

CENTRE FOR CORPORATE LAW AND SECURITIES REGULATION



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**AN APPRAISAL OF SOCIALLY RESPONSIBLE INVESTMENTS  
AND IMPLICATIONS FOR TRUSTEES AND OTHER INVESTMENT  
FIDUCIARIES**

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June 2002

# An Appraisal of Socially Responsible Investments and Implications for Trustees and Other Investment Fiduciaries

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*“A pension fund trustee is not the guardian of the moral welfare of the fund members”<sup>1</sup>*

## A. INTRODUCTION

This paper examines the suitability for trustees and other investment fiduciaries of the class of investments known variously as “socially responsible”, “ethical”, “screened”, “social” or “sustainable” investments, in the context of the legal duties imposed on fiduciaries to invest the fund entrusted to them in a prudent manner. The paper is intended to provide trustees and investment fiduciaries with the legal tools for appraising socially responsible investments, a task fraught with difficulties given the political sensitivities and controversies associated with such investments.

An estimated \$1.9 billion has been invested according to socially responsible investment (“SRI”) strategies by Australian managed investment schemes and superannuation funds (as at 31 December 2001).<sup>2</sup> The value of funds under management is likely to increase substantially, in line with the growing perception on the part of Australian investors in managed investment

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\* The authors are also principals of Stellar Capital, a private capital firm. We would like to thank Associate-Professor Geof Stapledon, Faculty of Law, University of Melbourne, Professor Michael S Knoll, Law School and the Wharton School, University of Pennsylvania for kindly providing us with his research on United States SRI funds, Professor Ian Ramsay, Faculty of Law, University of Melbourne for his comments on an earlier draft of this paper, and Mr Brent Miles, Royal Sun Alliance, Sydney for his assistance with programming and the preparation of data.

<sup>1</sup> Lord Nicholls of Birkenhead, “Trustees and their Broader Community: Where Duty, Morality and Ethics Converge” (1996) 70 ALJ 205, at 211.

<sup>2</sup> Source: *Rainmaker Roundup*, Dec. 2001.

schemes and members of superannuation funds that funds can be invested in a socially responsible manner without sacrificing financial performance.<sup>3</sup>

Moreover, the adoption of SRI strategies by trustees and other investment fiduciaries has been tacitly advanced by the Financial Services Reform Act 2001 (Cth). This Act - pursuant to amendments introduced in the Senate by the Australian Democrats in August 2001 - requires "Product Disclosure Statements" issued in respect of managed investment funds and other investment products to disclose the extent to which labour standards or environmental, social or ethical considerations have been taken into account by the manager of the fund or product in selecting, retaining and realising investments.<sup>4</sup>

### **Organisation of this paper**

This paper is divided into two parts. The first part provides a brief background to the SRI phenomenon in Australia, explains the legal structure of SRI funds, and discusses the duties incumbent on trustees and other investment fiduciaries when investing in an SRI fund or adopting an SRI strategy. The second part of this paper contains an empirical assessment of SRI strategies and considers the consequences for trustees and other investment fiduciaries.

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<sup>3</sup> A recent study undertaken by the Investment and Financial Services Association indicates that up to 45% of Australian fund managers are contemplating offering SRI funds during 2002 to meet expected future demand from superannuation trustees and individual investors.: *Key Industry Statistics Survey* (IFSA, Aug. 2001).

<sup>4</sup> Section 1013D(1)(l), Schedule 1, Financial Services Reform Act 2001 (Cth). The obligation to provide a Product Disclosure Statement for a financial product arises where a "regulated person" recommends the acquisition of a financial product or makes an offer for the issue or sale of a financial product: ss 1012A, 1012B and 1012C. Regulated persons include issuers and sellers of financial products, financial services licensees and their authorised representatives and certain parties that are exempt from the requirement to hold a financial services licence: s 1011B. The Act came into force on 11 March 2002.

## B. AN OVERVIEW OF SOCIALLY RESPONSIBLE INVESTMENTS

### Background

Socially responsible investing is not a new concept. It is generally accepted that SRI funds originated with the Quaker and Methodist religious movements in the 19th Century.<sup>5</sup> In the United States, the earliest SRI funds were the Pioneer Fund (founded in 1928), the Pax World Fund (founded in 1970) and the Dreyfus Third Century Fund (founded in 1972).<sup>6</sup> The first SRI fund in the United Kingdom, the Friends Provident Stewardship Fund, was launched in 1984 while the first Australian SRI fund, the Tower Ethical Growth Portfolio (previously called the Friends Provident Ethical Fund) was established in 1986.<sup>7</sup>

The growth of SRI funds in Australia is broadly attributable to two factors.

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<sup>5</sup> See further E M Wiegand, K R Brown and E M Wilhem, "Socially Principled Investing: Caring about Ethics and Profitability", *Trusts & Estates*, Aug. 1996. The funds of Catholic archdioceses, foundations and institutions are also managed according to SRI principles; in the United States, this investment practice has been formalised in the "NCCB/USCC Socially Responsible Investment Guidelines" (National Council of Catholic Bishops/United States Catholic Conference, 1991): see further M Naber, "Catholic Investing: The Effects of Screens on Financial Returns", *Journal of Investing*, Winter 2001. More recently, SRI funds managed according to the principles of Islamic law have been marketed to individual investors in the United States: see further *Guide to Dow Jones Islamic Market Index* (Dow Jones & Co, July 2001); Y T DeLorenzo, "Shariah Supervision of Islamic Mutual Funds", *Fourth Harvard University Forum on Islamic Finance*, Oct. 2000; R Wilson, "Islamic Finance and Ethical Investment" (1997) 24 *Int J of Social Economics* 1325; H Atta, "Ethical Rewards: An Examination of the Effect of Islamic Ethical Screens on Financial Performance and of Conditioning Information on Performance Measures" (University of Durham, 2001).

<sup>6</sup> See further M S Knoll, "Socially Responsible Investment and Modern Financial Markets" (University of Pennsylvania, 1999), at 5-6. As regards the impetus for SRI funds provided by the apartheid regime in South Africa, see P McCarroll, "Socially Responsible Investment of Public Pension Funds: The South Africa Issue and State Law" (1981) 10 *NYU Rev of Law & Social Change* 407.

<sup>7</sup> These funds mark the first time that pooled investments managed according to SRI principles have been made available to the general community of investors. Previously, SRI strategies were largely the province of wealthy individuals and charitable foundations.

First, the increasing popularity of SRI funds in Australia reflects heightened concerns in the broad community with environmental issues, occupational health and safety, and ethical standards (as exemplified, for example, by the broad-based support for the Kyoto Protocol to the United Nations Framework Convention on Climate Change and public perceptions of dereliction of duty by corporate officer-bearers in the wake of the collapse of Ansett, HIH Insurance, OneTel and Pasminco).<sup>8</sup> These concerns have been specifically addressed by the proponents of SRI strategies; it is claimed that it is no less profitable and prudent to invest money according to social or ethical criteria than it is to invest for financial gain alone.<sup>9</sup> In addition, recent moves by several of the large superannuation funds to implement SRI strategies have encouraged trustees of other superannuation funds and the managers of managed investment schemes to investigate those strategies.<sup>10</sup>

A further impetus for SRI funds comes from the diversification benefits promised by those funds; that is, SRI funds hold out the prospect of returns that are less strongly correlated to the performance of conventional equity investments.<sup>11</sup> This is significant, given the

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<sup>8</sup> Many SRI products are clearly differentiated by their socially-aware credentials. For example, the FTSE4GOOD Fund managed by Close Fund Managers has an SRI mandate and expects to donate approximately GBP1 million of investment income annually to UNICEF.

<sup>9</sup> These Australian developments are consistent with trends in other OECD countries. In July 2000, the UK Parliament amended the pension legislation to require the trustees of occupational pension plans to disclose their policy on the extent to which social, environmental or ethical considerations are taken into account in selecting, retaining and realising investments or exercising the voting or other rights attached to investments: s 35(3)(f), Pensions Act 1995 (UK); Reg 11A, Occupational Pension Schemes (Investment) Regulations 1996. The provisions of the Australian Financial Services Reform Act referred to in n 4 are based on the above UK provisions. Other OECD countries, including Austria, France, Germany and Switzerland, are considering enacting similar legislation.

