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Socially Responsible Investing in "High-Net-Worth" Asset Management Firms in Canada: An Exploratory Study

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Abstract

Socially responsible investing (SRI) is an increasingly well-known investment strategy. However, in most nations, SRI is not mainstream practice. This paper investigates perceptions of SRI amongst investment professionals from "high-net-worth" investment firms in Toronto, Canada. Existing corporate practices in relation to stock selection and client relations are documented, in order to assess how these practices might facilitate or prevent SRI. Views of SRI, and its current and potential future role in investment practice, were also explored. Results suggest that, while awareness of SRI has increased in recent years, it has not become accepted practice in high-net-worth investment firms. This lack of adoption stems from the perceived additional burden of researching the ethical (and not just financial) performance of companies, rather than any fundamental disagreement with the principles of SRI. In addition, interview participants pointed to low levels of client demand. Increased awareness of SRI among both professionals and clients was seen as the most effective way of increasing its adoption. The paper concludes by discussing the implications of this research for social responsible investing in Canada's high-net-worth investment firms as well as in the broader investment world.

Keywords

Socially responsible investing, ethical investing, investment practice, screening, corporate social responsibility.

Introduction

Socially responsible investing (SRI) is a method of investing that aims at being environmentally friendly and ethically and morally responsible, while at the same time generating wealth (Boutin-Dufresne and Savaria 2004; Basso and Funari 2003). There has been a great deal of controversy in the financial world around SRI since its introduction in the early 1990s. SRI invokes principles that have not been traditionally of importance to those who chose to invest. That is, most investing is done with wealth enhancement in mind, and so investors have not generally concerned themselves with the details of investments beyond their profitability. SRI, on the other hand, requires that investors concern themselves not only with financial return, but also with the social and environmental consequences of the investment decision.

While interest in SRI has grown considerably in recent years (Waring and Lewer 2004; Michelson et al 2004), SRI funds still appear as a mere footnote in today's financial world. If incorporated into the daily investment practices of professional financial analysts, SRI could become a central element of today's investment landscape. The purpose of this paper is not to explore whether such a change would in fact lead to meaningful beneficial social and environmental outcomes, as many would suggest. Rather, this paper investigates how SRI is currently incorporated into the daily practices of "high-net-worth" investment firms in Canada, and explores the facilitators and barriers that affect the use of SRI in this context. The paper therefore proposes to answer the following questions:

1.Is socially responsible investing a part of the investment strategy of "high-net-wealth" investment firms in Canada?

2.What are the barriers to, and possible facilitators of, socially responsible investing within these and similar firms?

In answering these questions, the paper hopes to add to the literature in two ways: first, by adding to our knowledge of this small but important sector of the investment community; and second, by identifying how the potential of socially responsible investing could be enhanced in ways that are consistent with existing practice within these (and other) firms.

The paper begins by briefly summarizing the existing literature in relation to SRI, in particular how this relates to the investment practices of financial analysts. The focus of this study on 'high-net-worth' asset management first is also described. Next, the methods used in this paper to investigate investment choices made by financial professionals in several "high-net-wealth" investment firms in Canada are elucidated. The data used in this investigation are then explored, followed by a discussion of the implications of the findings for socially responsible investing both within these firms and more generally.

Socially responsible investing and financial management

Socially Responsible Investing is a relatively new term. In the past, socially responsible investments were referred to as "ethical stocks" (Entine 2003). The purchase of "ethical stocks" was often based in religious beliefs, and investors supported funds endorsed by religious organizations (Domin 2001). SRI has since expanded to incorporate a wide variety of social and environmental concerns, including environmental protection, animal rights, and workforce diversity and relations (and often purposely excluding military involvement, the production of tobacco, and nuclear power – Entine 2003). It is believed by many that SRI helps direct capital to companies that generate economic growth while at the same time protecting the environment and promoting social welfare (e.g., Yach et al. 2001). To quote Boutin-Dufresne and Savaria (2004), SRI "reflects a broader philosophical movement committed to sustainable development and the advancement of human rights".

