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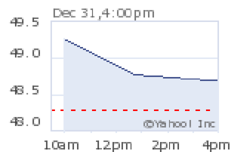

By Lorne Abramson , On Thursday December 31, 2009, 12:43 pm EST

Over the past decade, socially responsible investing (SRI) has emerged from a relatively niche corner of the investment landscape into the mainstream. According to the Social Investment Forum, SRI has been expanding at a much faster pace than the broader universe of all investment assets under professional management; as of 2007, almost one out of every nine dollars under professional management in the U.S. incorporated social and/or environmental screens.[1]

Indeed, the term “SRI” itself has become somewhat passe, surpassed by the acronym “ESG,” standing for environment, sustainability and governance screens. The change reflects the broader adoption of these principles by the mainstream institutional investment community.

Fortunately for those adhering to index/passive asset class investment strategies, there is a growing roster of cost- and tax-efficient ESG vehicles, although some notable gaps still remain within the asset allocation palette. Investors should recognize that ESG screens result in somewhat higher fund expenses than nonscreen alternatives. That said, with the advent of new index and passive asset class alternatives, it is getting easier to build well-diversified ESG portfolios at reasonable costs.

This article examines the current, broad-based secular ESG funds available to investors. There are other, narrower ESG-related index vehicles, focusing on specific niches such as clean energy—as well as other funds incorporating religious-based screens.

The focus of this survey is ultimately from the standpoint of ESG as an “overlay” component, building upon the fundamental investment principles of global asset class diversification, frictional cost minimization and tax efficiency. In other words, it assumes ESG is not a separate asset class, but a means of investing in existing, traditional asset classes.

One of the main takeaways is that there is no “one size fits all” solution. Investors—and their advisers—need to closely examine the alternatives, and understand the various screening parameters and any resulting sector biases (and consequent potential risks), as well as the usual considerations such as expenses.

Original ESG Index Funds

First, let’s take a look at two of the original ESG index funds, launched by two ESG-focused fund companies:

Domini

The Domini Social Equity Fund (DSEFX), established in 1991, originally tracked the first and perhaps most well -known ESG index in the U.S., the Domini 400 Social Index—a float-adjusted, market-cap-weighted index with screens based on a comprehensive range of social and environmental criteria. However, on Nov. 30, 2006, the fund transitioned to an active strategy, with Wellington Management Company, LLP serving as the subadviser.

Concurrent with this change, the fund increased its expense ratio from 0.95 percent to the current gross expense ratio of 1.31 percent.

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There remain two alternatives for those who desire to invest in the original index (which, it bears mentioning, has been re-branded as the FTSE KLD 400 Social Index, due to a new partnership between FTSE Group and KLD Research & Analytics, a leading SRI research firm and the creator of the original Domini 400):

- **Green Century Equity Fund (NASDAQ:GCEQX - News):** This open-end, no-load mutual fund carries an annual expense ratio of 0.95 percent, the same as the original DSEFX prior to its conversion to an active fund. Since its inception in 1995, the mandate of GCEQX has been to track the FTSE KLD 400 Social Index.
- **iShares FTSE KLD Social 400 (NYSEArca:DSI - News):** This exchange-traded fund launched around the same time DSEFX transitioned to active strategy. It sports an even lower 0.50 percent annual expense ratio.

It is interesting to note that since DSEFX turned active three years ago, it has slightly lagged the above two passive alternatives. Although over a still relatively short measurement period, the actively managed DSEFX has posted a three-year annualized return of -5.58 percent, vs. -4.87 percent for DSI and -5.26 percent for GCEQX as of Nov. 30, 2009.[2]

In addition to DSI, iShares has another ETF (NYSEArca:KLD - News) that tracks a derivation of the FTSE KLD 400 Social Index, called the FTSE KLD Select Social Index.

Unlike its original counterpart, the newer Select Social index is designed to exhibit risk and return characteristics similar to those of the unscreened FTSE US 500 Index. As such, and along with some of the other funds reviewed shortly, it has relatively more sector-“neutral” (and thus more balanced) industry weightings.

The flip side of this, of course, is that the fund may be less palatable to investors with particularly stringent screening criteria. Indeed, as a result of its more sector-neutral composition, KLD has a higher weighting in energy and industrial materials stocks than DSI.

KLD holds a narrower portfolio composed of 262 companies. Like DSI, KLD carries a 0.50 percent expense ratio.

While DSI and KLD have lower expense ratios than GCEQX, investors should still be mindful of other costs specific to ETFs. These include brokerage commission costs and bid/ask spreads. Indeed, bid/ask spreads are particularly relevant in the case of these two ETFs, as they trade with relatively light volume.