<sup>10</sup> For example, the Australian Retirement Fund (ARF), Commonwealth Superannuation Scheme and Public Sector Superannuation Boards (CSS/PSS), Health Employees Superannuation Trust of Australia (HESTA), Journalist Union Superannuation Trust (JUST), VicSuper and the Victorian Local Authority Super Scheme (LAS). As regards the adoption of SRI strategies by US pension funds, see further D J Martin, "The Public Piggy Bank goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustees' Social Agenda" (1992) 29 San Diego L Rev 39.

<sup>11</sup> Thus, the addition of an SRI fund to an investment portfolio should produce diversification benefits for that portfolio (that is, adding the SRI fund will reduce the risk exposure of the portfolio without sacrificing performance). The diversification benefits of SRI funds are supported by K A Hickman, W R

convergence of Australian investment portfolios (with the majority of Australian fund managers benchmarking their portfolios against the ASX indices published by Standard and Poor's) and the constraints imposed by risk budgets on active position-taking within conventional managed investment funds.<sup>12</sup>

Many investors, including superannuation trustees, have become dissatisfied with the level of convergence - also known as "closet indexing" - occurring between actively-managed portfolios and benchmark indices. This trend has been exacerbated by the increasing focus of industry "gate keepers" (namely, investment advisers and asset consultants) on relative performance against indices as opposed to absolute performance. Moreover, in the context of multi-manager portfolio construction, such convergence is undesirable because it limits the potential to diversify portfolio risk, and consequently transfers the market (or systematic risk) from the fund manager back onto the shoulder of the superannuation trustee or other investment fiduciary.

### **What is socially responsible investing?**

The federal legislature has, as noted previously, tacitly endorsed the use of non-financial criteria - namely, labour standards and environmental, social and ethical considerations - in formulating the investment strategy for a managed investment scheme or superannuation fund.<sup>13</sup> However, an investment strategy will not, merely by reason of the fact that it incorporates one or more of the above criteria, constitute an SRI strategy.

A more accurate picture of what constitutes an SRI strategy may be derived by contrasting conventional or "socially neutral" investment strategies with strategies that are overtly (a) "socially sensitive" or (b) "socially dictated".<sup>14</sup>

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Teets and J J Kohls, "Social Investing and Modern Portfolio Theory", *American Business Review*, Jan. 1999.

<sup>12</sup> See further P U Ali and M Gold, "An Overview of 'Portable Alpha' Strategies, with Practical Guidance for Fiduciaries and Some Comments on the Prudent Investor Rule" (2001) 19 C&SLJ 272, at 272-273. See also P U Ali and M Gold, "Portable Alpha Strategies offer greater scope", *JASSA*, Summer 2001.

<sup>13</sup> Refer n 4.

<sup>14</sup> See further J D Hutchinson and C G Cole, "Legal Standards governing Investment of Pension Assets for Social and Political Goals" (1980) 128 U Pa L Rev 1340, at 1344-136; P S Cross, "Economically

A conventional investment strategy is, in general terms, a strategy that seeks to optimise the returns of a managed investment scheme or superannuation fund, as measured against the investment objectives of the fund (for example, outperforming the S&P/ASX 200 Index by 3%), for an acceptable level of risk within the financial parameters dictated by the investment mandate (for example, no more than 5% of the fund assets are to be invested in the securities of any one company).<sup>15</sup> The key factor for consideration by the investment fiduciary is therefore an investment's risk/return profile and its likely impact on the fund's overall risk/return profile. Nonetheless, it is common for fiduciaries in designing or implementing socially-neutral investment strategies to take into account non-financial or fundamental factors that may impact upon the risk/return profile of investments (thus, the fiduciary may decide not to invest in the securities of a company that is in breach of environmental standards, due to concerns about the impact of the breach on the financial stability or profitability of the company). However, while non-financial factors may play an important role in the selection, retention or realisation of investments, that role is secondary and is subsumed within the overarching (financial) return objectives of the fund.

In contrast, non-financial factors are of primary importance in socially sensitive or socially dictated investment strategies. A socially sensitive investment strategy is one where the fiduciary makes its decision as to which investment, in a universe of investments having comparable risk/return profiles, is to be acquired, retained or realised by reference to non-financial factors (such as a company's compliance with environmental standards, the company's employment policies, or whether the company is involved in the manufacture or sale of alcohol, tobacco or armaments).

Non-financial factors play a more prominent role in socially dictated investment strategies: the fiduciary seeks to achieve returns that are acceptable for the level of risk assumed by the fund whilst, at the same time, undertaking a non-financial objective (for example, allocating

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Targeted Investments - Can Public Pension Plans do Good and do Well?" (1993) 68 Ind LJ 931, at 934-941.

<sup>15</sup> See further H E Bines, "Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine" (1976) 76 Colum L Rev 721; J H Langbein and R A Posner, "Social Investing and the Law of Trusts" (1980) 79 Mich L Rev 72, at 77-83.

investment funds to companies that have affirmative action hiring policies or are engaged in environmentally-beneficial activities such waste-recycling).<sup>16</sup>

On this basis, a general definition of SRI can be proposed. SRI funds and strategies are characterised by a dual-objective: in deciding whether to acquire, retain or realise an investment, the fiduciary takes into account both the financial performance (that is, the risk/return profile) of the investment and the social, ethical or environmental “performance” or track-record of the underlying company.<sup>17</sup>

### Legal implications of proper nomenclature

The definition of SRI carries with it significant legal implications: socially responsible investing is, as the label denotes, *investing*.<sup>18</sup> Corporate activism - that is, the purchase of voting securities in a company for the principal or dominant purpose of advancing a non-financial agenda at the company’s general meetings - is not investing. *Ergo*, such activities are not encompassed by SRI.<sup>19</sup> Nor does the diversion of funds to socially meritorious activities, without reference to the derivation of a return on the funds deployed or the eventual repayment of those funds, constitute SRI.<sup>20</sup>

The legal capacity of a fiduciary to invest the funds entrusted to it does not extend to the utilisation of those funds for purposes other than investment.<sup>21</sup>

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<sup>16</sup> See further E A Zelinsky, “The Dilemma of the Local Social Investment: An Essay on ‘Socially Responsible’ Investing” (1984) 6 *Cardozo L Rev* 111; M Statman, “Socially Responsible Mutual Funds”, *Financial Analysts Journal*, May/June 2000.

<sup>17</sup> All of the Australian SRI funds reviewed offer a “dual” investment objective - that is, they pursue their SRI objectives while also aiming to exceed a market benchmark such as the S&P/ASX200 Index.

<sup>18</sup> This is axiomatic. A useful analogy is the objectivist axiom of “A = A”, formulated by Ayn Rand.

<sup>19</sup> See further Knoll, *op cit* n 6, at 15. As regards the duty of fund managers and superannuation trustees to vote securities, see further G P Stapledon, “The Duties of Australian Institutional Investors in relation to Corporate Governance” (1998) 26 *ABLR* 331.

<sup>20</sup> For example, Bendigo Bank’s Ethical Investment account - where part of the interest on the credit balance of the account is donated to Oxfam Community Aid Abroad - is not an SRI product.

<sup>21</sup> See further W A Lee, “Trustee Investing: Homes and Hedges” (2001) 1 *QUT Law & Justice J* 1.



Although an investment fiduciary, pursuing a socially sensitive or socially dictated investment policy, can make investments based on social or ethical criteria, the fiduciary is not empowered to use the funds held by it for the principal or dominant purpose of advancing social or ethical goals (as laudable as such an objective might be).<sup>22</sup> Dealings by a fiduciary that fall outside the scope of its legal authority are void *ab initio* and, moreover, the fiduciary will - if the dealing is disavowed by the members of the managed investment scheme or superannuation fund - be personally liable to compensate the members for any loss incurred as a result of such transactions/dealings.<sup>23</sup>

### **Legal structure of socially responsible investments - using SRI screens to create investment portfolios**

The investment portfolios of SRI funds are commonly constructed using targeted security screens.<sup>24</sup> These screens filter potential investments in or out of a portfolio based on non-financial criteria. There are two types of “screens”, positive and negative screens, with the latter being the more prevalent (usually, positive screens are used in conjunction with negative screens). Positive screens are used to identify desirable investments for inclusion in a portfolio while negative screens are used to reject investments based on undesirable characteristics,<sup>25</sup> typically those related to the industry in which a company operates or the company’s organisational characteristics.

This screening process is not a new phenomenon. A similar process is used in the creation of sector or industry-focused managed investment schemes (for example, biotechnology,

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<sup>22</sup> In contrast, to the trustee of a charitable or purpose trust.

