US social investors

Market lessons left unlearned

By Jon Entine in New York

It is a case of first time tragedy, second time tragedy for social investors caught up in the credit crunch. In forgetting lessons of the past, "responsible" investors were doomed to repeat their mistakes

As the American philosopher and former baseball manager Yogi Berra once remarked, "this is like déjà vu all over again".

It seems like only yesterday that stocks throughout the world were jetting higher on the wings of New Technology. In 2001 Cisco traded at a price/earnings ratio of 99 and analysts considered it a "value play". Ethical investors had a prime seat at this casino economy, placing outsized bets on technology and computer firms. Adelphia, Level 3 Communications, USA Networks and the like were all profit-losing US corporations whose gravity-defying share price rises temporarily pumped the returns of social investors. At the height of the frenzy, leading ethical funds stuffed nearly 40% of their clients' money in tech bubble stocks, far more than the sector was weighted in the S&P 500 index. Then came the pop.

"It just wasn't smart for social investors, any investor, to have 35% of their money in technology, as some so-called diversified social funds did in 2000," says Bill Apfel, director of securities research at Walden Asset Management in Boston. Walden was far more prudent than most investment advisers, even steering away from socially indexed funds that skidded the hardest.

Today, the highest risks are in the financial sector and social investors are again among the losers. Almost every major diversified US social investment firm, even many non-index firms whose weighting is not linked to the S&P, has 25% or more of their holdings in financials. Domini, for example, lists JP Morgan, Citigroup, Goldman Sachs, Wachovia, Lehman and Wells Fargo among its largest investments. It has 129% of the S&P standard in financials, but only 55% of its weighting in industrials, 59% in energy, and 66% in materials. Over the past year, financial stocks have been the worst performing sector of the S&P, dropping 5.6%, while industrials, energy, and materials have soared 20% or more.

Domini is not alone. Financials make up 27% of Calvert's Social Index Fund, which avoids Lehman and Bear Stearns but includes firms such as Ambac Financial, First American, First Horizon National, First Marblehead and SVB Financial, which have all suffered heavy losses recently. Citizen invests in the usual array of non-transparent financials, while its money market fund holds Countrywide Home Loan debt and its income fund has 23% of assets in collateralised mortgages.

Familiar unknowns

There is a common thread that links the investments in technology in the 1990s and financial stocks today: both sectors are inscrutable when it comes to evaluating the social impact of their operations. Assuming the validity of "negative screening," which is a central tenet of social investing, it would seem that social researchers had a responsibility to clients to identify whom financial institutions consort with before giving them a positive rating. Do they loan to British American Tobacco? Altria? Or worse (based on common social investing preferences), to nuclear energy or defence companies or biotech firms that manipulate genes?

Who knows? Researchers cannot break below the surface of how most financials operate. Instead, the operating philosophy appears to have been: "Who cares? Their P/Es look cheap."

As savvy investment professionals have been warning for years, it is nearly impossible for many financial corporations to assign a reliable value to their own loan holdings, considering the complexity of today's collateralised products. Risky loans at high interest rates that initially but temporarily inflated profits were buried in securities constructed by slicing and splicing loans into unrecognisable sausages that were then sold to investors.

Yet, researchers slapped "buys" on companies the loan structure of which they knew almost nothing about. Many public pension funds, eager as everyone else to dine at the free lunch buffet, but which depend on social researchers to screen their stocks, acted on bogus advice and snapped up these stocks and collateralised products. Bottom line: the inability to understand what major financial institutions actually do with their money made this a disaster waiting to happen.

Lurching from crisis to crisis

"Many large financial institutions are not very transparent about the bulk of their lending outside what is reported on home loans and small business loans," says John Lind, executive director of Caniccor, a non-profit research organisation. For his social investor clients, Lind tracks home mortgage and small loan data that the government requires institutions to publish. And the data is two years out of date at best. His academic nit-picking did prompt some clients to steer away from some of the riskiest sub-prime lenders, such as Countrywide and IndyMac. But when it comes to major corporations whose stock is held by many investors, he has only sketchy information.

"Securitisation was supposed to spread the risk around, but because the risk was so non-transparent everything fell apart at once," Lind adds. "It is frustrating. And yes, it does concern me that the social investment community does not have as much information as we would like on financials and does not have the resources to fund it."

Even when social researchers have become aware that major financial institutions are loaning to corporations, the operations of which break traditional social conventions, such as non-involvement in the tobacco industry, they have failed to act. Lehman, for example, has had Altria as a client for years and recently announced it would guide the tobacco giant in spinning off its international tobacco unit. And its loan practices have been dogged with questions for years.

"Lehman Brothers had problems around 2002 because they securitised some loans of, and provided a wholesale line to, a finance company that went bankrupt in part because of fraudulent practices," says Lind, whose analysis is available to social researchers. Yet, Lehman remains a favourite stock among social investors and is on KLD Analytics' approved list and the Domini Social Index.

As another philosopher, George Santayana, has written, history has a way of taking revenge on the heedless. According to Morningstar data, over the past 15 years social funds have been dramatically underweighted in the safest and most transparent sectors: industrials, energy and materials. Not only are they the backbone of the world economy, they are among the world's fastest growing sectors, as sleepy giants like China and India awaken. In the past five years, major social investor indices in the US, such as Domini (based on KLD research), that leaned heavily on financial stocks have dramatically trailed their benchmarks, erasing their competitive performance in the years before.

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Is taking unknown risks socially responsible? Why were social researchers so enamoured with financial companies while shunning materials, energy and infrastructure investments that offered steady if unspectacular growth havens – and had an established history of public disclosure?

"[Social researchers] have misjudged some sectors in the past," says Ken Scott, portfolio director at Walden. "We have an obligation from a social perspective as well as a financial perspective to identify risk in financial corporations. But this information is often many layers back. In 2000, we needed disaster before people wised up. Let's hope this doesn't turn into another disaster."

The short-term fate of social funds that have ridden the roller coaster of the boom and possible bust in the financial sector is cloudy at best. We have now had four major financial crises in 20 years – the savings and loans debacle in the late 1980s, the Long-Term Capital Management hedge fund implosion of 1997, the technology market collapse and the financial scandals of the turn of the century, and the current liquidity squeeze.

After the most recent debacle, social investment professionals acknowledged and addressed the shortcomings of many screens that paid only cursory attention to corporate governance and financial transparency. The current crisis suggests they have not gone far enough. The growing complexity of the world financial system makes it increasingly prone to crises that are beyond the ability of traditional screening mechanisms to foresee. ■

It needn't be just a wheel of fortune

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