A somewhat related concern is their ultimate staying power, given each has attained only a relatively modest amount of total net assets thus far (DSI with $96 million, and KLD, $126 million as of early December 2009). It remains to be seen whether this concern will become even more poignant given the recent acquisition of the iShares franchise by BlackRock.

As it stands, these two iShares are the only ETFs in the U.S. that track relatively broad, secular SRI indexes. There are other ETFs that track narrower segments, such as clean energy. A more recent development has been the introduction of several religious-based index ETFs from FaithShares, based on custom indexes created by FTSE KLD, as well as Javelin Investment Management’s ETF (NYSEArca:JVS - News), which tracks the Dow Jones Islamic Market International Titans 100.

Calvert

Calvert is another established ESG-focused fund company with its own open-end index fund mutual fund, tracking the Calvert Social Index (NASDAQ:CSXAX - News). The fund was launched in 2000 and is currently subadvised by World Asset Management. The Calvert Social Index measures the performance of those companies that meet social investment criteria selected from the universe of approximately the 1,000 largest U.S. companies, based on total market capitalization, included in the Dow Jones Total Stock Market Index.

Like the aforementioned FTSE KLD indexes, it incorporates a broad array of ESG screens. As of Oct. 31, there were over 650 underlying company holdings. This load-fund has among the highest fees and expenses among those surveyed; the A share class levies a gross annual expense ratio of 1.10 percent, with a maximum front load of 4.75 percent. As with all ESG vehicles, investors should also be mindful of the fund’s screens impact on sector biases; as of Nov. 30, CSXAX had nearly a third of its assets in the information technology sector.

Newer Entrants

In addition to the original mainstays, there are some newer alternatives offered by traditional asset managers particularly known for low-cost index/passive asset class investing, beyond the two iShares ETFs mentioned above.

First, Vanguard offers its FTSE Social Index open-end mutual fund (NASDAQ:VFTSX - News). The fund tracks the FTSE4Good US Select Index (prior to Dec. 16, 2005, it tracked the Calvert Social Index). FTSE4Good is a separate and distinct index series from the aforementioned FTSE KLD collaboration. With this particular index,

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FTSE selects from approximately 700 of the largest public companies in the United States by evaluating each company's performance using a variety of ESG criteria; as of Nov. 30, the fund had 297 holdings. In true Vanguard fashion, one of the fund's most appealing attributes is its 0.31 percent annual expense ratio, the lowest among its peers.

Investors should note, however, that the FTSE4Good US Select index screens have resulted in highly concentrated industry sector exposure; in this case, financials—representing nearly 30 percent of the total fund as of Sept. 30. While this financial sector exposure is heterogeneous (i.e., not just limited to banks), it was responsible in part for a considerable -42.39 percent loss in 2008. That said, VFTSX has made up some lost ground by posting strong relative performance year-to-date (+31.5 percent as of Nov. 30).

Another option from a well-established, traditional asset manager is TIAA-CREF's Social Choice Equity Fund (NASDAQ:TICRX - News). Although not as inexpensive as VFTSX, TICRX, also a no-load fund, but now incorporating a 12B-1 distribution fee, carries a relatively competitive annual expense ratio of 0.56 percent. While the fund invests in companies included in the FTSE KLD Broad Market Social Index, a subset of the 3,000 largest publicly traded U.S. companies that meet or exceed various screening criteria, it does not track the index per se.

Rather, its objective is to "seek a favorable long-term total return that reflects the investment performance of the overall U.S. stock market while giving special consideration to certain social criteria." As such, its "optimization" approach is similar to the iShares KLD—it seeks to exhibit the risk and return characteristics of a traditional, unscreened benchmark; in this case, the Russell 3000. The caveat with this approach, again, is that it may involve less stringent ESG screens.

By benchmarking against a broader market index, TICRX provides more exposure to mid- and small-capitalization stocks than the other alternatives discussed thus far. As of Sept. 30, TICRX had 908 holdings. Another potential appeal is TIAA-CREF's strong corporate commitment to socially responsible investing, in general. This may be a reflection of its nonprofit heritage and client base. Indeed, the CREF Social Choice Account, a balanced SRI variable annuity within its massive 403(b) retirement plan platform, is proclaimed by TIAA-CREF to be "the largest globally screened investment vehicle for individual investors in the U.S."[3] with $6.9 billion in assets as of Dec. 31, 2008.

Finally, another relatively recent entrant into the passive ESG space is Dimensional Fund Advisors (DFA), a large, institutional asset manager dedicated to efficient market principles. DFA does not track commercial indexes, but rather, seeks to target and capture three specific compensating equity risk factors (or "dimensions"):the overall equity market, as well the premia historically offered by small company and value stocks.