<sup>23</sup> See further E O’Dell, “Incapacity” in P B H Birks and F Rose (eds), *Lessons of the Swaps Litigation* (Mansfield Press, 2000); P U Ali and T Russell, “Investor Remedies against Fiduciaries in Rising and Falling Markets” (2000) 18 C&SLJ 326, at 329-330.

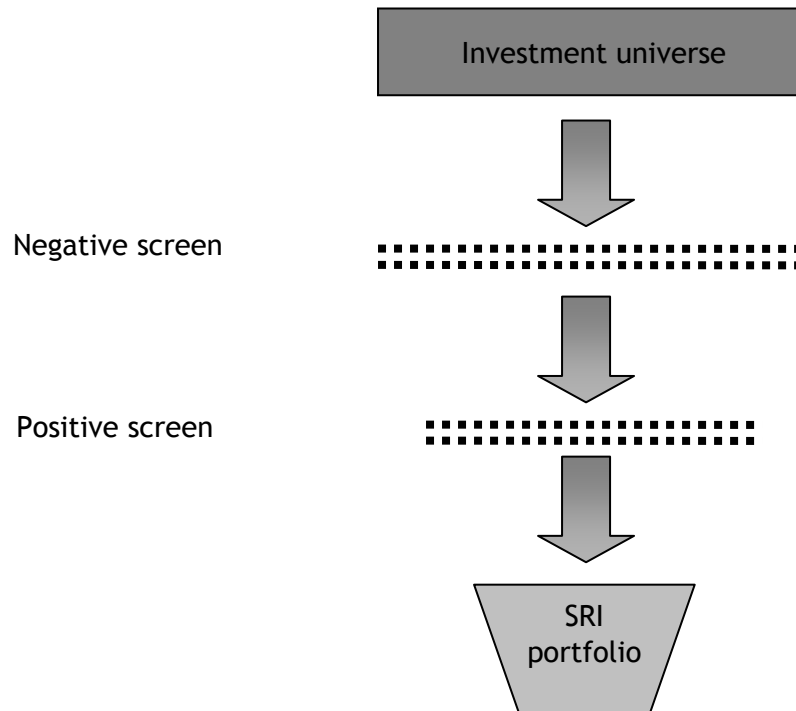
<sup>24</sup> Index vendors have also created socially responsible indices using SRI screens: two prominent examples are the Dow Jones Sustainability Group Indexes and the Financial Times FTSE4GOOD Index: see further *Dow Jones Sustainability Group Index Guide* (Dow Jones Sustainability Group Indexes GmbH, Sept. 2000); “Moral Guidance”, *Global Investor*, Sept. 2001.

<sup>25</sup> For example, the Summit Apex Total Social Impact Fund managed by Summit Mutual Funds invests in S&P 500 index companies that conduct their businesses commendably with respect to the interests of all stakeholders.

internet or telecommunications sector funds). However, SRI screens, unlike the screens employed in sector-specific funds, are designed to capture selected non-financial attributes across the entire universe of investable securities without focusing on companies that operate in a specific sector or industry.

SRI screens can be employed as part of the general investment selection process, although it is more common for such screens to operate at a discrete level - in the latter instance, an investable universe of securities is first created by reference to their risk/return profiles and those securities are then filtered through an SRI screen. A security must therefore pass both the financial hurdle (that is, possess a desirable risk/return profile) and the SRI screen; consequently, an investment will be rejected if it fails the SRI screening process, irrespective of how attractive the investment may be from a risk/return perspective and in terms of the likely impact of that investment on the overall risk/return profile of the fund. On the other hand, where the screen forms part of the general investment selection process (in the sense, that it operates at the same level as the conventional investment selection criteria), it is possible that an investment with a desirable risk/return profile may be included in the fund's portfolio despite failing the SRI screening process. This may be effected by downweighting the investment in the portfolio.

Figure 1: SRI screening process



Negative screens are typically used to exclude securities issued by companies that operate in what are considered to be “sinful” industries (principally, companies in the alcohol, armaments, gaming, pornography or tobacco sectors).<sup>26</sup>

More recently, negative screens have been used to filter out the securities of companies engaged in what are considered to be “socially harmful” practices (for example, non-observance of industrial or labour standards or human rights, or cruelty to animals). There is, of course, no limit to the non-financial criteria that may be employed to create an SRI screen; moreover, the investment fiduciary is free to create a screen that gives greater weight to one criterion than another. The following table provides details of the most common negative screens employed by SRI funds in the United States.

<sup>26</sup> See further M A Cohen, S A Fenn and J S Naimon, “Environmental and Financial Performance -- Are they related?” (Vanderbilt University, 1995); R N Kahn, C Lekander and T Leimkuhler, “Just say No? The Investment Implications of Tobacco Divestiture”, *Journal of Investing*, Winter 1997; L Gottsman and J Kessler, “Smart Screened Investments: Environmentally Screened Equity Funds perform like Conventional Funds”, *Journal of Investing*, Fall 1998.

Table 1: Negative screens used by US SRI funds<sup>27</sup>

Negative screen - criterion	US SRI funds which use a negative screen incorporating the criterion
Tobacco	96%
Gaming	86%
Alcohol	83%
Armaments	81%
Environmental standards	79%
Human rights	43%
Labour standards	38%
Birth control/abortion	23%
Animal welfare	15%

### Use of SRI screens in Australia

We have conducted a survey of thirty-four Australian SRI managed investment schemes and superannuation funds on offer to retail and institutional investors. The sample of 34 funds constitutes the entirety of SRI funds available to Australian investors as at the date of the survey (31 December 2001). The majority of the SRI funds reviewed employ negative screens while a small number employ both negative and positive screens.<sup>28</sup> The results of this survey are summarised in the following table.

Table 2: Use of SRI screens by Australian SRI funds<sup>29</sup>

Negative only screens	Positive only screens	Negative and Positive Screens
19 (56%)	3 (9%)	12 (35%)

<sup>27</sup> Source: *Biennial Report on Responsible Investing Trends in the US 1999* (Social Investment Forum, 1999).

<sup>28</sup> A number of the Australian SRI funds reviewed employ external specialists to undertake the construction of the screens or investment selection.

<sup>29</sup> Source: Stellar Capital (31 Dec. 2001).

The following tables provide details of the most common negative and positive screens employed by SRI funds in Australia.<sup>30</sup>

Table 3: Negative screens used by Australian SRI funds<sup>31</sup>

Negative screen - criterion	Australian SRI funds which use a negative screen incorporating the criterion
Armaments	23 (79%)
Uranium mining/Nuclear power	20 (69%)
Gaming	18 (62%)
Tobacco <sup>32</sup>	18 (62%)
Alcohol <sup>33</sup>	17 (59%)
Human rights	16 (55%)
Environmental standards	15 (52%)
Labour standards	15 (52%)
Animal welfare	7 (24%)
Pornography	7 (24%)

<sup>30</sup> In a minority of cases (2 funds out of 34), sufficient details of the screening criteria were not available. The two funds in question employed both negative and positive screens; thus, a total of 29 funds were reviewed for Table 3 and a total of 13 funds were reviewed for Table 4.

<sup>31</sup> Source: Stellar Capital (31 Dec. 2001).

<sup>32</sup> It is likely that this criterion would prevent an SRI fund from investing in securities backed by revenue from sales of tobacco (for example tobacco litigation bonds where the return on the bonds is dependent upon the level of tobacco sales). See further P U Ali, "Securitisation and United States Tobacco Litigation" (2000) 28 ABLR 214.

<sup>33</sup> Similarly, this criterion would prevent an SRI fund from investing in asset-backed securities issued against, for example, champagne inventory. See further "Champagne puts Fizz into French", *International Financial Law Review*, Feb. 2000; "Ancien French Security Structure puts the Fizz into the Champagne Industry", *International Financial Law Review*, April 2000.

Table 4: Positive screens used by Australian SRI funds<sup>34</sup>

Positive screen - criterion	Australian SRI funds which use a positive screen incorporating the criterion
Environmental standards	13 (100%)
Labour standards	9 (69%)
Corporate philanthropy	7 (54%)
Animal welfare	5 (38%)
Human rights	4 (31%)

### Screening investments - practical considerations for fiduciaries

Fiduciaries considering investing in SRI funds (or adopting SRI strategies) should be aware of the practical limitations inherent in the SRI screening process.

