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IR/PS CSR Case # 07-23

Social Screening in the Mutual Funds Industry:

An Analysis of Calvert Fund

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I. Introduction

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The origins of the Socially Responsible Investing Industry (SRI) can be traced back in the XVIII century when religious organizations solicited their members not invest in companies that promoted activities that were oppose to the organization's principles. The "sinful" activities prohibited by these organizations evolved among the time and included bans against companies that financed pornography, alcohol, gambling and weapons. The social indignation with corporate practices during the Apartheid in South Africa and the Vietnam War brought momentum to discuss the convenience of using other criteria to guide the investment decisions of people with anti-war sentiments or sensitive to human rights' violations. Based on these concerns, a few mutual funds started operations offering their clients screenings that identified companies suspicious of violating human rights or who did business with companies or countries involved in military activities. Immediately, this option attracted a considerable number of investors for whom these innovative screenings meant the only available way to align their ethical principles with their financial decisions. These funds adopted the logo "socially responsible" and broadened the screenings to issues that their clients felt important, like labor standards, environmental impact or gender equality. The growth and scope of the socially responsible funds transformed them into a real industry that ended up tapping a considerable market niche forgotten by the traditional mutual funds industry.

In general, the criteria used by the SRI industry include workplace, social, religious and environmental issues as part of the screenings.[1] Given the broad range of activities that may fit in the former categories it is not difficult to see what is the SRI's main difficulty: the universe of potential investments is very limited. The problem is not a small one since the industry –socially

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[1] Sturm points out an interesting difference between American and European SRI funds in terms of issue orientation: while in the United States the SRI funds tend to screen religious, cultural and social issues, in Europe they focus more on environmental, economic and workplace issues (Sturm 2005: 10)

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and no socially responsible- is primarily focused in getting the highest rate of return, which implies that any other considerations come in second place. It is precisely for this that specialists and disappointed investors have criticized the SRI industry because, in their view, it has betrayed their values (Hawken 2004). Although this debate is still in place, the future of the SRI industry will critically depend on the conclusions that both investors and mutual funds agree on. Calvert Funds, which is the focus of this paper, illustrates the pressures that the SRI industry faces to remain competitive without sacrificing ethical principles.

II. CSR Problem: Calvert's Conflictive Priorities

D. Wayne Silby and John G. Guffey Jr founded Calvert in 1976 with the objective of providing an innovative mutual fund that combined short-term fixed-rate securities with attractive yields. In 1982, the company introduced the Calvert Social Investment Fund, a group of screened investments that quickly grew to include not only money market but also fixed income and equity portfolios. This new group of holdings commenced as an option for investors who wanted to put out their money from companies that supported the Apartheid regime in South Africa. The list of issues included in the screenings evolved among the years and today includes seven areas: Governance and Ethics, Workplace, Environment, Product Safety and Impact, International Operations and Human Rights, Indigenous Peoples' Rights, and Community Relations. The Calvert family of funds consists of several different classifications of mutual funds. For each Fund, there is a Board of Trustees/Directors that supervises a Fund's activities and reviews its contracts with companies that provide it with services.

Calvert's mission, according to its 2007 brochure, is

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> "Offering a range of investment products and services, [that] enable individual and institutional investors to reach their financial goals in ways that are consistent with their beliefs and values. In our investment process, Calvert seeks successful companies that are good corporate citizens today and well positioned to remain responsible corporate leaders tomorrow"

In sum, Calvert seems to be similar to other "socially responsible" funds: in addition to provide competitive rates of return, the company screens potential investments against extra-financial criteria in order to satisfy its clients' ethical values. However, here is where the CSR problem resides. In an industry that makes a living from profits, meeting the investor' social and environmental concerns may limit the funds' financial performance and lead the company to a dilemma: should it defend the client's values even if that means dropping returns? What should Calvert's priorities be?. In other words, the SRI industry's goals are not always compatible and therefore there is a potential to violate the CSR principles that the company purportedly defends.

