Getting by Tensions in Responsible Investment

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Synonyms

Paradoxes; Practice; Socially responsible investment; Tensions

Introduction

Socially responsible investment (hereafter SRI) can be defined as the integration of environmental, social, and governance issues into investment decisions (Sparkes 2002; Waddock 2003). Although SRI goes by many names and forms, it is characterized by three common features: a long-term perspective, attention to stakeholders, and consideration of nonfinancial factors. For SRI investors, market signals alone cannot address many of the intangible values that are important for sustainable societies.

SRI attempts to blur the boundaries between financial and nonfinancial values. It can therefore be described as a hybrid activity, which brings together "multiple and inconsistent goals, norms, and values, creating contradictory prescriptions of actions" (Besharov and Smith 2014). The practice of SRI is a fertile ground for paradoxes resulting from competing demands, leading to tensions and ethical dilemmas.

As a result, its practice can be difficult. Bringing together the short and long term; measuring nonfinancial criteria; including or excluding a company; engaging with companies and stakeholders; defining criteria; and all the while producing competitive returns for investors are complex tasks for which there are no simple answers.

In this chapter, we focus on the tensions asset managers (or any other actors of the SRI field) may face because of the complex nature of SRI and how to get by them. We first present the different practices of SRI and then consider the tensions managers face each time illustrated with concrete cases, to finally discuss ways of dealing with those tensions.

The Practice of SRI

SRI covers a variety of practices (Louche and Lydenberg 2011). Company screening and engagement are the two main approaches, often combined.

Screening refers to the use of criteria to evaluate a company's performance on environmental, social, and governance issues or/and its involvement in certain activities and behaviors regarded as irresponsible. We can distinguish three ways screens are used: negative or exclusionary

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screens, positive or inclusionary screens, and best-in-class or relative screens.

Negative screens are avoidance strategies, shunning investments in companies engaged in businesses or practices regarded as unacceptable or generally harmful to society. The most widely used negative screens are tobacco, alcohol, landmines, and violation of human rights.

Positive screens aim at encouraging corporations to enter sustainable lines of business or to develop strong stakeholder relations. With this strategy, investors select companies engaged in business areas or practices they view as exceptionally beneficial to society or stakeholders. Examples of positive screens are renewable energy, pollution control, or public transportation.

Best-in-class screens select sector leaders on environmental, social, and governance criteria. They usually employ a substantial number of ESG criteria to score companies, rank them, and then select the best-performing one (e.g., top 10%) in each industry. The number of ESG criteria used varies greatly (from as few as one or two per industry to more than 200), with some widely used ESG criteria for best-in-class screening, shown in Table 1. ESG criteria tend to evolve over time as new challenges, such as stranded assets or obesity, emerge.

The second approach, company engagement, is motivated by a desire to change corporate behavior toward sustainable practices. By engaging, investors voice their concerns on social, environmental, and governance issues. The three primary modes of SRI engagement are proxy voting, the filing of shareholder resolutions, and direct dialogue with corporations.

The Paradoxical Tensions of SRI

SRI confronts asset managers with complex issues and tensions. It confronts them with situations in which they need to simultaneously address multiple desirable but conflicting outcomes, such as financial return and societal impact, that operate at different time frames – long term versus short term – and follow different logics. Those paradoxes should not be neglected. Although difficult to get by, they are also the distinctiveness of SRI.

We present below four major paradoxes embedded in the practice of SRI. This list is not meant to be exhaustive but illustrative. However, we first need to specify two notions, dilemma and paradox, which are commonly used as synonyms in everyday language but which involve different actions.

A *dilemma* refers to a situation in which a choice has to be made between two or more alternatives. Resolving a dilemma requires an either/or trade-off involving weighing pros and cons and addressing the contradictory elements separately (Luscher and Lewis 2008).

