite possibly reducing participation.

We don't pretend that SRI mutual funds are not problematic on occasion, nor do we wish to duck the practical problems that choosing to include them in a DC plan might create. But we do want to make it clear that, given the fiduciary obligations of the trustees and the criteria for fund selection (as laid out by the Foundation for Fiduciary Studies), the trustees of defined contribution retirement plans have the option and authority to offer investment choices that employ social criteria, so long as those "prudent processes" are followed.

#### **IV: Defined Benefit Plans**

The traditional form of DB plan is the pension: an employer makes a variable contribution to a pool of funds to be invested for the benefit of current and future retirees. How much needs to be contributed is calculated by the employer and its actuaries, and how much is to be distributed is calculated according to details of the retiree's situation (often including length of employment and final rank or salary). The investment decisions in a DB plan are left to the discretion – and placed entirely in the responsibility of – the plan trustees.

Traditionally, trustees of defined benefit plans have followed the provision that their duty, pure and simple, was to maximize investment return, minimize risk, and to make no decisions that were not in good faith for the exclusive benefit all plan participants and beneficiaries. Simple SRI strategies, such as negative screening, were deemed to represent the desires of the few, or for the general public good, and were routinely rejected. Even in cases where plan participants shared a "common bond", such as the Lutheran Brotherhood case, there was no clear-cut rationale to support investment decisions based on anything but financial theory and performance. Other SRI strategies, such as community investments, below market rate investments, and Economically Targeted Investments (ETIs), were also

routinely rejected as being violations of fiduciary duty. Shareholder proxies, when voted at all, were typically rubber stamps of management recommendations. Conventional money managers argued that voting against management, or voting in favor of shareholder resolutions had the potential to damage the company and subsequently reduce the value of an investment.

Corporate Defined Benefit Plans are still expected to be managed for the exclusive benefit of plan participants. However, the determination as to whether an investment portfolio is suitable is made at the portfolio level, not at the level of the individual investments or management styles. Larger plans frequently hold hedge funds, private equity, and venture capital investments. While applying social screens across all investment styles and types in a corporate DB plan would almost certainly fail fiduciary guidelines, emerging investment strategies employing over-weighting or under-weighting of positions based on certain social criteria could be included in a large portfolio just as any other strategy designed to add alpha. Innovest Strategic Value Advisors, at the behest of “a major U.S. public pension fund”, performed an extensive set of simulations using just such a strategy. They found that “in five of the six investment portfolios, use of Innovest ratings improved investment return ... In most cases, this improvement increases as the ‘volume’ of the Innovest signal increases”.<sup>19</sup> Recent corporate scandals and abuses have led to a major change in the behavior of many of the largest pension plan trustees. The recent votes at Disney, Intel, Gillette, and others demonstrate that institutional trustees are far less trusting of management recommendations and far more likely to consider the merits of well-crafted shareholder resolutions.

DB plans for government employees fall into a more complex area. What is the appropriate relationship of public policy to the investment decisions or proxy votes of government funded pension plans? In some cases, legislation exists to eliminate or restrict certain investment options. For example, in September of 1996 the U.S. Congress passed an act

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19. Innovest Strategic Value Advisors, “New Alpha Source for Asset Managers: Environmentally-Enhanced Investment Portfolios” New York, April 2003. Available online at [http://www.innovestgroup.com/pdfs/Portfolio\\_Simulation\\_4-03\\_Exec\\_Sum.pdf](http://www.innovestgroup.com/pdfs/Portfolio_Simulation_4-03_Exec_Sum.pdf).