Consequently, the CSR problem is: how can investors ensure that their money is not used to finance companies or countries that violate the social and environmental criteria set by Calvert? Indeed, Calvert's clients have shown dissatisfaction with the company in the past (see Figure 1). Whether this disappointment comes from the funds' financial performance or from the way Calvert allocates money in companies that do not meet the social and environmental criteria, is something that the company does not clarify in its third (and apparently last) Corporate Sustainability Report of 2005. This paper's aim is to describe how the SRI industry's conflictive goals may create different incentives for Calvert, the companies and investors to comply or to cheat the CSR principles and how that could be related to the customers' disillusionment with

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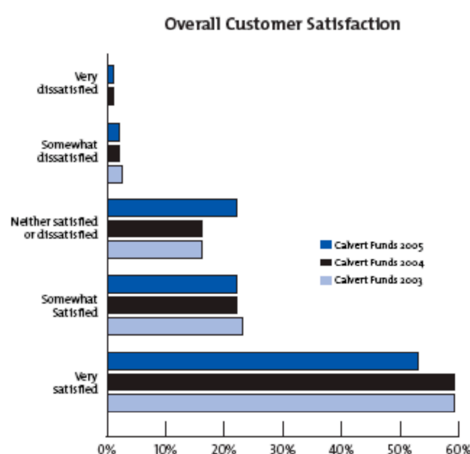
Calvert.

Figure 1. Calvert's overall customer satisfaction[2]



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To complicate this problem, Calvert's acquisition by the UNIFI Corporation in 2005 adds a major challenge for the prevalence of CSR principles. UNIFI is a larger parent company that provides life insurance, retirement plans, investments, mutual funds, banking and public finance. Its guiding principles, according to the website, are "portfolio growth, cash accumulation, tax protection, asset allocation and hedges against inflation". The lack of references to CSR principles and the fact that UNIFI holds a principal role over Calvert makes more difficult –and necessary- to define who is Calvert loyal to and what are its priorities?. When Calvert states in the website that "We, too, meet the exacting standards we've set for the companies in which we invest" one cannot stop wondering if the partnership with UNIFI is an appropriate way to meet the social and environmental concerns of its clients.

[2] Taken from Calvert Corporate Sustainability Report 2005, p. 11.

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III. The Anarchy of Standards

The analysis of Calvert's CSR problem is not complete without a reference to the standards it defends. Calvert states "a company must meet Calvert's minimum standards for each of the following seven social criteria to be eligible for investment:

- Governance and Ethics
- Workplace
- Environment
- Product Safety and Impact
- International Operations and Human Rights
- Indigenous Peoples' Rights, and
- Community Relations"

The issues of what exactly "Calvert's minimum standards" mean, why those standards and no others and what constitutes meeting the standards according to whom, pop up after reading the company's statement. Actually, this accounts as a CSR problem in itself and has received a great deal of attention from academics and analysts. This paper will not enter in that debate due to time limitations; however it is worth noting to outline its main points. In doing so, I will use the Human Rights criteria as an example of the difficulty to reach an agreement in the SRI industry.

The most important problem in the socially responsible funds industry is the lack of worldwide-accepted extra-financial criteria (and consequently what metrics to use). However, some actors actually find this vagueness convenient because they can make profits from setting their own standards. For this reason, an agreement on what constitutes a human rights' violation (or any

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other issue violation) is resisted by the mutual funds industry that keeps a major share of the market by loosening their definitions.[3]

The debate of what should be considered a human rights' violation revolves on the issues of what standards are currently applied, first; and second, what level of the production chain is going to be screened.[4] Take Calvert's definition of human rights standards, for example: "Calvert avoids investing in companies that have serious and persistent human rights problems or directly support governments that systematically deny human rights. For this purpose, Calvert measures a prospective firm against the following criteria:

- Create and implement codes of conduct that cover their entire scope of operations
- Adopt specific human rights standards for their operations and practices;
- Actively address human rights abuses; and
- Promote social and economic justice for all people"

How does Calvert define "serious and persistent" human rights problems and why a single human rights violation does not deserve the same attention for them? Should we imply from this statement that Calvert has no problem investing in companies that indirectly support oppressive

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[3] Note that the lack of standards definition is intrinsically related to our CSR problem, for it leads to the same question: how can investors make sure that that their money is not used to finance companies or countries that [according to Calvert's definition] do not violate [its] social and environmental criteria but indeed they do?