Four main approaches to ethical investment have been identified in the literature: screening, shareholder advocacy,

community investing, and the provision of social venture capital (Harrington 2003). In this paper, the focus is on the first method – screening – which involves the selection of investment opportunities in relation to the ethical performance of the companies being investigated. That is, stocks are selected for purchase (or not) based on their performance in relation to a number of ethical indicators, in addition to the usual performance assessment criteria (Thompson 2004; Basso and Funari 2003; Harrington 2003). In this way, investors both satisfy their own ethical requirements (i.e., by not investing in products or practices they find morally repugnant) and attempt to influence corporate behavior by rewarding companies that support their values.

In the last 10 years, Socially Responsible Investing has emerged in the financial world as an increasingly popular tool (Waring and Lewer 2004; Sparkes and Cowton 2004; Parris 2001). The amount of "socially responsible" investment being undertaken has increased considerably in recent years. In the United States, the Social Investment Forum (2003) reported that:

From 1995 to 2003… assets involved in social investing, through screening of retail and institutional funds, shareholder advocacy, and community investing, have grown 40 percent faster than all professionally managed investment assets in the U.S. Investment portfolios involved in SRI grew by more than 240 percent from 1995 to 2003, compared with the 174 percent growth of the overall universe of assets under professional management over the same time period.

A similar trend is also seen in Canada (Boutin-Dufresne and Savaria, 2004). SRI has also 'matured' in the sense that more people are beginning to believe that social responsibility should be incorporated into investment practice (Sparkes and Cowton 2004). Still, SRI accounts for only a small percentage of investing. In the United States – by far the global leader in this sector – only 11.3% of professionally managed funds were invested in SRI stocks in 2003 (Social Investment Forum 2003). In Canada, socially responsible investment assets represent 3.3 % of the institutional investment market and the retail mutual fund market (Social Investment Organization 2003). Thus, while the growth of the sector has been considerable, SRI has a long way to go before becoming truly "mainstream".

SRI is subject to a couple of criticisms that could be limiting its adoption. One critique is that the definition of "socially responsible" somewhat subjective; there is no universal standard for determining what is, or is not, a socially responsible investment, and criteria – and the ways in which criteria are applied – are quite varied (Entine 2003; Hayes, 2005). A second and perhaps more fundamental criticism of SRI is that it is inherently less profitable than traditional investing. That is, SRI is assumed to automatically lower the overall performance of a client's portfolio, and therefore the investor will lose money on SRI investments in comparison to conventional investments (Thompson 2004; Basso and Funari 2003; Tippet 2001; Johnsen, 2003). There is no reason to believe, then, that socially responsible investments are inherent underperformers. Indeed, recent analyses suggest that social responsible investments perform comparably to traditional investments (Bauer et al, 2006; Barnett and Salomon, 2006; Kreander et al, 2005; Thompson 2004; Basso and Funari 2003). Thompson (2004) asserts that corporations with "sound environmental practices and diverse work forces are outperforming companies that do not emphasize those goals", and that this is likely to result in increased returns for SRI. If this is the case, why are investors failing to adopt SRI practices? This paper explores this issue in relation to a limited case study of "high-net-worth" investment firms in Canada.

The choice to focus only on high-net-worth firms has a three-point rationale. First, these firms for the most part do not invest in mutual funds or other compiled stocks. The fact that these firms rarely invest in mutual funds removes an additional level of complexity from the investment process. Second, these firms focus on personal service. Among "high-net-worth" firms, however, the investment philosophy is to select stocks and bonds based on the individual needs of clients. Since these firms pride themselves on giving focused attention to individual client needs, it was thought that they would provide an interesting picture of how investment professionals interpret their commitments to investors, and how SRI fits in to this picture. Finally, given the large minimum investment that these firms require (ranging from $850,000 to $1,000,000), it was thought that the clients of these firms might be better informed about investment strategies and potential investments, and also might take more active role in directing their investments, than most investors.