First, there may be a mismatch between the investable universe delivered on execution of the screening process and that which the screen is designed to deliver. This is likely to be due to the fact that fund managers need to be able to invest in a reasonably broad universe of securities (there is little commercial sense in creating a fund or investment strategy that cannot be effectively invested).

Secondly, screening involves arbitrary decisions not only as to the criteria that should be employed in filtering securities but also to the relative ranking of such criteria. The providers of SRI screens will, in practice, often have different views as to how a screen should be created or implemented and this is likely to be reflected in the creation of markedly different investable universes.<sup>35</sup>

Further, some service providers may not exclude “filtered out” companies but may instead, in creating the investable universe for a SRI fund, downweight the securities of those companies relative to their market capitalisation. As a result, notwithstanding the promotion of the

<sup>34</sup> Source: Stellar Capital (31 Dec. 2001).

<sup>35</sup> See further D C Tarlas and M J Christ, “Socially Responsible Investing presents Practical Challenges”, *Trusts & Estates*, June 2000; “Warm and Fuzzy. Ethical Investment: The Woolliness of Ethical Investment”, *The Economist*, 14 July 2001. This “ethical dispersion” may be due to the different data available to the service providers and the costs associated with maintaining such data or may simply be attributable to service providers seeking to differentiate themselves from their competitors.

fund as an environmentally-aware or ethical fund, that fund's investment portfolio may include so-called "polluters and shooters" (that is, chemical, mining and petroleum companies, and armament manufacturers). The perception that the fund has not been invested "true to label" poses a significant reputational risk to both the manager of the fund and fiduciaries (such as superannuation trustees) that have invested their beneficiaries' assets in the fund. Moreover, investors in the fund may consider that they have been misled by the manager and promoters of the fund.

That discrepancy is also likely to be present where the manager of an SRI fund utilises proxies to achieve exposure to the market. For example, the investment mandate for one SRI fund expressly authorises the fund manager to use exchange-traded funds to achieve exposure to international markets. Exchange-traded funds track broad-based and sector indices without reference to SRI criteria.<sup>36</sup>

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<sup>36</sup> As regards exchange-traded funds, see further P U Ali and M Gold, "The Next Generation of Index-Trackers: Exchange-Traded Funds and the Investment Duties of Fiduciaries" (2000) 18 C&SLJ 570; G L Gastineau, "Exchange-Traded Funds: An Introduction", *Journal of Portfolio Management*, Spring 2001; P U Ali and M Gold, "The New Model Index Fund", *JASSA*, Spring 2001. On the risks inherent in abdicating the selection of securities to the compiler of the index, see further R P Austin, "The Role and Responsibilities of Trustees in Pension Plan Trusts: Some Problems of Trusts Law" in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (Carswell, 1989); J B Shoven and C Sialm, "The Dow Jones Industrial Average: The Impact of Fixing its Flaws" (Stanford University, 2000); M Gold, "Indexing - the Fundamental Difference", *JASSA*, Autumn 2001. A similar issue confronts the managers of SRI funds in relation to investment products developed using securitisation technology: refer nn 32-33. For instance, it is unclear whether investing in asset-backed securities issued against a pool of life insurance policies is permissible under the current screening criteria employed by Australian SRI funds (the cash flow from the policies - and consequently the risk/return profile of the securities - is dependent upon the actual mortality rates of the insured persons): see further "Interest in Life Insurance Securitization Heats Up" (Standard & Poor's, 23 Oct. 2001).

## Socially responsible investments and the investment duties of fiduciaries - an overview of the prudent investor rule

### *Introduction to the prudent investor rule*

A trustee or other fiduciary that is empowered to invest the funds entrusted to it by its unit-holders or other beneficiaries, must exercise that investment power in a prudent manner. This duty of prudence - the so-called “prudent investor rule” - arises at general law and supplements the statutory duties of care, skill and diligence imposed by the Corporations Act 2001 (Cth) on the single responsible entities of managed investment schemes and the Superannuation Industry (Supervision) Act 1993 (Cth) on the trustees of superannuation funds.<sup>37</sup>

The application of the prudent investor rule in Australia has previously been the subject of detailed consideration.<sup>38</sup> For the purposes of this paper, it suffices to note that the Australian courts are likely, in interpreting the prudent investor rule, to adopt the approach of the United Kingdom and United States courts, and thus require fiduciaries to assess prospective investments in the context of their impact on the whole of the fiduciary’s investment portfolio.

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<sup>37</sup> Corporations Act, s 601FC(1)(b); Superannuation Industry (Supervision) Act, s 52(2)(b).

<sup>38</sup> R P Meager and W M C Gummow, *Jacob’s Law of Trusts in Australia* (6th ed., Butterworths, 1997), para 1802; F J Finn and P A Ziegler, “Prudence and Fiduciary Obligations in the Investment of Trust Funds” (1987) 61 ALJ 329; P U Ali, “Riskless Trading: Passport Options, Fund Managers and the Prudent Investor Rule” (2000) 18 C&SLJ 209; P U Ali and M Gold, “An Overview of ‘Portable Alpha’ Strategies, with Practical Guidance for Fiduciaries and Some Comments on the Prudent Investor Rule” (2001) 19 C&SLJ 272; P U Ali, “Holistic Risk Management, Nature-Linked Securities and Investors” (2001) 29 ABLR 246; P U Ali and M Gold, “Using the Market to Beat the Market: A Look at ‘Geared Beta’ Strategies and Implications for Fiduciaries” (2001) 19 C&SLJ 379; P U Ali, “Adding Yield to Stable Portfolios: Regulating Investments in Australian Hedge Funds” (2001) 19 C&SLJ 414.



This “whole-of-portfolio” approach is based upon modern portfolio theory:<sup>39</sup>

“The central principle of portfolio theory ... is that the risk of a portfolio is wholly distinct from the risk of any particular investment contained in the portfolio. The risk of a portfolio is a function of the interaction of its component investments. Thus, a trustee can use securities and instruments that are highly risky viewed in isolation to assemble a portfolio that is safe ... Portfolio theory justifies the inclusion, in appropriate amounts, of stocks thought to be risky. It also justifies the use of financial instruments, highly volatile in themselves, that may be deployed so as to lower portfolio risk or to attain a portfolio of a given risk at a lower cost.”

### *Socially responsible investing and the prudent investor rule*

The duty encapsulated in the prudent investor rule is owed by the fiduciary to its unit-holders or other beneficiaries. The object of that duty is to provide financial benefits to the beneficiaries through the derivation of an optimum return on the funds entrusted to the fiduciary - that involves, as noted above, maximising the return on the funds in accordance with the fund’s investment objectives, for an acceptable level of risk.<sup>40</sup> There are two aspects to this principle.

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<sup>39</sup> J N Gordon, “The Puzzling Persistence of the Constrained Prudent Investor Rule” (1987) 62 NYU L Rev 52, at 67. The framing of the prudent investor rule in terms of modern portfolio theory is discussed in detail in: Bines, op cit n 15, at 763-797; P G Haskell, “The Prudent Investor Rule for Trustee Investment and Modern Portfolio Theory” (1990) 69 North Carolina L Rev 87, at 100-108; E G Halbach, “Trust Investment Law in the Third Restatement” (1992) 77 Iowa L Rev 1151, at 1159-1175; R A Levy, “The Prudent Investor Rule: Theories and Evidence” (1994) 1 George Mason L Rev 1, at 10-18; R J Aalberts and P S Poon, “The New Prudent Investor Rule and the Modern Portfolio Theory: A New Direction for Fiduciaries” (1996) 34 ABLJ 39, at 52-60; C L Duronio, “Fiduciary Concerns under the Prudent Investor Standard”, *Trusts & Estates*, Dec. 1996; W B Phillips, “Chasing down the Devil: Standards of Prudent Investment under the Restatement (Third) of Trusts” (1997) 54 Washington & Law L Rev 335, at 348-361.

<sup>40</sup> *Cowan v Scargill* [1985] Ch 270; *Harris v Church Commissioners for England* [1992] 1 WLR 1241. See also A Leigh, “‘Caveat Investor’: The Ethical Investment of Superannuation in Australia (1997) 25 ABLR 341, at 344-345.

