Social investment

Crunch time for ethical investing

By Jon Entine

Social investors will have to refocus on the nuts and bolts of companies in which they invest if they are to survive the current market turmoil

Crises are defining moments, and the worst financial meltdown since the Great Depression of the 1930s may be a telling time for ethical investors and social progressives. Certainly, easy-money policies, relaxed regulations and the creation of arcane credit and debt products have played key roles in getting us into this mess. But looking for scapegoats leads nowhere, and that's exactly what is happening.

Populists are attempting to brand the worldwide crisis as a failure of free markets and deregulation. Even as a debate raged about what to include in a rescue plan, the Social Investing Forum, a US trade group, sent a letter to Congress pointing fingers at "the unconscionable lending practices that have decimated vulnerable communities", in effect casting supposedly predatory lenders and greedy bankers as central villains in this narrative. It's not that simple, and social investors must share a measure of responsibility for the fix we are in.

Progressives, including social investors, have stressed transparency and accountability as guiding principles. Yet, well into this year, many ethical investment researchers were still handing out top ratings to the financial institutions that traded in the mortgage-backed securities at the heart of the crisis. At the very least, the meltdown raises questions about whether those standards, at least as practised, are fundamentally flawed.

But the elephant in the room is the social engineering policies embraced by ethical investors and progressives alike. Beginning in the 1970s, activists began demanding easier access to loans, with low or even no documentation, often secured with low or no down payments to spur home ownership among lower income and minority Americans struggling to bootstrap themselves into the middle class. It was a heartfelt social goal but risky economic policy. When you start replacing market signals with politics, it's only a matter of time before something goes awry.

Fallen icon

Fannie Mae and social investors are joined at the hip when it comes to understanding the origins of this crisis. For years, Fannie handed out subprime loans like candy and guaranteed debt products cobbled together by other financial institutions that were riskier still. Yet, analysts in socially responsible investment funds consistently feted this publicly traded government sponsored entity (GSE). Between 2000 and 2004, Fannie was named the top corporate citizen in America based on data compiled by the leading US social research firm, KLD Research and Analytics in Boston, and was on many approved lists well into this year. But it didn't quite live up to its billing. This quasi-government agency and its sibling GSE, Freddie Mac, ended up as the catalyst for trillions of dollars of losses by shareholders and taxpayers. On the other hand, Fannie Mae does have a nice diversity programme.

This colossal mistake in judgment might be excusable if it was isolated, but it's not. The problem revolves around what are supposed to be central tenets of corporate responsibility: transparency and accountability. But what do those terms really mean?

Until now the focus of ethical investors has been disproportionately on social and environmental issues – the so-called top of the pyramid issues that rarely impact the day-to-day workings of a firm. While social investors regularly restrict investments in natural resource companies because their extraction methods are visible and considered environmentally messy, and urge boycotts of companies that do not aggressively support carbon footprint reduction, they issue get-out-of-jail-free passes to financial firms whose inscrutable products – the core of their business model – are not examined at all.

Throughout most of this crisis, socially responsible investment funds held far more financial stocks on a percentage basis than did conventional index funds, and that has cost social investors dearly. In an article, Can Strategic Investing Transform the Corporation? in the September issue of Critical Sociology, Linda Markowitz, a professor at Southern Illinois University, reviewed the largest 41 US SRI funds. Three of the top eight holdings were financials: AIG, Bank of America and Citigroup. AIG was praised for its retirement benefits and sexual diversity policies; Bank of America strived to reduce greenhouse emissions and promote diversity; and Citigroup donated money to schools and 9/11 victims, and tied some of its loans to environmental guidelines. The stock price of all three of these companies cratered in part because their loan portfolios were weighed down by securities that even their own accountants could not understand.

Complex debts; helpless traders

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One year ago, as the financial crisis began in earnest, the Domini Social Index, which selects stocks based on KLD's research, held 29% more financials than did the Standard & Poor's 500 benchmark index, and included JP Morgan, Citigroup, Goldman Sachs, Wachovia, Lehman Brothers and Wells Fargo among its largest investments. The percentage was even higher at SRI fund Calvert. For SRI researchers, who pontificate about the need for corporate transparency, when it came to financial stocks it was "don't ask, don't tell". If the central operations of a business are not transparent and clearly accounted for – and many of the loan products of financial firms are not – then social investors who slap on green seals of approval are misleading and irresponsible.