Methods

As an initial step in the research process, The Toronto Society of Financial Analysts (TSFA) was contacted, to gather information about the designation and the process of accreditation for Chartered Financial Analysts (CFAs). While there are a number of respected designations among the financial world, the CFA designation is one of the most sought after. CFAs have passed exams administered by the U.S.-based Association for Investment Management and Research (Financial Planners Standards Council 2004). They provide guidance to businesses and individuals to help them make investment decisions, by gathering financial information, analyzing it, and making recommendations to their clients (Bureau of Labour Statistics 2004). CFAs are empowered with the potential to invest and help grow their clients' money; they do so while following a set of guidelines outlined by members of the CFA board (CFA Institute 2004). As these guidelines form the basis of ethical practice in the investment field, it was considered important to evaluate the potential implications of these codes of conduct for the adoption of socially responsible investing.

Next, preliminary interviews were conducted with ten financial professionals in Toronto, Canada. Among them, they held various educational designations, including Certified Financial Analyst (CFAs), Masters of Business Administration (MBA), Chartered Accountant, and financial lawyer. In these interviews, participants were asked questions according to their position and place of employment. Questions pertaining to what SRI funds meant to the interviewee and how they were employed in the industry were important in every interview, as well as questions on where each interviewee believed the SRI market was going in the future. Those involved with non-profit organizations were asked questions about what their organizations are doing to promote the awareness of SRI funds and how they are working to develop educational programs to educate the industry leaders. In addition to building an initial data set, these interviews – along with the literature review and industry publications – served as the basis for selecting "reputable" high-net-worth investment firms for investigation the final stage of the project.

On the basis of preliminary interviews, six highly reputable Canadian "high-net-worth" wealth management firms were contacted for further involvement in the research. Interviews with financial advisors from each of the six companies were held,

either over the phone or in person, over a two month period. These financial advisors were from various departments and were responsible for different tasks within their selected fields, including research, analysis, investment, and client relations (that is, acquiring prospective clients). In these interviews, participants were asked about the everyday practices of the companies at which they worked. In particular, attention was focused on the process of stock selection and how it varied from firm to firm. Participants were also asked if SRI was entertained as an option for their clients and if they promoted the selection of stocks based on ethical criteria. They were questioned about their and their company's views on corporate governance and how informed clients are (or should be) about the particulars of their investments. Finally, participants were asked specific questions about educational designations they held and their views on continuing professional education, as well as what it meant to be a high-net worth company and what type of clients this type of firm usually handles.

All interviews lasted between 30 and 90 minutes. Detailed written notes of all interviews were taken by the principal researcher to record the conversations for subsequent analysis. Interview notes were reviewed to identify key themes, in three specific areas: current investment practice, existing use of SRI, and perceptions of the future potential of SRI in relation to their firm. Results are admittedly based on the researchers' interpretations of the interviews, and the sample size is too small to draw any broad generalizations about investment practice, particularly beyond Canadian "high-net-worth" firms. However, they do provide a small snapshot of views of SRI within one segment of the investment world, and allow insight into the factors at play that might hinder or facilitate the incorporation of socially responsible investment techniques into mainstream investment practice.

Findings

Codes of Conduct

In order to understand the role that SRI plays in professional investing practices, it is important to understand the roots of, and the strategies used in, current practice. The roots of current investment practice lie in existing codes of conduct for the industry. In this paper, we focus on the code of conduct for chartered financial analysts (CFAs). While "there are a number of reputable and helpful credentials that financial professionals in different disciplines may hold", none is "as rigorously focused on investment knowledge as the Chartered Financial Analyst" (CFA Institute 2004).

The CFA designation includes many guidelines of practice for those who hold the title. The CFA Institute publishes a Standards of Practice Handbook which includes a section on the Code of Ethics and The Standards of Professional Conduct. The Standards of Professional Conduct states that members shall:

a)Exercise diligence and thoroughness in making investment recommendations or in taking investment actions.

b)Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions.

c)Make reasonable and diligent efforts to avoid any material misrepresentation in any research report or investment recommendation

d)Maintain appropriate records to support the reasonableness of such recommendations or actions. (Association for Investment Management and Research, 1999)

As the handbook for conduct illustrates, those who are members of the CFA Institute are responsible for investing with their clients' best interests in mind. Regardless of what a portfolio manager believes about a certain investment, no investment should be made where the investor has not executed due diligence. However, the strategies used to meet these ethical and practical requirements differ somewhat by firm. Results from the in-depth interviews are used to provide a sense of these day-to-day practices.