[4] The first issue involves taking the appropriate conventions and international treaties to establish what are human rights and consequently what is a violation of such rights. Some funds say these conventions are good enough but others, like Calvert, resist that option and set additional standards that reproduce anarchy in the industry. The second issue is about what exactly the funds industry is suppose to screen. Should it assess human rights compliance at the production level, at the business level (up and down the production chain) or both? This in turn is problematic because depending on what they screen some could argue that it is leaving the human rights scope and enters into the labor rights terrain which may vary from country to country and therefore, allow the industry to loosen its criteria.

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regimes? What kind of codes of conduct is Calvert thinking about?, what specific human rights standards should companies adopt in order to make Calvert happy?, what does "actively address" mean for Calvert? What is considered an "abuse" and "social and economic justice"? No answers to this questions were provided neither in the website, nor in the interviews I conducted. Some analysts discredit this debate for being "too normative, ultra-orthodox and relativist" (Kurtz 2005). However, it is the core of the CSR scandals that the mutual funds industry experienced in 2003. The CSR problem that this paper tries to describe will touch on this issue back and forth.

IV. Monitoring Process: Who Certifies, Who Verifies?

One way to identify conflicts of interest is by analyzing the process by which an agent earns its living. In the case of Calvert that implies analyzing the way it achieves the highest rate of return, which is the final product it sells. In order for that to happen, Calvert screens every company's financial performance and social records, thus the processes of certifying and verifying a company are instrumental for the funds' success.

Unlike other organizations that fight against the concentration of certification and verification processes in the same company, Calvert's success depends greatly on that same concentration of processes. Due to the industry's for-profit nature Calvert has an incentive to prefer financial returns to ethical compliance; and thus, it has an incentive to certify as many profitable companies regardless their social and environmental records. Consistent with the former

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predictions Calvert has its own in-house screening team -the Social Research Department[5]- that assesses the social and environmental records of companies previously clarified for investment by Calvert's portfolio managers.[6]

After the portfolio managers identify "financially attractive opportunities" in the NYSE, NASDAQ and AMEX stock indices, the Social Research Department screens each company against 7 criteria (Calvert refers to this process as the "Double Diligence research process"): Governance and ethics, environment, workplace, product safety and impact, community relations, international operations and human rights, and indigenous Peoples' rights[7]. Given the lack of in-site visits to the companies[8], the information for the screenings comes from open public sources, including:

- Information using the Lexis-Nexis database and specialized publications.
- Conversations with company management.
- Data from US environmental and social regulatory agencies.
- Discussions with advocacy organizations

Finally, a company qualifies for investment if the Social Research Department finds that it meets Calvert's minimum standards (again, this information is not available to the public). Conversely, "if a company fails to meet any of Calvert's basic social criteria, it is ineligible for investment"[9]. Unlike other organizations, Calvert does not issue a certificate that the company can hang on in the door, however, the certification process which basically consists in assuring the company

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[5] As of December 2007, 14 analysts comprised Calvert's Social Research Department each one holding a post-graduate degree and experience in social issues and advocacy (http://www.calvert.com/sri_4857.html)
[6] Calvert does not charge any fee to the companies it screens, thus Calvert does not face a potential conflict of interest because its income comes from premiums paid by investors and the investments it makes.
[7] Neither the website, nor the analyst I interviewed provided information on what specific metrics are used for each criteria, which highlights the lack of internationally accepted standards discussed in the previous section.
[8] Information provided by Erica Lasdon, Social Research Analyst at Calvert Group.
[9] (http://www.calvert.com/sri_815.html)