First, the interests of the unit-holders and other beneficiaries are paramount. As such it is irrelevant, in addressing the question of the fiduciary's compliance with the prudent investor rule, to inquire whether the investment of the funds by the fiduciary has benefited employees (as the objects of labour standards), the wider community (as the objects of environmental standards and human rights) or, indeed, animals (as the objects of animal welfare).<sup>41</sup>

Secondly, the primary objective of the trust fund is the generation of an optimal return for the benefit of the unit-holders and other beneficiaries (that is, the fiduciary must seek to maximise the return on the fund assets in accordance with the investment objectives of the fund, for an acceptable level of risk that is within the financial parameters set out in the fund's investment mandate). This is explicit in the case of managed investment schemes and superannuation funds where the beneficiaries have bargained with the fiduciary for economic exposure to the relevant investment market.

The fiduciary cannot, as a general rule, prioritise non-financial objectives, such as social or ethical objectives, over the financial objective of optimising the return on the fund assets.<sup>42</sup> However, the pursuit of non-financial objectives is not, of itself, inimical to the financial objective of optimising the return on the fund assets.<sup>43</sup> It is possible for fund assets to be

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<sup>41</sup> *Cowan v Scargill* [1985] Ch 270. See also A W Scott and W F Fratcher, *The Law of Trusts* (4th ed., Little, Brown & Co, 1988), para 227.17; R J Lynn, "Investing Pension Funds for Social Goals Requires Changing the Law" (1981) 53 U Colorado L Rev 101, at 105-106; G McCormack, "Sexy but not Sleazy: Trustee Investments and Ethical Considerations" (1998) 19 Co Law 39, at 41-43.

<sup>42</sup> See L J Bobo, "Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule" (1984) 33 Emory LJ 1067, at 1087-1089; Nicholls, op cit n 1, at 210-211. Where priority is accorded to non-financial objectives there is a substantive risk that the deployment of funds by the fiduciary (however, socially or ethically laudable) will not constitute an investment, placing the fiduciary in the position of having acted *ultra vires*. The trust instrument can, of course, authorise the pursuit of non-financial objectives. However, such a trust would be more properly characterised as a charitable or purpose trust (depending on the stipulated objectives), as opposed to an investment trust.

<sup>43</sup> As noted above, non-financial factors are often taken into account in implementing conventional or socially neutral investment strategies and, in the case of socially sensitive or socially dictated investment strategies, non-financial criteria are of equal importance to financial criteria in the investment decision-making process. cf G Djurasovic, "The Regulation of Socially Responsible Mutual Funds" (1997) 22 J Corp Law 257 where it is argued that the nature of the investment fiduciary's duties should reflect the expectations of investors in the fund. Hence, the trustee of an SRI fund cannot

legitimately deployed with the aim of improving labour or environmental standards, human rights or animal welfare provided that, in the pursuit of those goals, the above-stated financial objective is not disregarded or subordinated to the non-financial goals.<sup>44</sup>

On this basis, a fiduciary that sacrifices an adequate rate of return on the fund assets or places the fund assets in jeopardy, in the pursuit of a non-financial objective, is at risk of being in breach of the prudent investor rule.<sup>45</sup> This leads directly to the hypothesis that is tested in the second part of this paper: can a fiduciary implement an SRI investment strategy or invest in an SRI fund without sacrificing an adequate rate of return on the fund assets, that is, is there a financial cost involved in implementing an SRI investment strategy or investing in an SRI fund?

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pursue financial goals at the expense of the social or political goals of the fund. This, of course, raises the question of whether a trustee that prioritises social or political goals over financial goals has properly discharged its duties.

<sup>44</sup> Interestingly, some well-credentialed screened index providers do not take account of the financial performance of firms in compiling SRI indices. For example, the Dow Jones Global Sustainability Index ignores the financial performance of index companies beyond a consideration of how a company has adapted to the changes in its economic environment: *Dow Jones Sustainability Group Index Guide*, op cit n 23, p 9. In the context of the prudent investor rule, these approaches are establishing a precedent of challengeable legality.

<sup>45</sup> See R B Ravikoff and M P Curzan, "Social Responsibility in Investment Policy and the Prudent Man Rule" (1980) 68 Calif L Rev 518, at 520-528. In addition, the investable universe for an SRI strategy is, by definition, narrower than the relevant market. This diversification cost may lead to an increase in the market or systematic risk of the SRI portfolio. The sacrifice of portfolio diversification by the fiduciary may, depending upon the increased market risk of the SRI portfolio compared to a diversified portfolio for which investments can be selected from the entire market, constitute a breach of the prudent investor rule. See further Langbein and Posner, op cit n 15, at 85-92; Knoll, op cit n 6, at 20-31.

## C. EMPIRICAL ASSESSMENT OF SOCIALLY RESPONSIBLE INVESTMENTS

### Introduction

Although it is possible to posit a general legal definition of SRI, there are significant variations between the screening techniques commonly used by the providers of SRI screens and the managers of SRI funds. This inherent level of definitional subjectivity - and the consequent lack of comparable data - means that it is not possible to determine the characteristics of Australian SRI strategies and funds as an investment asset class objectively, with obvious difficulties for the assessment of whether or not SRI strategies represent a more optimal risk/return trade-off for investors, in terms of modern portfolio theory.<sup>46</sup>

### Overseas studies of SRI strategies

A number of empirical studies conducted overseas have considered the optimality of SRI strategies (that is the ability of such strategies to deliver maximum returns for their level of risk).<sup>47</sup> Generally, these studies can be categorised into two groups. The first group, which includes studies by D'Antonio, Johnsen and Hutton (1997) and Abramson and Chung (2000), has focused on the performance of a hypothetical SRI portfolio.<sup>48</sup> The second group, which

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<sup>46</sup> The relative immaturity of this market category in Australia, in terms of asset scale and the population of comparable funds with extended performance records, is illustrated by a brief report released by AMP Henderson Global Investors ("The Investment Implications of Choosing an SRI Fund", Feb. 2002). The AMP report examines the returns of nine Australian SRI share funds selected from the wider population of SRI funds available to Australian investors. The report compared the median (not a fund-weighted average) return of the nine funds with the performance of S&P/ASX 200 Index and observed that for the subset of the nine funds in operation for 3 years or more, the median return exceeded the returns for the broad market before fees.

<sup>47</sup> For example, S Hamilton, H Jo and M Statman, "Doing Well while Doing Good? The Investment Performance of Socially Responsible Mutual Funds", *Financial Analysts Journal*, Nov/Dec. 1993; L D'Antonio, T Johnsen and R B Hutton, "Expanding Socially Screened Portfolios: An Attribution Analysis of Bond Performance", *Journal of Investing*, Winter 1997; M G Reyes and T Grieb, "The External Performance of Socially-Responsible Mutual Funds", *American Business Review*, Jan. 1998; L Abramson and D Chung, "Socially Responsible Investing: Viable for Value Investors", *Journal of Investing*, Fall 2000.

<sup>48</sup> D'Antonio, Johnsen and Hutton, *ibid*; Abramson and Chung, *ibid*.

includes studies by Hamilton, Jo and Statman (1993) and Reyes and Grieb (1998), has, instead, examined the returns generated by individual SRI funds.<sup>49</sup>

D'Antonio, Johnsen and Hutton (1997) constructed a hypothetical portfolio of SRI debt securities (the portfolio comprised debt securities issued by companies with shares represented in the Domini 400 Social Index) and compared the performance of the portfolio over the period from May 1990 to March 1996 with the performance of the leading United States corporate bond index, the Lehman Brothers Corporate Bond Index. Abramson and Chung (2000) also tested a hypothetical SRI portfolio. However, in that case, the portfolio comprised SRI "value" shares (shares with relatively high yields or lower than average market capitalisation-to-revenue ratios were selected from the shares represented in the Domini 400 Social Index). Abramson and Chung compared the performance of their portfolio over the period from July 1990 to March 2000 with the performance of the leading United States value indices (that is, the Russell 1000 Value, S&P Barra Value and Wilshire Large Cap Value indices).

Neither study disclosed material differences between the performance, during the relevant analysis period, of the hypothetical SRI portfolio and that of the non-SRI benchmark index.

As noted above, the second group of studies has examined the comparative performance of individual SRI funds. Hamilton, Jo and Statman (1993) calculated the excess returns or "alpha" of 17 individual SRI funds over the period from January 1981 to December 1990.<sup>50</sup> This study did not find any statistically significant variations in the performance of the individual funds.<sup>51</sup> Reyes and Grieb (1998) undertook an examination of the monthly prices

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<sup>49</sup> Hamilton, Jo and Statman, op cit n 47; Reyes and Grieb, op cit n 47.