Current investment practices

The investment process within the high-net-wealth investment firms under study began once an individual decided to become a client. At that point, the client was asked about their investment needs (e.g., their need for a steady income, their desire to increase their capital as much as possible, etc.) in order to determine how able they were to tolerate market volatility. New clients are also generally asked about their existing investments and whether they want to keep them intact, to ensure that the portfolio created is sufficiently diverse once existing assets are taken into account.

The general process of stock selection and the basic investment strategies of the six high-net-worth firms contacted were similar. Interview participants highlighted four basic steps involved in the investigation of a particular corporation's stock. The first step involves determining what type of industry the company in question is involved in, and where the company does most of its business. Once this is complete, the second step is to screen companies to make sure their debt is manageable and that they are in good standing. It is also important to talk to others in the financial world to see how they view the company and if they have information of importance for the screening process. The third step involves reading through all publicly available information about the company (including annual reports), in order to understand the attributes of the company involved. Finally, the corporate governance of the company is researched and documented. It is important to know who is on the Board of Directors of the company (because the Board of Directors is the most direct representative of the shareholders' interests) and if the share-holders are able to vote on key issues affecting governance and policy. Interview participants noted that, while it is commonly assumed that corporate decisions are made with the investors' best interests in mind, this may not always be the case, particularly if members of the Board of Directors are also the senior executive officers of the company. After a stock passes all the screening processes listed above, it is then brought to the attention of the partners (or executives) in the particular firm and they collectively decide whether or not to incorporate it into their clients' portfolios.

Interview participants noted that choosing the correct stocks to hold in a portfolio is a very difficult task. When researching stocks, it is important to know how an addition or deletion of stock will affect an overall portfolio. To do this, the researcher must know the structure and diversification of each company within the portfolio. It is therefore essential to investigate the attributes of each corporation involved, a lengthy and time consuming process. Participants therefore highlighted the fact that they wanted to determine reasons why they should not buy the stock of a particular company (vividly described as "killing" a stock) as quickly as possible in the screening process. Once they have determined that the company is not right for the investment firm they can move on to another potential stock, without wasting valuable time on further investigation.

The stock selection process, while lengthy and tedious, must be completed to satisfy the due diligence that every portfolio manager owes to their clients. Interviewees confirmed the importance of this process as a fundamental principle of the work they do, and all agreed that investment firms are responsible for ensuring that their clients invest in sound and well- researched funds. This was considered true whether or not the investment professionals undertook the research themselves (or in-house), or outsourced their research to other firms (a practice which is fairly common among these firms, on the assumption that specialists in particular areas are likely to make the wisest investment decisions).

The inclusion of Socially Responsible Investing in current practice

Each interviewee was asked to discuss whether and how clients are introduced to socially responsible investing, and if SRI is promoted (or even mentioned as an option) to clients. Results from this line of questioning indicated that the majority of companies involved in this research do not offer a SRI option for their clients. Of the six firms contacted, only one had an option for their clients to invest in SRI funds. In this case, the research was outsourced and not done in-house. The reason given when asked why they outsourced was that there is not enough demand currently amongst their clients for an onsite SRI division.

Out of the remaining five firms contacted, two consistently asked their clients in initial contract discussions whether there are any stocks that the client was averse to holding, or alternatively was determined to see in their portfolio. However, interviewees stated that clients rarely instructed their investment advisors even when asked about preferences, choosing instead to rely entirely on their advisors' professional expertise. Stock selections, therefore, were almost exclusively made in the "traditional" manner, without taking into account SRI principles.

The lack of SRI seen here may result from the limited attention paid to SRI within the investing mainstream. According to interview participants, the topic of socially responsible investing was not a common one within the financial community until recently. Participants noted that it was usually assumed that clients were not interested in constraining their potential returns in any way, ethical or not. While most interview participants reported having heard information suggesting socially responsible investments and positive monetary returns can go hand in hand, they felt that the extra work involved in researching stock using an SRI approach was not worthwhile.