A *paradox* refers to “contradictory yet interrelated elements that exist simultaneously and persist over time” (Smith and Lewis 2011). In paradox thinking contrary to dilemma thinking, the contradictory elements are not separate but interwoven. As a result, no choice can resolve the tension because opposing solutions are needed. In this perspective, reflexive questioning (Tomm 1987) becomes essential to examine deeper implications and their consequences and therefore leads to a higher level of abstraction. This enables double-loop learning (Argyris 1993) as actors not only question their current understanding but also their way of thinking. In other words, the paradoxical way of thinking – viewing tensions as complementary and interwoven – encourages managers to develop new, creative alternatives to the challenges they encounter.

Acceptable Versus Unacceptable

How can SRI investors, whether asset managers or asset owners, define what is an acceptable or unacceptable activity, business, or behavior? Although SRI is a financial product that has to follow certain procedures and criteria to objectivize decisions, the ethical dimension cannot be and should not be excluded. The most recent developments of SRI, through the process of mainstreaming, tend to neglect or ignore this question. The change of name from ethical finance to ESG investing characterizes this shift.

Getting by Tensions in Responsible Investment, Table 1 Examples of environmental, social, and governance issues (extracted from Louche and Lydenberg (2011))

Environmental (E)	Social (S)	Governance (G)
Emissions	Stakeholder relations	Board structure
Environmental policies	Working conditions	Independent directors
Environmental management systems	Respect for human rights	Independent leadership
Toxic chemicals	Diversity	Separation of chairman and CEO
Genetic engineering	Workplace health and safety	Remuneration
Pollution	HIV/AIDS	Shareholder rights
Water	Product safety	Accounting quality
Energy efficiency	Treatment of customers	Audit quality
Hazardous and solid waste	Labor relations	Board skills

The fact that "ethics" tends to disappear from the vocabulary does not make it irrelevant. We would even argue that it is even more important. Accepting the ethical dimension is also recognizing that the paradoxical tensions cannot be addressed with a cost-benefit analysis. The notion of ethics is central as it raises the question of what SRI is about. The exclusion of ethics emphasizes a unidimensional activity, disconnected from societal debates, while the inclusion of ethics reflects the interconnection between SRI and society/people and the multidimensionality and dynamic interests of SRI that is taking responsibility for a greater common good (Louche and Hebb 2014).

You are a SRI asset manager. . .

What to exclude and on what "ethical" grounds? . . .So far you have only used the best-in-class approach. Your CEO sends you a memo asking to consider divesting from manufacturers of landmines and weapons of mass destruction including nuclear weapons because it is an 'unacceptable business.' On what grounds is it 'unacceptable'? Should you also exclude uranium mining companies, nuclear power companies, and tobacco companies as well? (Adapted from Louche and Lydenberg 2011)

Can ESG criteria refer to universal values? . . .Your CEO has asked you to develop a new SRI product that can be rolled out by your banking divisions around the world. After presenting the product in a meeting with colleagues from different regions of the world, your Middle East colleagues tell you that they could never sell the product unless all financial services companies are eliminated because the Qur'an forbids usury; your Asian colleagues say that the fund's requirement that women be represented on boards would result in excluding all Japanese companies; and your colleagues from South Africa point out that job creation and black empowerment are two issues that mattered greatly, both politically and financially, and need to be included. How will you manage to build a standardized product? (Adapted from Louche and Lydenberg 2011)

Assessing Companies

A challenge for many investors considering SRI is how to assess the ESG performance of companies. ESG reporting is improving but still incomplete and far from standardized. Different frameworks exist, proposing lists of indicators per sector for a fundamental analysis of companies. While these lists of indicators are helpful, they contain some of the paradoxes of SRI: ESG data is selectively available in a subjective way, so investors combine subjective judgment and objective measures of ESG performance. ESG performance data is less available than ESG exposure data (reported as the existence of a health and safety policy or being a signatory of an ESG initiative), which are proxies that investors will often use to assess the ESG performance of companies.

You are an ESG analyst. . .