<sup>50</sup> Jensen's alpha was used to measure excess returns: see further M Jensen, "The Performance of Mutual Funds in the period 1945-1964" (1968) 23 J of Finance 389.

<sup>51</sup> The SRI funds examined by Hamilton, Jo and Statman all employed both negative and positive screens. The negative screens used by these funds were substantially similar. There were, however, significant variations between the positive screens. See further Hamilton, Jo and Statman, op cit n 47, at 63-64. The difficulties of comparing SRI funds with substantially different screens is acknowledged by Statman: M Statman, "Socially Responsible Mutual Funds", *Financial Analysts Journal*, May/June 2000. Hamilton, Jo and Statman also compared the average performance of the 17 funds with the

and rates of return for 15 individual SRI funds over the period from January 1986 to December 1995. However, because of the substantial differences between the SRI funds (in terms of screens used and investment objectives), the performance of the SRI funds was evaluated against conventional or “non-SRI” funds with identical investment styles (that is, “aggressive growth”, “balanced”, “growth” and “growth and income”).<sup>52</sup> Again, this study did not find material variations between the performance of individual SRI funds and the performance of conventional funds employing the same investment style.

Thus, all of the studies referred to above indicate that SRI strategies can be implemented without incurring a material financial cost.

The approaches adopted in the above articles are not, however, readily adaptable to the Australian context for a number of reasons: namely, the relatively small number of Australian SRI funds (34), the subjective nature of the screens used by the funds and the substantive differences between those screens,<sup>53</sup> and the general lack of comparable data. This not only renders it difficult to construct a meaningful common benchmark for Australian SRI funds (such as an SRI index analogous to the Domini 400 Social Index) but it also means that any comparison of the returns of individual Australian SRI funds will be of questionable quality.<sup>54</sup>

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average performance of conventional (ie non-SRI) funds. Again, this comparison did not disclose any material differences in performance: Hamilton, Jo and Statman, *ibid*, at 64-66.

<sup>52</sup> Reyes and Grieb, *op cit* n 47, at 2. For a comprehensive account of investment styles, see “Equity Style Investing and the Salomon Smith Barney World Equity Style Indices” (Salomon Smith Barney, Jan. 2000).

<sup>53</sup> Refer n 50 and, in particular, Statman, *op cit* n 51.

<sup>54</sup> Likewise, it is difficult to conduct a meaningful comparison of Australian SRI and non-SRI funds. In addition, the small number and disparate nature of Australian SRI funds renders it difficult to categorise Australian SRI funds into investment styles (*per* the analysis of SRI funds undertaken by Reyes and Grieb, *op cit* n 47): refer n 51.

## Methodology of this paper

This paper considers the optimality of SRI strategies in the Australian market. The key claim that is made by the proponents of SRI strategies - and one that is consistent with the overseas studies mentioned above - is that it is no less profitable or prudent to implement an SRI strategy or invest in an SRI fund than it is to invest in a socially neutral fund.

The majority of Australian SRI funds employ negative screens and the majority of those funds exclude the securities of companies in the armaments, uranium mining/nuclear power, gaming, tobacco and alcohol sectors.

This provides a strong foundation for empirical assessment by mutual exclusion. It is therefore possible to conduct a meaningful appraisal of a paradigmatic SRI strategy by measuring the performance contribution of “sinful” industries (*viz*, alcohol and gaming) to the broader stockmarket and thus the “market portfolio”. The “mutual exclusion” methodology employed in this paper differentiates this paper from previous empirical studies of SRI strategies undertaken in the United States and elsewhere.<sup>55</sup>

Accordingly, where the sinful industries do not reflect a positive contribution to the market, in absolute or risk-adjusted terms, then it would be reasonable to conclude that their omission from an SRI portfolio would not entail a financial sacrifice (in the form of a lower rate of return) or reduce the efficiency of the portfolio or vice versa. If, however, the exclusion of sinful industries entails a financial cost to the investor or the fiduciary has not considered the characteristics of the SRI strategy, there is a real risk that a fiduciary which allocated the funds of its unit-holders or other beneficiaries to the SRI strategy may be taken to be in breach of the prudent investor rule.

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<sup>55</sup> L Kurtz, “No Effect, or No Net Effect? Studies on Socially Responsible Investing”, *Journal of Investing*, Winter 1997 summarises the leading United States studies of SRI strategies. For a recent overview of SRI strategies in the United Kingdom, see S Williams, “UK Ethical Investment comes of Age”, *Journal of Investing*, Summer 1999.

## Australian “sinful” industry proxies

In the Australian context, the most suitable data available relates to the Australian Stock Exchange’s Alcohol and Tobacco, and Tourism and Leisure, sub-indices.<sup>56</sup> These proxies are used to assess the contribution of Australian “alcohol” and “gaming” companies to investment portfolios.

The ASX Alcohol and Tobacco (“ALTO”) Index comprises wine makers and brewing companies; it no longer includes tobacco companies, with the last tobacco constituent being removed from the ALTO Index on 9 May 2001.

The ASX Tourism and Leisure (“TOUR”) Index data commences in December 1994 and, despite its benign name, includes Australia’s largest casinos and wagering organisations and gaming machine manufacturers. This proxy also includes companies that are engaged in hotel management and entertainment; however, in terms of market capitalisation, the impact of the securities of those companies on the TOUR Index is not significant (these companies account for approximately 13% of the TOUR Index).<sup>57</sup>

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<sup>56</sup> Gaming” and “Alcohol” are, respectively, the third and fifth most popular negative screens used by Australian SRI funds: refer to Table 3. As regards publicly-traded Australian shares, there are no equivalent market proxies for screens such as “armaments”, “uranium mining/nuclear power”, “human rights” and “environmental standards”.

<sup>57</sup> The TOUR Index is thus not a perfect proxy for the gaming sector. However, the performance of the TOUR Index is driven substantially by gaming companies (which have an aggregate index weighting of approximately 87% versus 13% for non-gaming companies).



The following tables provide details of the ALTO and TOUR Index constituents.

Table 5: ALTO Index constituents<sup>58</sup>

<b>ASX Alcohol and Tobacco Index</b>	<b>Market value (\$ million)</b>	<b>% of index</b>
Brian McGuigan Wines	186	0.9%
BRL Hardy	1,907	9.3%
Cranswick Premium Wines	55	0.3%
Evans & Tate	72	0.4%
Fosters Group	9,903	48.3%
Lion Nathan	2,461	12%
Peter Lehmann Wines	134	0.7%
Simeon Wines	199	1.0%
Southcorp	5,569	27.2%
	20,486	100.0%

Table 6: TOUR Index constituents<sup>59</sup>

<b>ASX Tourism and Leisure Index</b>	<b>Market value (\$ million)</b>	<b>% of index</b>
Amalgamated Holdings	311	2.7%
Aristocrat Leisure	2,978	25.8%
Breakwater Island	43	0.4%
Burswood	314	2.7%
Casino Austria Intl	105	0.9%
Earth Sanctuaries	11	0.1%
Fleetwood Corporation	58	0.5%
Hamilton Island	92	0.8%
Jupiters	1,207	10.5%
Reef Casino Trust	13	0.1%
Sea World Trust	189	1.6%
Sydney Aquarium	73	0.6%
TAB	1,360	11.8%
TAB Queensland	386	3.3%
Tabcorp Holdings	3,673	31.8%
Village Roadshow	446	3.9%
Village Roadshow "A" Pref.	279	2.4%
	11,538	100.0%

