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Socially Responsible Investing: An Overview

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6-8 minutes

When you invest, are you simply trying to make as much money as possible without taking on too much risk? Or are you trying to accomplish other goals as well, perhaps making sure that your investments align with your values or that you're using your money to help make a positive difference in the world? If those latter goals matter to you, you might be interested in socially responsible investing, or SRI.

SRI is the umbrella term Schwab uses to describe various investing approaches that emphasize social or environmental factors in addition to risk and return. You may see some other terms to describe some of these approaches, such as values-based, sustainable, socially conscious, ESG focus, impact investing and others. When we talk about SRI, we're talking about all of these.

The history of SRI

In the United States, the roots of socially responsible investing can be traced to the

18th century, when religious groups began forbidding investments in companies whose products or services had what they considered to be negative societal impacts. At the time, this meant avoiding investments in the slave trade, alcohol, gambling and tobacco. However, in the 1970s and ’80s, activists adopted the same practice to shun companies profiting from the Vietnam War and to protest South African apartheid. Today, the practice of removing a single industry or group of industries from a portfolio is known as “exclusionary screening.”

However, SRI has come to mean more than simply removing certain types of businesses from a portfolio based on political or religious values. Today, “sustainable investing” refers to assessing environmental, social, and governance risks to all the companies in a portfolio, and then determining how well each one is addressing the risks relevant to its business. This type of environmental, social, and governance (ESG) integration received a jumpstart in 2004, when former UN Secretary General Kofi Annan wrote to the CEOs of major financial institutions, inviting them to participate in a joint initiative led by the UN Global Compact. The goal of the initiative was to find ways to integrate ESG considerations more broadly into capital markets. This initiative resulted in the launch of the Principles for Responsible Investment (PRI) at the New York Stock Exchange in 2006. The PRI’s six principles are designed to encourage asset managers to think about ways socially responsible investing can become a bigger part of their daily investment activities.

Basic SRI approaches

Under the SRI umbrella, there are several different approaches that you can find via mutual funds and other investment vehicles.

Values-based: The financial industry’s insider definition of SRI, which we call values-based investing, usually means a specific investment approach that excludes certain sectors or certain types of companies, such as tobacco, firearms or fossil fuels companies. This approach often appeals most strongly to investors who care about avoiding having investment dollars in companies that some people consider to be objectionable.

Environmental, Social and Governance: ESG refers to a more modern approach that started with large investors such as pension funds and endowments. The thesis behind ESG investing is that environmental, social and governance factors are important in determining the future risk and return of investments. ESG strategies are typically more similar to broad benchmarks than values-based strategies are,

typically including some exposure to all economic sectors rather than completely excising certain sectors as unacceptable. It is common for ESG strategies to include exposure to potentially “objectionable” industries via stocks that are “best-in-class”—for instance, energy companies that are investing in non-fossil fuels in addition to their main line of business. That is, ESG strategies are more likely to include the “less bad” companies within various industries, thus keeping overall industry exposures in line with the broad market. The term “integration” is often used to describe this approach, because it aims to integrate ESG factors that aren’t explicitly tied to risk and return with principles of good portfolio construction.

Impact investing: This is a term that refers to explicitly deploying investment dollars in an effort to directly achieve some desired outcome. Examples include financing loans to low-income homebuyers, funding projects to reduce air pollution at factories, buying stock in a company in an effort to put positive shareholder initiatives on proxy ballots, etc. Impact investing is the closest type of investing to philanthropy. Impact investors are typically more concerned with changing the world or the companies they invest in.

Why SRI?

The appeal of socially responsible investing is twofold. First, some investors hold their social responsibility and ethical values above pure financial profit motives and are willing to sacrifice (at least partially) profits for greater societal good. Second, there are profit-motivated investors, who expect that companies concerned about social responsibility will be better managed and potentially better at anticipating and mitigating risk. In their opinion, companies with strong SRI characteristics make for better long-term investments.

Schwab’s research has generally found that SRI funds as a whole have fairly similar return and risk to regular non-SRI funds. While we don’t think investors should have to give up the prospect of earning good returns in order to invest in a socially responsible way, we also don’t see strong evidence for SRI being the path to greater returns or lower risk overall. If you decide to explore socially responsible investing, it should be because you feel that it will help you achieve more of your goals, beyond just risk and return.