restricting US investment in Burma (also known as Myanmar),<sup>20</sup> in response to public pressure regarding human rights abuses “including forced labour in chain gangs, mass rape, and ‘ethnic cleansing’ including summary execution of the ethnic Karen and Mons peoples”.<sup>21</sup> In other cases, practical and logical considerations of public policy might seem to imply investment restrictions. Government policies at federal, state, and local levels compete with one another to both punish and incent tobacco use. States that sue tobacco companies are actively attempting to damage those companies economically, but many of the same states’ employee retirement plans continue to invest in tobacco stocks. Recently, many of those states have been securitizing their anticipated tobacco revenues to fund budget deficits. Should the pension plan’s trustees, in their fiduciary roles, simply ignore these issues of public policy and their potential affect on investments, or can they find an acceptable way to translate public policy into investment strategy? Finally, if the portfolio holds a stock, can it be appropriate to vote proxies in ways that are consistent with governmental policy on health care, pollution, or corporate citizenship? Can voting against management further the public good, or does it simply introduce partisan politics into areas where they do not belong?

The possibility of converting some portion of the largest defined benefit plan in the country, Social Security, into a plan offering some investment choices to the plan participants, could elevate the question of SRI to an even higher level. A partial privatization of Social Security, comparable perhaps to the experience in Argentina,<sup>22</sup> could easily include a

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20. “Foreign Operations, Export Financing, and Related Programs Appropriations Act”, 1997, §570, 110 Stat. 3009-166 to 3009-167. Interestingly, a similar but more stringent statute was passed by the Massachusetts legislature – “An Act Regulating State Contracts with Companies Doing Business with or in Burma (Myanmar)” (1996 Mass. Act 239, ch. 130) – but this was struck down by the US Supreme Court on the grounds that it undermined the Federal act. See *Crosby v. National Foreign Trade Council*, 2000 US LEXIS 4153 (US June 19, 2000).

21. Russell Sparkes, *Socially Responsible Investment: A Global Revolution* (Chichester, UK: John Wiley & Sons, 2002), p. 183. Sparkes draws this list of abuses from the reports of Amnesty International and Human Rights Watch, and notes that these accusations were “substantiated by the US State Department in 1997”.

22. For the World Bank’s analysis of the lessons learned in the ten years since Argentina’s pensions system was partially privatized, see Rafael Rofman, “The Pension System and the Crisis in Argentina: Learning the Lessons”, Background Paper of Regional Study on Social Security Reform, Office of the Chief Economist, World Bank (n.d.); available at [www.worldbank.org](http://www.worldbank.org). For critique, see also Dean Baker and Debayani Kar, “Defined Contributions from Workers, Guaranteed Benefits for Bankers: The World Bank’s Approach to Social Security Reform”, Center for Economic and Policy Research (July 2002), available online at [www.cepr.org](http://www.cepr.org).

socially screened choice for participants. If given a choice in how some portion of these retirement assets are to be invested, why shouldn't taxpayers be allowed to "opt out" of certain investments that they may find objectionable? Here, though, we will find some of the same practical difficulties faced by DC plans: too many investment options might prevent participation, but adding only one SRI option might prevent proper diversification. Most importantly, for the Social Security Administration's trustees to choose any limited number of SRI strategies over all the others might have important political ramifications. How will they decide which social and environmental goals to prioritize? Whose research will they follow? For example, were the trustees to decide that "global warming" is the greatest challenge to environmental sustainability, which sets of data should they use to make investment decisions – the data of those who find no evidence of significant warming trend, those who find such evidence but deny the importance of the warming trend, or those who find such evidence and are genuinely concerned by it? We are not sure that there are any simple solutions to these and similar practical conundrums; our key point here, though, is that these are practical problems, not conflicts with fiduciary duty.

In short, the trustees of a DB plan face some of the same problems as the trustees of a DC plan – but there is no sense in which the individual retiree has any responsibility for the investment of the assets being managed for her benefit, and the trustees bear the entire burden of responsibility. This makes the selection process more fraught with peril, and more difficult from a practical point of view – but it does not shut the door on SRI. If an SRI investment manager can demonstrate that certain primary financial criteria are met or exceeded, and that SRI strategies have not had and probably will not have a detrimental impact on portfolio returns, then the trustees have the authority to entrust to them a portion of the plan's assets, even if the political ramifications of doing so effectively prevent it.