How to assess companies in case of lack of publicly available information? . . .You must review the ESG records of 20 European companies in the food industry. Ten of them are large and well-known companies, with well-developed CSR reports. Activities and controversies related to those companies are well covered in the press. The other ten are smaller companies with no CSR information available, and the companies did not appear in your press search. After contacting directly those last ten companies, you learn that some of them do

have CSR programs but do not report publicly about them. Moreover, you know from informal sources that one of these companies has taken a very innovative CSR approach recently. How can you compare the 20 companies? (Adapted from Louche and Lydenberg 2011)

Conflicting Logics

Two issues are related to this third paradox: the measure of societal returns and the different time perspectives between financial and societal returns.

SRI investors need not only account for the financial returns of their investments but also for the social and environmental benefits that their investments have provided. This is a difficult task. If sophisticated tools for reporting financial impacts exist, little has been done on the ESG impacts. It is far more difficult to quantify, measure, and report ESG value created by SRI. One complication comes from the fact that ESG returns take into account the interest of multiple stakeholders – employees, customers, suppliers, communities – in addition to investors. It is not immediately obvious how to calculate it; still it is important to do it.

The second aspect is related to time perspective. There is a persistent tension in SRI between the aspiration to adopt a long-term sustainable view and the business reality of investors and companies who need to meet quarterly results and provide annual returns. This tension appears when SRI investors want to estimate future growth, as time is relative, and framed differently in each sector: how far in the future is "long term" for the technology industry, and how does this compare to "long term" in the utility industry?

Some may wonder if there is a trade-off to be done between financial and societal value. Many studies have investigated this link (Margolis et al. 2009) concluding that there is no proof that SRI funds underperform conventional funds.

You are a SRI asset manager. . .

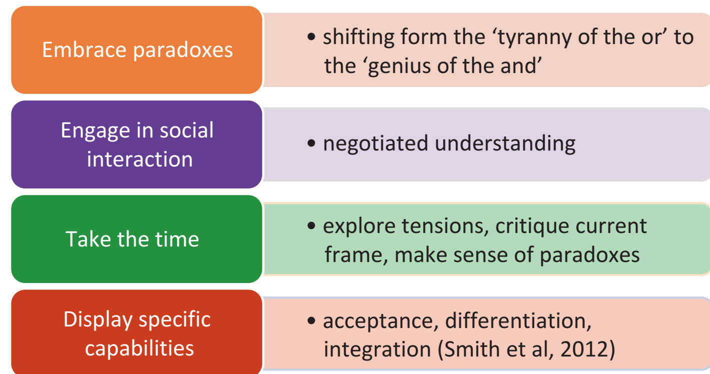
Is there a dichotomy between financial and societal returns? . . .. You work at a major bank. Some of the board members are concerned about environmental issues. They want you to divest from airlines to railways because it is a more energy-efficient mode of transportation. But financial returns from railways are lower than from airlines. After explaining to the board that divesting from airlines may hurt the portfolio's short-term financial performance, they ask you whether there is an equivalent 'societal' return from investing in railways to compensate for the poorer financial performance. How are you going to answer this question about societal returns? What is most important for the competitiveness of the bank? (Adapted from Louche and Lydenberg 2011)

You are an ESG analyst. . .

How far in the future is "long-term"? You are an ESG analyst specialized in the technology sector. You plan to apply a best-in-class screen in favor of renewable energy. Your company rightly points out that renewable energy is not financially interesting today. However, you consider that the positive externalities of renewable energy have value as well, and you defend your choice as positioning for future growth in this industry. This will make sense depending on the profile of your fund's clients whose investment horizon will be short-term or long-term. But how long-term should their long-term be to benefit from this investment?

