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Pairing Financial Goals with Social Good

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Socially responsible investing (SRI) is an increasingly popular way of investing that integrates financial objectives with environmental, social, and corporate governance (ESG) issues. It offers a practical way to reflect your values and core beliefs in your investments. Investors who choose SRI add an additional challenge to the already complex world of investing, but with proper advice and guidance, investors can integrate their nonfinancial, social, and financial goals. Following are some things to think about if you are considering investing in a socially responsible manner.

Clarify your definition of "responsible"

The first step is to ask yourself what nonfinancial considerations are important to you. SRI is an umbrella name that covers a variety of issues and approaches, and your answer should be based on your values. You may wish to invest in a manner consistent with environmental sustainability; you may prefer companies that explicitly incorporate social responsibility into their governance systems; or you may want to avoid companies that engage in certain types of activities (for example, manufacturing and selling tobacco, alcohol, or firearms).

Consider your approach

There are three general approaches to socially responsible investing, and investors may combine one or more of them. The first is portfolio screening, which creates an investment universe based on certain criteria relating to a company's policies, actions, products, or services. Perhaps you want to exclude gaming companies from your portfolio or include companies with strong diversity programs. Another approach is best practices classification, which chooses companies that rank highly in one or more environmental, social, governance, or ethical criteria as well as financial criteria. A third common approach is shareholder influence through proxy voting or direct engagement. This active approach may not be feasible for the typical investor, but investors can choose investment managers, pension funds, and mutual funds that make such efforts part of their investment strategy.

Select an appropriate benchmark

As with any investment, you should choose a benchmark against which to evaluate your investments' performance. In the case of SRI, an appropriate benchmark portfolio might include companies that adhere to the same principles that you value and that would, therefore, be viable investments. Dow Jones (www.sustainability-index.com), MSCI (www.mscibarra.com, which now includes the family of KLD Research Indices), and Standard & Poor's (www.standardandpoors.com) have several global SRI indices available.

Choose an SRI rating firm

A number of firms rate companies based on their social, environmental, and governance track records. Some rating methods focus on specific countries or regions and others are more global. Rating firms also vary according to what criteria are used to rank companies. In any case, firms that supply SRI ratings can do much of the work for you and be a useful tool in implementing an SRI strategy. Calvert Investments (www.calvert.com), FTSE (www.ftse.com), KLD Research & Analytics (www.kld.com), and RiskMetrics Group (www.riskmetrics.com) all offer rating services and, in some cases, indices for SRI.

Investigate SRI vehicles

Several mutual fund families specialize in offering funds with a socially aware approach by using both active and passive investment strategies. Investors can also choose from almost a dozen exchange-traded funds (ETFs) with an SRI bent. Be aware, though, that some SRI ETFs—such as those focusing on alternative energy technologies or even more specifically, nuclear power—can be highly specialized and come with increased concentration risk.

Look into SRI options in your 401(k) plan

Check the investment options in your 401(k) plan. Many plans offer mutual funds that select stocks by using certain screening criteria. Most SRI funds in the United States use a screening strategy, so be sure the screens and/or exclusions are consistent with the values and goals that motivate your SRI intentions in the first place.

Be aware of fees

Expect to pay higher management fees for socially responsible mutual funds and ETFs. The average annual expense ratio for the equity funds featured on SRI World's socialfunds.com[1] site (a personal finance site dedicated to SRI) is more than 10 percent higher than the average domestic stock fund expense ratio as reported by the Investment Company Institute[2] as of 31 December 2009. SRI ETF fees range from about 0.40 percent to 1.00 percent of portfolio value, which are substantially higher than those of ETFs that track traditional broad market indices, such as the S&P 500 Index, and have expense ratios that range from 0.08 percent to 0.40 percent. Investment management fees are an important component of investment performance, especially over the long term. Only you can determine whether the cost differential, if any, warrants pursuing your SRI objectives.

Regardless of your particular goal or approach, SRI is still investing. When social concerns are added to your financial plan, it can help to have a professional at your side with experience and a comprehensive body of investment knowledge. To find an adviser in your area, visit cfainstitute.org/adviser.

Frances Melville and William Ortel contributed to this article.

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[1] Average expense ratio of 1.68 percent is a simple average of the expense ratio of 88 active equity funds. Source: socialfunds.com as of August 2010.

[2] Average expense ratio of 1.52 percent is a simple average of equity fund expenses. Source: Investment Company Institute, 2010 Investment Company Factbook.

For more information, please consult www.cfainstitute.org/adviser

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