## **V: Conclusion: Retirement Investment and SRI**

SRI strategies tend to fall into three categories: screening (both negative and positive), shareholder advocacy, and community investment. From this description alone, it should be clear that "socially responsible investing" is not one simple thing that can be debunked – or defended, for that matter. Social and environmental screens can be applied to any

portfolio, as another (if unusual) layer of fundamental research, and may or may not have a significant impact. After all, if Brinson and his colleagues are right to argue that approximately 95% of a portfolio's variability depends on asset allocation, not on security selection,<sup>23</sup> then we should not expect SRI screening strategies to have a large effect, favorable or detrimental. All investors, small and large, have an obligation to take part in the management of the companies they own, by voting their shares – and by engaging corporate management in discussions on matters of shareholder interest, and sponsoring shareholder resolutions for general shareholder vote when direct engagement fails. To refuse to invest in our own community, because we can obtain a better return on similar investments elsewhere, seems justifiable from the financial viewpoint, but reprehensible from a moral viewpoint.

Looking squarely at the specific obligations entailed by a retirement plan trustee's fiduciary status, we believe that the trustees of all retirement plans have two overarching obligations. (1) They have an obligation to **conduct due diligence** on all investment managers, products, and processes, holding all to the same standards.<sup>24</sup> (2) They have an obligation to **vote the shares they own** (whether in person or by proxy), both to elect boards of directors and to inform management of their opinion of proposals from both management and other shareholders.<sup>25</sup> These two obligations in turn imply, we have argued, that plan trustees have the following options:

- 1a. Trustees of all plans have the authority to entrust a portion of plan assets to managers employing SRI strategies, so long as certain primary financial criteria are met or exceeded.
- 1b. Trustees of defined contribution plans have the authority to include managers or mutual funds that invest a portion of assets in community development investments,

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23. See Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance", *Financial Analysts Journal*, July/August 1986, and Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update", *Financial Analysts Journal*, May/June 1991. Note that while many writers refer to this research, most believe that it claims that 95% of returns come from asset allocation – an altogether different claim.

24. Foundation for Fiduciary Studies, *Prudent Investment Practices*, p. 35 – "Practice 4.4".

25. Securities and Exchange Commission, *Release No. 34-46518, IC-25739; File No. S7-36-02* (September 2002). Available online at <http://www.sec.gov/rules/proposed.shtml>.

so long as the overall investment performance meets or exceeds portfolio standards. Trustees of defined benefit plans probably do not have this authority.

- 2a. Trustees of all plans have the authority to disclose how the shares for which they are responsible have been voted.
- 2b. Trustees of all plans have the authority to develop and publish formal voting guidelines for the members of the board (e.g. the members of the audit or nominating committees), and for proposals relating to corporate governance, social and environmental proposals which will come before the meeting of the shareholders.
- 2c. Trustees of all plans have the authority to enter into dialogue, as appropriate, in public or in private, with corporate management concerning areas of corporate governance, social or environmental responsibility issues.
- 2d. Trustees of all plans have the authority to sponsor a shareholder resolution.

We have shown here that when we set aside the practical questions of implementation, and consider fiduciary duty alone, there is nothing to prevent retirement plan trustees from implementing basic SRI strategies in the plans for which they are responsible. The range of permissible options is wide open for purely self-directed retirement plans such as the IRA; it is narrower for defined contributions plans such as the 401(k), in that a formal due diligence process will eliminate all but the highest-quality options; and it is narrower still for defined benefit plans, in that they probably have to exclude community investment strategies. In the end, fiduciary prudence is not determined by what you do, why you do it, or even how it turns out, but by how you design a process that you can consistently apply across all products and strategies, with appropriate concerns for the needs and risk tolerance of the plan and its beneficiaries.