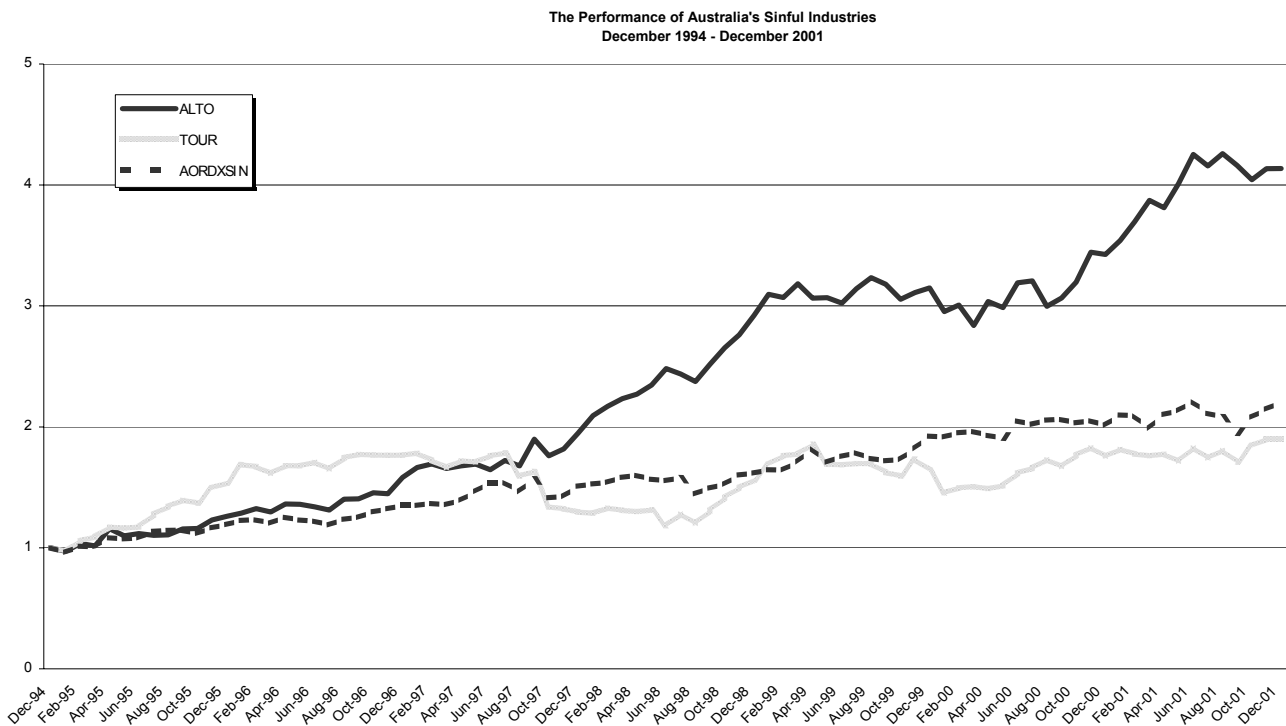
<sup>58</sup> Source: Datastream (31 Dec. 2001).

<sup>59</sup> Ibid.

## Financial performance of sinful industries

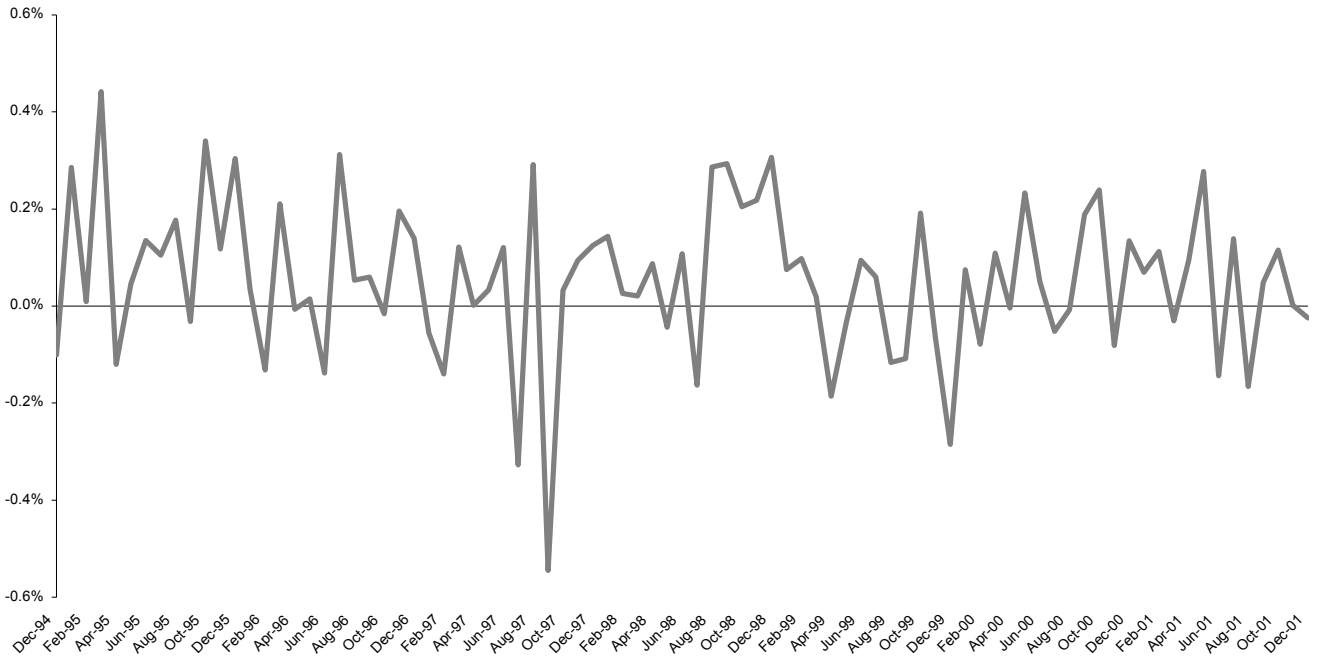
We have calculated the total return (capital appreciation and income receipts) from the sinful industries (with the ALTO and TOUR indices as proxies for such industries) and the broad market (represented by the ASX All Ordinaries Index) since the commencement of the TOUR index in December 1994 (our base date) for the seven year period ending 31 December 2001. We have also decomposed the total return contributions from the ALTO and TOUR indices to generate an “All Ordinaries ex-Sinful Industries” (“AORDXSIN”) Index. The figures below show the performance of the sinful industries proxies vis-à-vis the broad market over this period.

Figure 2: Total returns from “sinful” industries versus broad market<sup>60</sup>



<sup>60</sup> Sources: Datastream; Burdett Buckeridge Young (31 Dec. 2001). The returns have been re-indexed to a common base for comparative purposes.

The monthly return contribution from Australia's Sinful Industries  
December 1994 - December 2001



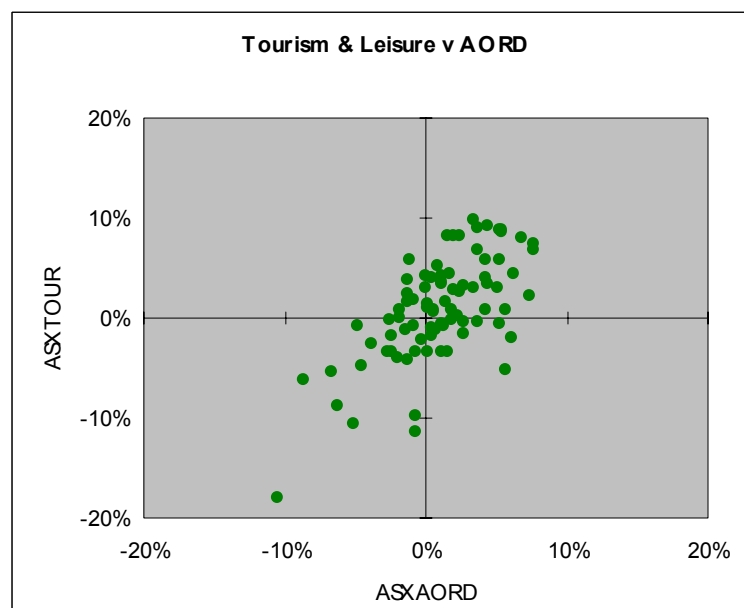
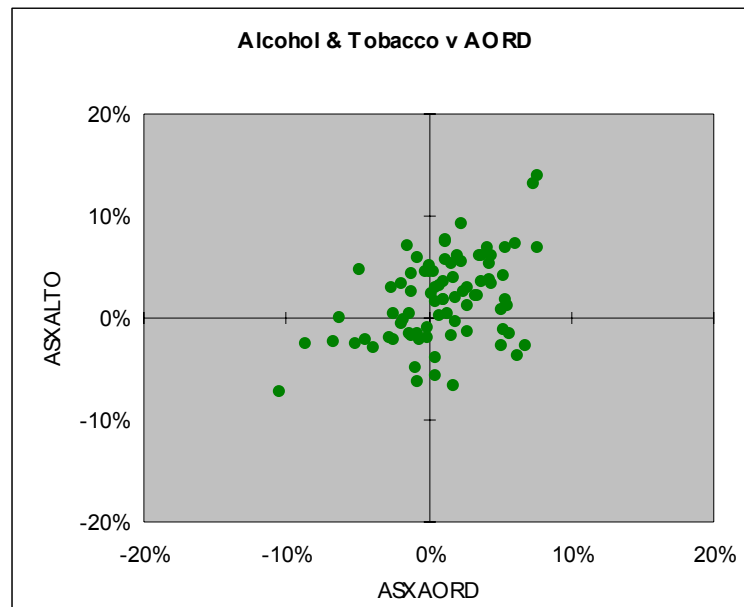


Figure 3: Scatter plots for “sinful” industries versus the broad market<sup>61</sup>

<sup>61</sup> Sources: Datastream; Burdett Buckeridge Young (31 Dec. 2001).