The potential for increasing SRI within high-net-wealth investment firms

As mentioned earlier, very few of the firms contacted currently encourage investment in SRI funds. It was clear from these interviews that these investment professionals would not endorse 'green' or 'ethical' investment as a separate category, as there was a sense that this would limit investor returns.

Interview participants also found it difficult to reconcile an even more comprehensive stock selection process (i.e., one that took into account ethical concerns in addition to the current screening) with existing practices, particularly in terms of providing resources for extra research by staff. It was not clear who would be expected to invest the extra time or cover the cost of purchasing the research if outsourcing was necessary. Given that taking social responsibility into account was not standard practice, interviewees could not see an immediate or pressing need to take on this extra burden, particularly in the absence of pressure from clients. However, despite this lack of enthusiasm about SRI per se, it was clear that all of the interviewees believed that there was a need for better research into company's environmental and social policies and the way in which the leaders governed the companies.

One potentially important factor that was considered by interviewees to be lacking from the current stock selection process is the impact of a company's image (current or projected) on its future success. It was mentioned in several (but not all) interviews that researchers should add a component to their stock selection process which took into account the future or anticipated trends of the company, and that one way of anticipating the future (and particularly long-term) success of a company would be to investigate its environmental and social responsibility. One interview participant highlighted the ongoing disinvestment in tobacco stocks as example of how social and environmental issues (broadly speaking) can impact on a stock's potential investment return (see Yach et al. 2001 for further discussion of this issue). This interviewee emphasized the difference between laypersons' reasons for avoiding tobacco stocks (i.e., it is ethically wrong to support tobacco companies) and the financial professionals' rationale (the profitability of these stocks will be negatively impacted by ongoing lawsuits, corporate image problems, and a decreasing market, and so they are not a good investment). Another participant suggested that the ethical and social performance of companies should be investigated as part of reviewing corporate governance, which is already a key component of a duly diligent stock selection process.

A few interview participants (in particular, those interviewees most directly involved in stock selection) were aware of SRI indices that could be used to evaluate companies based on their performance on social and ethical issues (using indicators such as the company's position on the Kyoto Protocol, energy efficiency/green energy, and labor issues such as child labor, employment equity and unionization). These published indices, as well as specialized investment firms such as Michael Jantzi Research Associates (MJRA), make it possible for companies who may not have the time or the expertise to attain all the necessary information to outsource some of the necessary research. This tactic was already being used by one of the investment firms in the study, but the practice was expensive.

Interview participants all agreed that for SRI funds to become part of everyday practice within their firms, more attention needs to be brought to them both inside and outside the financial establishment. Interviewees felt that both clients and professionals needed to be more aware of SRI in order to better inform their practice. Not very surprisingly, while interviewees currently involved in SRI highlighted the importance of continuing education for investment professionals in relation to SRI, other interviewees were not interested in seeing mandatory continuing education in this area. Interestingly, representatives of the CFA Institute highlighted SRI as an important and emerging issue in the financial world, and noted that the CFA Institute has been working to provide courses to CFAs on the subject of SRI funds. There are also seminars held through the CFA Institute with guest speakers who specialize in SRI management.

Discussion of findings

Socially Responsible Investing is on the rise worldwide. However, it is not clear whether SRI is likely to become more than a niche market in Canada and elsewhere. The results of this research suggest that, while awareness of SRI as an investment practice has increased in recent years, it has not become part of mainstream practice in high-net-worth investment firms in

Canada. While these firms cannot be considered representative of all investing in Canada, their focus on personal service and the potential for highly engaged clients provides an interesting case study of the facilitators and barriers to socially responsible investing.

Among the financial professionals surveyed in this research, SRI was not particularly popular, not because the participants disagreed with its principles, but rather because of the amount of extra research involved in assessing the ethical (and not just financial) performance of companies. Research was considered time-consuming and difficult, and interview participants were therefore reluctant to add what is seen as an additional level of complexity to the existing screening process.