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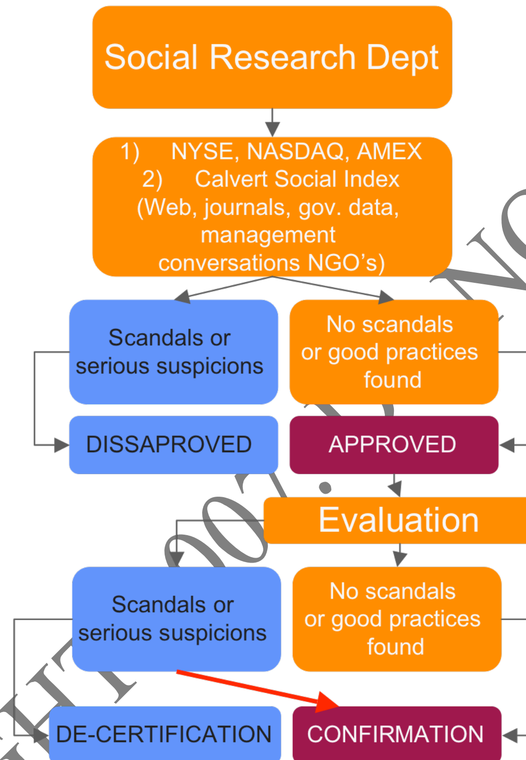
complies with the certifier' standards is a *de-facto* certificate. Figure 2 illustrates Calvert's screening process.

Figure 2. Screening Process[10]



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Calvert's policy is to conduct verifications every year to confirm the company's compliance with the social criteria. This process involves the same assessment as in the screening stage and leads to confirm or de-certify companies based on their social and environmental records. However, as Lasdon pointed out to me in the interview "[Calvert's] timetable to review companies is generally guided by our investment process, so there are many events that may retard a review of

[10] Diagram elaborated by the author with information provided by Erica Lasdon, Social Research Analyst at Calvert Group.

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a company, including a financial determination that it is a desirable investment" which means that Calvert reserves the right to delay or stop verifications. The red arrow in Figure 2 illustrates this possibility.

V. CSR Compliance

Since both certification and verification processes are conducted by Calvert under very opaque conditions, the potential for conflicts of interest is permanently present because there is no way to question the decisions of the Social Research Department. The lack of transparency during the screening process enormously shapes the incentives of the actors involved. Table 1 summarizes the incentives to comply, to cheat and to blow the whistle for Calvert, the screened companies and investors.

Table 1. Incentives, disincentives and conflicts of interest

	COMPLY	INFRACT	BLOWING THE WHISTLE
CALVERT	Keep customers' trust Reputation Keep market share	Loyalty to UNIFI Keep "desirable investments" Competitive rate of return Operations expenses No dispute resolution panels	Only when scandals are evident Pressures from investors

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Companies	Keep cash flow Avoid Corporate scandals (PR solution) Avoid boycotts Gain new contracts granted to SR co.	Cost-benefit argument No in-site evaluations No random verification No dispute resolution panels	Only "go-beyond-standards" companies because their efforts are not rewarded No dispute resolution panels
Investors	Align their ethical concerns with financial decisions		Self-research, Media scandal NGOs' pressure No dispute resolution panels

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A. Calvert

The monitoring process described earlier creates pressures for Calvert to pick profitable companies with dubious CSR records and then initiate shareholder activism to justify choice. On the one hand, Calvert has an incentive to comply (or to say it does) with the (auto-imposed) CSR principles because it seeks to maintain the customers' loyalty as well as its own reputation, and in addition to that it allows Calvert to keep a market niche untapped by the traditional mutual funds industry. On the other hand, Calvert faces strong pressures to cheat the CSR principles because it has to demonstrate to its parent owner (UNIFI) and its clients that the firm's products have competitive rates of return. This is why it is not surprising that Calvert announces ahead when the certification and verification processes will take place. Even more, Calvert has an incentive to announce ahead what the company's weaknesses are so it can correct them before

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the verification process takes place[11]. Only when CSR scandals are evident or investor pressure is unstoppable, Calvert has an incentive to blow the whistle and signal the CSR' violator.

B. Companies

Companies have incentives to comply because they can maintain the flow of investments and use the CSR-certificate to win contracts granted only to "CSR-responsible" firms. In addition, the CSR-certificate helps the company to avoid boycotts from customers and thus motivates companies to comply with CSR principles. However, the screening process also leaves a wide room to cheat because Calvert neither conducts in-site visits at the evaluation and verification stages, nor it evaluates the degree of compliance, so companies can say they do comply when in reality they don't and still be eligible for investment. Interestingly, only the companies that go beyond the minimum requirements of Calvert would have an incentive to blow the whistle because their efforts are not communicated to investors thus canceling their chances to be rewarded (Dixon 2004).

