Morgan Stanley Smith Barney

Closing the Morality Gap

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A corporate focus on ethical issues and portfolio-management methods may help socially responsible investing pay off, says Steve Schueth of First Affirmative Financial Network

Building a portfolio in the early days of what became known as socially responsible investing was more often a matter of deciding what to leave out than of choosing what to put in. Managers 15 or 20 years ago identified industries that, based on moral or ethical criteria, they or their investors deemed beyond the pale: producers of tobacco, alcohol, or weapons, for example, or anything whose manufacturing resulted in excessive pollution. Then these managers simply excluded those groups from investment consideration.

Contemporary portfolio managers practice socially responsible investing, or SRI, in ways that are broader yet more nuanced, explains Steve Schueth, President of First Affirmative Financial Network, an investment consulting firm specializing in SRI portfolios. They still may eliminate certain industries, he notes, but they also apply an SRI filter across the remaining sectors to choose "the best corporate citizens and the best managed companies in each industry group."

Schueth says that modern analytical programs—the sort of technology-driven techniques employed by quantitative funds to screen thousands of stocks for various criteria—help these managers as they try to avoid one shortcoming of SRI portfolios: significant performance discrepancies with the broad market that occurred when certain industry groups shunned by SRI funds were in or out of favor. A way around that today, Schueth says, is to screen the universe of stocks to find companies in industries that money managers find palatable and that have comparable financial profiles with those in industries that these asset managers avoid.

Just which sectors are acceptable and which are assigned pariah status is a matter of taste and the personal morality of each investor—and the bylaws of a given SRI fund. Some portfolios emphasize environmental or health issues or workplace practices; others are created to invest in ways that uphold the values of a particular religion. The myriad sets of beliefs and priorities lead some companies to serve as moral Rorschach tests for investors, showing up in many portfolios while being actively excluded from others. "A lot of this comes down to balancing the good against the bad," Schueth says. "Wal-Mart is a good example of it. They've made huge progress in terms of their commitment to the environment," he notes. "However, they still have some serious problems on the people side of the ledger," he says, referring to criticisms of the company's employment practices.

The ethical bona fides of a company can change without notice, Schueth adds. BP used to be one of the preferred energy stocks of SRI portfolio managers, because of the priority that the company was seen to place on developing alternative fuel sources. Attitudes toward BP changed markedly after the Gulf of Mexico oil spill in 2010.

Schueth believes that certain trends in American business and society may allow SRI portfolios to broadly match the returns of conventional ones. He cites greater consumer interest in such areas as healthy foods and alternative energy and a desire among individuals and government entities to assign blame and cost in events that harm the environment or have some other negative public impact. "Avoiding lawsuits and staying ahead of regulators are two very important business strategies, Schueth says. "So if you just look at the issue from that narrow perspective, that's a strong argument for doing this, There are lots of ways to make money in the process of being more responsible."

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