However, there was also a sense among the financial managers interviewed that certain elements of SRI practice could or should be incorporated into day-to-day investment practice (e.g., screening for corporate ethical lapses likely to impact on future profitability). The desire for some SRI screening had more to do with compliance to the standards of due diligence and reporting than it had to do with personal ethical beliefs or environmental concerns. Financial professionals' codes of ethics (including the CFA standards of practice) demand comprehensive research into potential investments, in order to ensure that investments made are in the client's best interest. Therefore, if the social responsibility of a company is likely to have a meaningful impact on corporations' profitability (in the short and long term), then it is important for financial professionals to incorporate these issues into their stock selection process, regardless of the work involved. There was a tension, then, between a sense of responsibility to the client and to their own code of practice on the one hand, and an unwillingness to "make work" on the other.

Central to this tension is uncertainty amongst the interview participants as to whether social responsibility really does make a difference to corporate profitability. While the current literature is increasingly suggesting that social responsibility can have long term positive impacts on the bottom line, investors are unwilling to take on extra work if there is no compelling financial reason to do so. That is, equivalent performance is not enough: SRI must perform better than conventional investments in order to be seen as worth the additional effort.

The results also point to a fairly low level of client engagement in the investment process overall, and in relation to ethical concerns more specifically. Despite the relatively large investments being made by the clients of the "high-net-worth" wealth management firms investigated here, clients remained relatively passive, allowing their portfolio managers to make decisions about the specific assets in their portfolio. In addition, interview participants pointed to low levels of client demand as part of the reason that SRI was not adopted in their firms.

Interview participants highlighted the need for better promotion of SRI as an investment strategy, and some pointed to opportunities for improving education around SRI through continuing education. Participants saw increased awareness of SRI among both professionals and clients as the most effective way of increasing its adoption and moving it towards the mainstream.

Conclusion

There is still considerable debate in the literature about the importance (both morally and financially) of socially responsible investing (for example, see the January 20th 2005 edition of The Economist). However, assuming that the incorporation of ethical principles into mainstream investment practices would have noticeable environmental and social benefits, this paper points to several ways that the potential of socially responsible investing could be enhanced (at least in Canadian "high-net-worth" wealth management firms). First, financial professionals need to be convinced that environmental and social responsibility can – and indeed often does – go hand in hand with profitability. Education, as well as further confirmatory research, would be helpful in this regard.

Second, an ethic amongst financial professionals that broadens the conception of "responsibility" to recognize clients' moral as well as financial interests needs to be developed. This is not to say that financial professionals need to become a kind of "social police", or that they should be investing according to their own social mores, but rather that they should go further in ascertaining their clients' values than the typical "level of risk tolerance" conversation.

Finally, financial professionals should be encouraged to incorporate at least a basic assessment of corporations' social and environmental responsibility into the routine stock selection process. This could be achieved by following a set of stock selection guidelines supplemented through increased background research on the companies under review. If the firm is unable to go into the detail necessary to find out all the information about a given company, outsourcing the research to a specialized firm is also a possibility. Investment firms owe it to their clients to ensure that the best possible investments are made.

This is not to suggest that SRI is a panacea for current social and environmental problems, or that SRI is not without flaws. There are many potential problems with the current SRI practice, and it is not the purpose of this paper to downplay these issues. Rather, the paper attempts to highlight areas where investment strategies could be improved, at least within one small segment of the Canadian investment arena. In rapidly evolving world markets, it becomes more and more important to know everything possible about the companies one plans to invest in – in this context, social responsible investing should not be seen as a niche market outside of the investing mainstream, but rather as a fundamental component of a modern investment strategy. If SRI is going to have a significant impact on investing in Canada and the rest of the world, it cannot remain as a separate practice, but rather needs to be integrated into the everyday practices of investment professionals. This paper attempts to engage with this process by providing a more detailed, on the ground understanding of the institutional/practice-based barriers to socially responsible investing within one type of investment firm. It also provides new insight into the practices of "high net worth" investment firms, illuminating this small but important segment of the investment world.

List of Abbreviations

SRI – Socially Responsible Investing
CFA – Chartered Financial Analyst

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