C. Investors

Since Calvert's main difference is the social and environmental screenings it provides, investors are the more interested in complying with the CSR principles because they see Calvert as the only fund that can align their ethical concerns with financial decisions. Should investors, the media, or NGOs discover CSR scandals in companies where Calvert invest, they would have an incentive to blow the whistle because the company that promised to use their money in accordance with their values ended up betraying them.

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[11] Information provided by Erica Lasdon, Social Research Analyst at Calvert Group.

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As Table 1 shows, in only one case Calvert's incentives to cheat provoke accusations from both investors and companies: the absence of dispute resolution panels. The screening process's lack of transparency gives companies and investors a great incentive to blow the whistle because they do not have a mean to question Calvert's opinions and force it to reconsider its decisions. Not all companies would oppose this though, for some would actually benefit from keeping their critics out; but should a company is no longer satisfactory for Calvert and it believes that decision is unjustified that company has no means to override that decision and therefore would have great incentives to blow the whistle.

Calvert illustrates that the screening process of the SRI industry plays a critical role in shaping the attitudes of investors, companies and the fund managers towards the CSR principles. Unless Calvert makes this process transparent and open to criticism, the company will lose (or perhaps deepens) its customers' satisfaction. The nature of the industry (for-profit) and the UNIFI ownership of Calvert, however, reduce the chances for that to happen.

VI. Why do People Buy Calvert? Sources of Shareholder Trust

Calvert remains as one of the most popular Socially Responsible Funds in the United States despite the transparency issues of its screening process. Primarily it is the result of a reputation built upon 30 years of experience and being pioneers in the introduction of social screens. Nevertheless, Calvert has two instruments from where it extracts most of its shareholders' trust: the company's de-certification rate and shareholder advocacy.

A. Refusals and de-certification ratio

According to MISTRA generally 50 to 60% of companies analyzed by Calvert are accepted for investments, which means that the remaining 40% of companies are refused by the Social

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Research Department (MISTRA 2001: 26). Unfortunately there is no benchmark to determine if this figure is large or small, but even if it were one, its usefulness would be minimal given the lack of international standards agreeable for the SRI industry. [12] However, this number is capitalized by Calvert who uses it as a proof of the company's strictness with social screenings. In addition, Calvert publishes every year a list of companies that no longer receives investment based on CSR reasons. Sometimes the companies de-certified are big firms that, because of their weight, increase the investor's confidence in Calvert. [13]

B. Shareholder Advocacy

As for shareholder advocacy, Calvert has a consistent tradition of filling shareholder resolutions and using proxy voting at annual stockholder meetings. Shareholder resolutions are filled only when the dialogue with corporate managers is unsuccessful in persuading a company to take action. When the company is a big firm, these resolutions increase Calvert's reputation for exposing the corporation's misbehavior[14]. All resolutions and proxy voting are available on line[15], which reassures the company's compromise with CSR principles and thus, increase the confidence of investors in Calvert.

But there is one factor that may explain better the investors' fidelity to Calvert: investors, after all, expect a return from their money and they may not need assurances that 100% of Calvert's investments meet strict social and environmental criteria. Actually, they may stick to Calvert only because in their view it is better than others. This perception may be reaffirmed by reports

[12] Depending on how companies define social standards, their refusal and de-certification ratios will vary. Therefore any comparison would be meaningless, for we would be comparing apples with oranges. Sierra Club Funds, for example, excludes 80% of the S&P (Kurtz 2005) which leaves Calvert as a loose screener.

[13] In 2007, for example, Calvert stopped investing in Bank of America, 3M, Black & Decker, Home Depot, Target and 31 other companies (http://www.calvert.com/pdf/6132.pdf.)

[14] In 2006, Calvert sent shareholder resolutions to Bank of America for "policies on predatory lending" and to Home Depot for resisting "diversity data disclosure" ((http://www.calvert.com/pdf/6132.pdf.)