Like their nonscreened US Core Equity 1 Portfolio fund, US Sustainability Core 1 (NASDAQ:DFSIX - News) provides total domestic market exposure, with small-cap and value-oriented "tilts" resulting in a lower weighted average market cap and lower market price-to-book value than the overall market. As the fund's name and screening criteria suggest, the focus of DFSIX has a more narrow scope than the other funds discussed above, taking only into account environmental impact considerations.

DFA incorporates an overlay based on ratings provided by a third-party vendor, Sustainable Holdings, LLC. Stocks are scored from best to worst within each industry sector on a quarterly basis; Dimensional then incorporates these rankings into the fund in a manner that conforms to its investment principles. Again, it is important to examine the underlying constituents to ensure compatibility with the investor's own ESG criteria, as some may be intrigued by the fund's largest holding as of Sept 30:Chevron Corporation.

Among those funds surveyed in this article, DFSIX is the most diversified, with over 2,400 holdings as of Sept 30. Its gross expense ratio is 0.61 percent.

DFA does have another domestic screened fund, Social Core Equity 2 (NASDAQ:DFUEX - News). However, this is not a secular ESG fund; per the Statement of Additional Information (SAI), over 62 percent of the shares were owned by a religious-based health care organization as of January 2009, which the screens and resulting sector biases reflect (presumably, this organization seeded the fund). DFUEX is modeled after DFA's nonscreened US Core Equity 2 Portfolio, which has an even higher concentration of small and value-oriented stocks than the Core Equity 1/Sustainability Core 1 strategies. Finally, it bears mentioning that DFA does not offer its funds directly to the general public, but through a select group of fee-only advisers (which, in the interest of full disclosure, includes my firm, ELM Advisors).

International:The Next ESG Index Frontier?

While index/passive offerings are still sparse, some alternatives have recently availed themselves of the international SRI index arena. To date, DFA has launched two international screened funds:Emerging Markets Social Core (NASDAQ:DFESX - News) and International Sustainability Core 1 (NASDAQ:DFSPX - News).

As with the aforementioned domestic Social Core Equity 2, Emerging Markets Social Core is more of a religious-based than secular ESG fund (which is, again, consistent with the principal holders, as detailed in the SAI). International Sustainability Core 1 seeks to purchase a broad and diverse group of stocks of non-U.S. companies in developed (not emerging) markets, and like its domestic counterpart, only incorporates environmental impact considerations. Similarly, it tilts toward value and small company stocks. The fund's gross annual expense ratio is 1.00 percent.

Currently, the only other screened, international index-based alternative is Northern Trust's Global Sustainability Index Fund (NASDAQ:NSRIX - News), launched in March 2008. The fund's strategy is to track the FTSE KLD Global Sustainability Index, a "diversified, sector neutral global benchmark constructed using environment, social and governance (ESG) factors." Thus, its screens are broader-based than DFA's International Sustainable Core 1. For those seeking pure SRI international index exposure, however, investors should bear in mind that this fund includes the U.S., representing just over 40 percent of the portfolio as of Sept 30. Furthermore, the fund's gross annual ratio is 1.23 percent.

More international alternatives may be on the horizon. Pax World Management Corporation, another longtime ESG-focused fund company, has licensed several FTSE KLD indexes for the basis of launching ETFs, including the KLD Europe Asia Pacific Sustainability Index. Their registrations are still awaiting approval by the SEC. The KLD Europe Asia Pacific Index includes companies screened by ESG factors and is weighted sector neutral relative to the S&P/Citigroup BMI Europe Pacific Asia Composite Index. According to Pax World's SEC filing, the fund's projected expense ratio is 0.55 percent.

Conclusion

While it is encouraging to see more funds emerging, there are still noticeable asset class gaps. For instance, there are presently no index and/or passive asset class alternatives that focus exclusively on mid- or small-capitalization stocks. Nor is there an international option with broad, secular ESG screens that also excludes the U.S.

Fortunately, with growth and innovation continuing in both the ESG and indexing arenas, there appears to be a decent probability of more alternatives eventually coming to market. FTSE KLD has an expansive suite of sustainability indexes available for licensing across the market capitalization spectrum, in addition to the separate FTSE4Good Series licensed by Vanguard and the FTSE Environmental Market Index series. And, although there are no licensees yet in the U.S. for the basis of an index fund or ETF, the Dow Jones Sustainability Index family (a collaboration of Dow Jones, STOXX Limited and SAM launched in 1999), now has more than 70 total licensees globally, representing over $8 billion of aggregate assets based on the DJSI.

If current trends continue, the gaps should hopefully be filled over time, making it even easier to incorporate one's values into a broadly diversified, cost- and tax-efficient asset allocation plan.

Endnotes

1. Social Investment Forum:2007 Report on Socially Responsible Investing Trends in the United States.
2. Data sources:Morningstar and iShares
3. TIAA-CREF, Socially Responsible Investing at TIAA-CREF:2009 Update.

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