Our performance analysis of the two sinful industries (alcohol and gaming) indicates that the alcohol companies - but not gaming companies - contributed positively to the market portfolio over the analysis period. Exclusion of the securities of alcohol companies from the market portfolio therefore means investors would have forgone returns over the analysis period.

The ALTO Index made a strong and consistent performance contribution, outperforming the broad market by 9.8% per annum (that is, 22.5% for the ALTO Index versus 12.7% for the broad market). Over the analysis period, a \$1m portfolio invested in the ALTO Index would have returned approximately \$4.1m, compared with \$2.3m (a shortfall of \$1.8m for market investors) if the portfolio had been indexed to the broad market over this period instead.

The performance of gaming companies as represented by the TOUR Index was more variable. Over the analysis period, the TOUR Index underperformed the broad market by 3.1% per annum (that is, 9.6% for the TOUR Index versus 12.7% for the broad market), and variability of the TOUR Index returns was higher. Over the analysis period, a \$1m portfolio invested in the TOUR Index would have returned approximately \$1.9m compared with \$2.3m (a shortfall of \$0.4m for TOUR investors) if the portfolio had been indexed to the broad market over this period instead.

The following table summaries the relative financial performance of the sinful industries over the analysis period.

Table 7: Performance characteristics of Australia's sinful industries

	ALTO	TOUR	All Ords	AORDXSIN
Market capitalisation (\$billion)	\$20.5	\$11.5	\$720.5	\$688.3
Return (per annum)	22.5%	9.6%	12.7%	12.0%
Risk (per annum)	14.4%	17.7%	12.4%	12.0%
Sharpe ratio <sup>62</sup>	1.14	0.20	0.53	0.49
Reward ratio <sup>63</sup>	1.57	0.54	1.02	1.00

To determine the efficiency of the returns from sinful industries we have analysed performance according to a risk-adjusted framework. The “reward ratio” shows the contribution of returns per unit of risk taken. Clearly, the ALTO sector was an efficient contributor to market returns, while the TOUR sector was inefficient (the reward ratio was significantly below that of the overall market).

We have also conducted a regression analysis of ALTO and TOUR Index returns against the broad market to calculate the beta (or sensitivity) of returns for the sinful industries. The betas calculated demonstrated a very strong correlation (95%) between the returns of TOUR Index and the broad market. The ALTO Index, however, had strong absolute returns with low market sensitivity (51%). This indicates a highly beneficial contribution to the market

<sup>62</sup> The Sharpe ratio has been calculated as follows:

$$S_j = (r_i - r_f)/R_i$$

where:

- $(r_i)$  is the investment return;
- $(r_f)$  is the rate of return from a risk free asset;
- $(R_i)$  is the risk of the investment denoted by the standard deviation of its returns.

We have used the UBS Warburg Australia Bank Bill Index as the proxy for risk-free returns available to most local investors.

<sup>63</sup> The reward ratio is the quotient of return over risk, and thus represents the contribution to a portfolio of returns per unit of risk taken.

portfolio, with strong outperformance at the expense of a slight increase in risk coupled with low correlation to the broad market.

The contribution to market performance is a function of returns and market capitalisation. As shown in Table 7, the ALTO and TOUR sectors represented approximately 3.2% and 1.7% respectively of the total market benchmark as at 30 November 2001.

On average, over the seven year analysis period, the exclusion of the sinful industries from the market portfolio resulted in a performance shortfall of 0.70% per annum, reducing the broad market return from 12.7% to 12.0% per annum. While the exclusion of sinful industries did reduce the volatility or risk of the market portfolio (from 12.4% per annum to 12.0% per annum), the reward ratio also fell, reflecting a sub-optimal risk/return trade-off.

### **Real world costs and opportunities**

The above empirical analysis of the performance of companies in the alcohol and gaming sectors suggests that there can be a financial sacrifice involved in excluding sinful industries from an investment portfolio. However, due to the nature of the screening techniques employed, SRI strategies may be highly correlated to the broad market; most SRI funds will be able to generate returns from the largest market sectors, namely banks, telecommunications and media, as is the case with conventional managed funds. Investment fiduciaries should therefore be aware of the costs of a pure SRI strategy but also the potential of the SRI funds promoted in Australia to track or outperform the broad market.

In addition, investors need to be aware of the higher management expense ratios associated with the SRI funds on offer in Australia. Our review of Australian SRI managed investment schemes and superannuation funds reveals that investors in Australian SRI funds generally face additional fee imposts, compared to investors in mainstream Australian managed investment schemes or superannuation funds.<sup>64</sup> This is largely attributable to fund managers passing on

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<sup>64</sup> In a climate of lower absolute market returns, this can have a large impact on the net return to the investor. See further Langbein and Posner, *op cit* n 15, at 93-4.

to investors the development and marketing costs for SRI funds and the fees paid to external service providers (primarily, index vendors and SRI research providers).<sup>65</sup>

#### D. CONCLUSION

The empirical analysis of SRI strategies, in the Australian market, suggests that there are implicit costs in avoiding so-called “sinful” industries (as exemplified by companies in the alcohol sector). Over the analysis period - from December 1994 to December 2001 - the ALTO index (as the proxy for alcohol companies<sup>66</sup>) strongly outperformed the broad market, with its constituent companies proving to be efficient sources of diversification and portfolio return. Moreover, investors that avoided the companies in the ALTO index but otherwise invested according to the broad market index would have underperformed relative to the broad market. Gaming securities, in contrast, would have been a relatively poor portfolio bet for investors.<sup>67</sup>

Excluding the securities of alcohol companies from the portfolio of an SRI fund would, over the analysis period, have entailed a significant financial cost to investors in the SRI fund. This raises doubts as to the prudence of fiduciaries that allocate the funds of their unit-holders or other beneficiaries to an SRI strategy or fund which uses a negative screen to reject the securities of alcohol companies (which is the case with 59% of Australian SRI funds that employ a negative screen). In contrast, the decision of a fiduciary to allocate funds to an SRI fund that rejects gaming securities (which is the case with 62% of Australian SRI funds that employ a negative screen) is considerably more defensible legally, given the relatively poor performance of gaming securities, as illustrated by the performance of the TOUR Index over the analysis period.

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<sup>65</sup> However, direct investors that operate relatively simple internal screens are unlikely to incur significant additional costs.

<sup>66</sup> As noted above, tobacco companies are no longer represented in the ALTO Index.

<sup>67</sup> The authors’ findings with regard to the poor performance of gaming shares relative to other sinful industries are consistent with a previous United States study of the gaming industry: see further C Luck, “‘Sinful’ Industry Returns in the United States”, *BARRA Newsletter*, March/April 1992.



This does not, however, mean that the mere allocation by an investment fiduciary of funds to an SRI strategy or SRI fund that excludes, for example, alcohol securities, is, of itself, inconsistent with the prudent investor rule. It is unlikely that an Australian court would consider such a fiduciary to be in breach of its duty of prudence where the decision to invest has been made after due consideration of the performance characteristics of the relevant securities, and the impact of their exclusion on the risk/return profile of the fiduciary's portfolio and, consequently, the fiduciary's ability to generate an optimum return for its unit-holders or other beneficiaries. Moreover, given the nature of the screening techniques employed by Australian SRI funds, returns from those funds may be correlated to the broad market.

SRI proponents may point to market outperformance by SRI funds as validating the proposition that SRI strategies do not entail any significant financial sacrifice and may in fact provide superior returns. The efficacy of these claims is undermined by the relative immaturity of the Australian SRI market in terms of the scale of assets under management and the absence of a comparable population of funds with extended performance track-records. The potential for an SRI fund to beat the market (as measured by an index) may exist where the fund does not employ an index-weighted approach to stock selection. Such outperformance, however, is dependent upon portfolio selection, the broad market return and the period used for analysis. Accordingly, the phenomenon of (short-term) outperformance does not necessarily affirm the superiority of SRI strategies as the potential to beat the market is a characteristic of all non-indexed portfolios.