Considering this huge disconnect between what SRI researchers promise and what they practice, it is no wonder that most of the broad-based socially responsible mutual funds, overloaded with financial stocks, have experienced wrenching slides. Many of the largest funds, including Domini, trail their benchmarks over periods of one, three and five years. Many funds are doing far worse. In a typical example, Sierra Club's high-profile social fund trails the S&P 500 index by about 6% a year over the past three years.

"This crisis highlights the limitations of social research methods," says Dirk Matten, the Hewlett-Packard chair on CSR at the Schulich School of Business at York University in Toronto. Although some research models are more sophisticated than others, particularly ones that eschew simplistic screens, most do not appreciate the importance of governance structures, which were only considered by most US-based corporate

responsibility advocates after the accounting scandals that came to light as Enron imploded in 2001, Matten adds. "They don't look at the degree of professionalism of an organisation. They have tended to look at the visible social initiatives that have always appealed to this community, and not at the governance issues or the actual operations of a business. Yet that's what makes corporations viable enterprises."

History of a meltdown

This crisis is a classic case of misplaced good intentions. The mutant seeds were planted during the Carter administration of the late 1970s. Mortgage lenders faced charges of racism and "redlining" because minorities were being denied mortgages at a higher rate than whites. Congress passed the Community Reinvestment Act (CRA), which gave regulators the power to punish banks that failed to address the "credit needs" of "low income, minority and distressed neighbourhoods". The Federal Reserve Bank of Boston even went so far as to advise mortgage lenders to drop prudent lending safeguards to promote home ownership. "Lack of credit history should not be seen as a negative factor," the guidelines instructed. Even welfare payments and unemployment benefits were to be counted as "valid income sources" to qualify for a mortgage – when documents were required at all.

The movement accelerated in the early years of the Clinton administration in the 1990s, which was publicly committed to spurring home ownership among minorities. Mortgage lenders faced political pressure to lower lending standards. Having traditionally required between a 10% and 20% deposit on a new home, mortgage lenders began offering loans with deposit requirements of under 5%, and eventually with no deposit requirement at all.

Between 1995 and 1997, Congress tweaked the CRA, establishing a rating system that looked at how aggressively banks lent in low-income neighbourhoods. Because banks needed a good CRA rating to get regulators to sign off on mergers, expansions and even new branch openings, loans to low income families, many with questionable financial situations, soared. These "reforms" fuelled a boom in business at Fannie and Freddie, which exploited their quasi-government role to circumvent the rules regulating privately owned lenders.

Politics, rather than market or prudent lending standards, had captured the subprime loan business

In 1997, Bear Stearns became the first company to securitise a CRA-backed subprime loan, which was immediately guaranteed by Freddie Mac and given an AAA rating. The financial sausage was overcooked, a huge success, and no wonder. Here was a new but barely understood product approved by government-backed agencies that themselves would benefit, as its proliferation sent their stock valuations and executive salaries skyward. The GSEs were now active proponents of a social agenda that many people, against all reason, convinced themselves carried few risks: increasing home ownership for financially unstable Americans. It turned out that many of these aspiring home owners did not have the means to ride out a housing market downturn and probably should never have had a mortgage in the first place.

No matter. Now that politics, rather than market or prudent lending standards, had captured the subprime loan business, the incoming (GW) Bush administration saw an opportunity to do some social engineering of its own. In 2002, motivated in part by its zeal to convert Hispanics to the Republican fold by helping them become homeowners, the Bush administration engineered passage of the American Dream Downpayment Act, which opened the door to buying a house for those with little savings or equity.

According to Harvard's Joint Centre for Housing Studies, black and Hispanic borrowers accounted for 49% of the increase in homeowners from 1995 to 2005. But the study also showed that low income Americans were far more likely to leverage the American Dream with subprime loans issued on the basis of little or no documentation – now dubbed "liar loans".

With markets booming, money sloshed through the system – tens of trillions of dollars – and the GSEs, as public traded companies, were under pressure to get their share of the pie. By 2005, with political pressure to lower standards coming from Democrats and some Republicans, regulators sharply increased Fannie's affordable-housing goals once again. Over the next two years, it bought or guaranteed more than three times as many mortgages as it had in all of the previous years combined, according to company filings. Whenever competitors or worried economists asked Congress to rein in the GSEs, lawmakers were besieged with letters and calls from angry constituents keen to keep the money flowing – and Congress invariably complied. When the government rescued them, Fannie and Freddie owned or guaranteed almost half of the $12tn in outstanding mortgages. About 7% of these mortgages are classed as subprime.