Engaging with Companies: Between Voice and Exit

One of the keys to engagement is communication as a means of influencing corporate behavior. When talking about engagement, we often refer to the use of dialogue which can be private (behind closed doors) or public, through meeting with the management or by filing a shareholder resolution. Through dialogue, investors express their concerns to the company and develop a shared discourse frame with the company, which facilitates successful engagement. This dialogue form of engagement refers to what Hirschman (1970) calls "voice." But following Hirschman's theory, investors actually have another option to raise their concerns: "exit." It is often referred to as the 'Wall Street Walk' and means the sale of shares. If 'voice' is 'messy' and implies the articulation of one's critical opinions, 'exit' is more straightforward, impersonal, and indirect. Should SRI investors use the 'voice' or 'exit' approach to exert pressure on the company to change? Actually, it is not an either/or question. It is best to consider the dynamic between both strategies, as shown by Goodman et al. (Goodman et al. 2014). One may start with engaging in a private dialogue



Getting by Tensions in Responsible Investment, Fig. 1 Competencies to deal with paradoxes in SRI

with a company, but in cases where there is a lack of responsiveness or inappropriate level of change, the exit approach might be envisaged.

A second aspect of engagement is whether to do it individually or collectively. Building trust between investors and companies on ESG issues can be difficult and long. Using collective engagement means involving other stakeholders including not just other investors but also NGOs, which may put this trust at risk. But acting collectively can be, in certain cases, much more powerful and impactful. Here again comes the question: when to act individually or collectively, both can be complementary.

You are a SRI asset manager. . .

When to keep the dialogue private and when to become confrontational through public engagement? . . .You have a private discussion with a large garment company with operations in China about its labor standards for its subcontractors. Discussions have been friendly and open but have not lead to much progress. You are approached by other investors to join a public campaign. You are tempted to join because you believe the company should be moving faster. However, by doing that, you will most probably lose the company's trust and the possibility to have confidential talks with the company. Will harsh public criticism relayed by the press be more effective than behind-the-scenes discussion? What can be gained and lost by joining the public campaign? (Adapted from Louche and Lydenberg 2011)

How to Deal with Paradoxes

As illustrated in the previous section, SRI is full of paradoxes. What does it mean for SRI asset managers or analysts? They have to get by them, working through the paradoxes, and embrace them rather than eliminating or resolving them since they are part of SRI's nature. To do so, they have to manage a constant back and forth between the different logics present in SRI, thinking paradoxically in terms of "or/and." They have to engage in social interaction, collaborating with other investors or with frameworks of ESG factors. All of this requires time, to make sense of the paradoxes and determine an appropriate course of action, etc., and taking the time is not something that fast-paced finance is accustomed to. Is also requires specific capabilities, which SRI teams might look for in their recruits, including acceptance of tensions and paradoxical thinking. Fig. 1 summarizes the four competencies we have just highlighted to deal with paradoxes in SRI.

Conclusion

To conclude, practicing SRI requires combining multiple dimensions: financial returns, ethical considerations, and sustainability principles. Since 2010, SRI has entered into a mainstreaming era with the inclusion of ESG criteria in institutional investor's decision process (Dumas and Louche 2016). If SRI was once a niche activity, it has become a widespread practice among mainstream asset managers. In this wave of

mainstreaming, the design of new tools to address contradictory requirements has become essential and vital. These tools need to be more systematic so that SRI does not come as an afterthought; they may rely on ESG ratings; they might adjust cash flows or discount rate in valuation models, to give more weight to the long term. Whatever the type of solution thought up, it is essential that it embraces the tensions of SRI by addressing these multiple logics. Indeed, if the financial logic dominates, all other dimensions or if mainstreaming means fitting ESG into conventional evaluation instruments, SRI will lose its essence and its specificity.

Cross-References

- ▶ Emerging Trends in Socially Responsible Investment
- ▶ Ethical Dilemmas
- ▶ How Responsible Investors Respond to Conflict Zones
- ▶ Investor Response to the Climate Change Challenge
- ▶ Socially Responsible Investment and Company Engagement
- ▶ SRI's Normative and Ethics-Based Rationale

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