[15] http://www.calvert.com/sri_resolutions.html; http://www.calvert.com/sri_7558.html

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of the SRI industry that rank Calvert, Domini, Citizen, Trillium Asset Management and Innovest as "best-practice" examples in the United States, although all of them recognize that transparency problems are common in these funds.[16] At the end of the day, investors buy Calvert funds because screening processes are a difficult concept to digest and Calvert's is the "less-worse" they know. It provides "just the right" amount of compliance that permits competitive rates of return.

VII. Conclusion

"Is your money where your heart is?", this is how Paul Hawken (2004) starts his report on the Socially Responsible Investing industry (SRI) that, according to him, has failed to respond to people who want to align their investments with ethical principles. Unlike other organizations that defend the principles of social responsibility as part of their mission, the mutual funds industry does not consider that defense as its first and most important priority. This is so because the nature of the mutual funds industry is for-profit oriented and it cannot stick to social responsible principles if they hazard substantial rates of return. The reason of why the SRI industry has failed to the people is, therefore, very simple: the funds' managers do not always share the investors' priorities.

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For Hawken, however, the reason has to do more with the concept of SRI. The term "socially responsible investment" can include funds that invest in companies that overtly violate human rights or pollute the environment because they only use a "negative screen": if a company does not do something –gambling, for instance- or it says it does something even though it does not –such as environmental assessments-, it qualifies for investment (Hawken 2004: 14). Moreover, given the lack of a socially responsible rate of return, investors and the SRI industry wrongly

[16] MISTRA 2001, ELLIPSON 2005, MISTRA & SustainAbility 2004, Nelson Capital Invest

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assume that conventional rates of return are a good benchmark to measure the SR funds' performance. This allowed the SRI industry to sold the idea that SR funds outperform conventional funds and in many cases they manipulated the screening process in order to demonstrate their assertions. Taking Hawken's arguments in consideration –the broad concept of SRI and the use of conventional benchmarks to measure SRI performance- it is easy to understand the people's disappointment with SR funds.

What is, then, a Socially Responsible Fund? Hawken concludes that it is a meaningless term and will remain so "unless the industry reforms *in toto*, or the portion of the industry that wants to maintain credibility breaks off from the pretenders and create an association with universally accepted standards, enforceability and transparency"(Hawken 2004: 17). In sum, the SRI industry needs to model the behavior that it demands in other companies. For Calvert this is not a feasible possibility, for as we saw it depends greatly on providing high rates of return which in turn depends on keeping standard setting and screening processes under its total control.

Calvert's CSR problem will continue unless it:

- Outsource screening and verification processes to independent third-party certification bodies
- discloses a ranking of compliance so investors can reward or penalize companies
- implements random in-site verifications so companies would permanently work to improve their social records
- implements dispute resolution panels where everyone can challenge Calvert and its screeners' decisions

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In sum, Calvert needs to bring transparency to a vicious process where every one's incentives to cheat reinforce the other one's. Calvert's loyalty to its new owner- UNIFI- and the for-profit nature of the mutual funds industry impede this reform in the short run, but may be there is room for an outside-driven change on the hands of investors who, disappointed by Calvert's betrayal to their values, could divest their money to other funds and force Calvert to rethink what mission it promised to honour.

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VIII. Discussion Questions

1. What concrete measures can Calvert take to ensure investors that its SRI principles have not been compromised by its acquisition by UNIFI Corporation?

2. Would you invest in a firm like Calvert? Do you agree with the author's conclusion that the SRI industry has "failed" people? Why or why not?

3. Given that Calvert evaluates companies based on public information, why would investors choose to invest in one of Calvert's mutual funds when they can theoretically create a portfolio by themselves? Do you believe it is possible to be a SRI conscientious investor and still make a good return? What does the literature say about this?

4. Given the incentives of the various actors of the Social Responsible Investing industry, do you believe there it is possible for the SRI industry to evolve towards a more credible business model? Is socially-responsible investing a conflict of interest between the investor and the firm communicating "CSR"? How do you think the SRI industry will evolve? How should it evolve to improve credibility that investments meet CSR goals? What would induce the industry to change?

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