Let's be clear here: throughout the Clinton and Bush administrations, what social investors now call "predatory lending" was consistently being praised by activists, left and right, as innovative and

Overstretched and out of time

necessarily "flexible" loan products to help minorities lift themselves into the middle class.

After months of credit and liquidity convulsions, the markets, governments, and the public are now clamouring for genuine transparency and oversight. As in the case of Enron and the accounting scandals earlier this decade, the fault lines for this disaster run through the system of risk management. Spotting risks should be the calling card of social investors, who have long claimed they were more adept at identifying market landmines. But critics argue that SRI research methodology was no better, and arguably considerably worse, at identifying cracks in the mortgage market. It may even have encouraged the problem by bypassing market forces and injecting a social agenda into the mix – lowering lending standards to increase home ownership among many people who were financially ill-suited to be homeowners.

REUTERS

All guilty

Real impact

"CSR as it's practised has mirrored some of the naïve expectations of its proponents, and these are not necessarily the real issues of concern," says York University's Dirk Matten. He suggests that many social investors have downplayed the actual business of a business, including whether it can create jobs and spread wealth, while overweighting what he believes are less critical and more symbolic concerns, such as announced programmes to combat climate change or targeted philanthropy. "CSR still carries with it an anti-corporation, anti-business bias," he says. "Shareholders are considered rich and bad – fat cats. They are not a species that needs protection. If those who espouse CSR principles want to have a real impact, there needs to be a shift in emphasis from a focus on mostly social issues to shareholder rights, but that's not popular in those circles."

George Dallas, director of corporate governance at London-based asset manager F&C Investments, which manages roughly £100bn with a responsible investment overlay, agrees that shareholder rights require more protection and enhancement – both to encourage new investment and to allow shareholders to exercise meaningful oversight over companies and the directors they elect to represent them. With regard to the current financial crisis, "a key issue is complexity", Dallas says. "Financial institutions disclose a lot of information that doesn't necessarily enhance insight or proper understanding. Even their boards and their own internal auditors didn't always understand the risks of their products or their financial exposures."

"Analysts of all sorts made poor decisions, not just SRI ones," adds My-Linh Ngo, associate director of SRI research with Henderson Investments in London. She maintains that no one's hands are clean and that many ethical investors were actually more sensitive to the risks that these new lending products posed.

The swiftness and steepness of the crisis are already shifting research and oversight priorities in the sustainable investment community. Ngo, Dallas and other top managers are recalibrating what factors to examine more closely, focusing more on nuts and bolts practices, including recapitalisation challenges, risk management and incentive structures.

Social investing must shift its emphasis more to the real workings of a corporation

"With good capitalist red blood flowing through our veins, we take the position that governance is central to this discussion," says Dallas. "As we move from crisis mode to reconstruction mode, everyone is demanding more accountability." But that doesn't mean compromising sustainability goals, he stresses. "From an SRI perspective, the current crunch is, hopefully, a cyclical issue. Investors shouldn't lose sight of the more systemic environmental and social challenges, including climate change. Social, ethical and environmental factors can play a significant role in enhancing – or destroying – shareholder value, particularly from the long-term perspective that is taken by pension funds, insurance companies and many retail investors."

This worldwide meltdown, a once-in-a lifetime challenge to all investors, will reshape everyone's investment models and risk tolerance for many years to come. If social investing is to emerge from this crisis with its image intact, it must professionalise its data collection techniques and shift its emphasis more to the bottom of the pyramid – the real workings of a corporation, where business is managed and jobs are created. That's where its unique perspective and opportunities to serve the public welfare reside.

"The SRI community must educate the investor and make the case that a narrowly based screening system based primarily on social issues is fundamentally unbalanced and ultimately irresponsible," says Katherina Glac, assistant professor of ethics and business law at the University of St Thomas in Minneapolis. "They have access to the investors who care about ethics more than other groups, they have a captive audience, so I believe they have a responsibility to act. The current crisis is probably the most expensive learning opportunity we will have in a long time. It should not be wasted." ■

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