

## **Ethical Investments**

- Towards a Sound Theory and Screening  
Methodology

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<b>Title and subtitle of the report</b> Ethical Investments - Towards a Sound Theory and Screening Methodology	
<b>Summary</b> This study aims to test and develop methods for environmental and social screening of companies in order to support informed investment decisions. Among others the report deals with the following questions: <ul style="list-style-type: none"><li>- What are the characteristics of current ethical screening methods?</li><li>- What steps and criteria should be included in an ethical screening?</li><li>- What are advantages/disadvantages of intuitive methods versus analytic methods?</li><li>- How should gathered information be evaluated?</li><li>- Does social screening differ from environmental screening?</li></ul> <p>The available literature on ethical screening and decision making has been evaluated. Also, the current screening practices in Sweden and elsewhere were mapped and analysed. Subsequently a flowchart for ethical screening was developed and the method was tested in three case studies.</p> <p>The overall conclusion of the study is that it is both common and motivated that different objectives are used for ethical screening. These different objectives lead to different preferences regarding methods for screening. But to conduct a more elaborate screening, competence concerning companies' ethical practices and the capital market is essential.</p> <p>We acknowledge that intuitive and informal steps always will be present in a screening process. But, to ensure comparability, we believe it is crucial that the overall approach is analytic, formalised, and transparent</p>	
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## **Foreword**

This study was carried out from 1999 to 2001 by Markus Åhman, Lars Zetterberg and Marcus Carlsson Reich at IVL Swedish Environmental Research Institute, and by Olof Zaring and Rolf Wolff at Chalmers University of Technology. Skandia Insurance Ltd and the Swedish Environmental Protection Agency jointly financed the study. Skandia has also generously provided access to different types of data.

The report was written at Scancor, Stanford University, California, and we gratefully acknowledge Scancor's hospitality.

## Abstract

This study aims to test and develop methods for environmental and social screening of companies in order to support informed investment decisions. In the report we deal with the following basic questions:

- Is ethical screening possible?
- What are the characteristics of current ethical screening methods?
- What steps and criteria should be included in an ethical screening?
- What are advantages/disadvantages of intuitive methods versus analytic methods?
- How should gathered information be evaluated?
- Is it possible to rank companies?
- What kind of data should be collected?
- How can these data be evaluated?
- Does social screening differ from environmental screening?

The available literature on ethical screening and decision making has been evaluated. Also, the current screening practices in Sweden and elsewhere were mapped and analysed. Subsequently a basic theoretical flowchart for ethical screening was developed, with the following steps:

1. Defining the Screening Objectives
2. Defining Screening Criteria
3. Collecting of Data
4. Evaluation of Companies.

This method was tested in three case studies, in which the screening was made for a hypothetical investment universe.

The overall conclusion of the study is that it is both common and motivated that different objectives are used for ethical screening. These different objectives lead to different preferences regarding methods for screening. But to conduct a more elaborate screening, competence concerning companies' ethical practices and the capital market is essential.

We acknowledge that intuitive and informal steps always will be present in a screening process. But, to ensure comparability, we believe it is crucial that the overall approach is analytic, formalised, and transparent.

## 1 Introduction

During the last few years, an increased interest in ethical fund saving has been observed.\* Today, approximately one and a half percent of the private fund saving in Sweden is placed in ethical funds, but the growth-rate is strong. In USA some 10-20% of the total fund saving is in some form environmentally and/or ethically screened (SIF, 1999). Thus, the Swedish market for ethical screening will most likely increase in importance.

Ethical investment is often seen as an important step towards a sustainable society, and it is sometimes even argued that ethical investment increases profit on savings in the long run. However, one issue that can easily create a crisis of confidence in ethical investments is the screening process (the assessment of what companies to include in ethical investments). The screening processes used today often lack in transparency, are difficult to communicate or are incomplete or even lack connections to the environmental and ethical impact of the assessed corporations (cf. Stone, 2001).

### 1.1 Objective of the Study

This study aims to test and develop methods for environmental and social screening of companies in order to support investment decisions.

In the report, the following basic questions are dealt with:

- **Is it possible to perform ethical screenings?**
- **What are the characteristics of current ethical screenings?**
- **What should be included in an ethical screening?**
- **What methods are preferred: intuitive or analytic methods?**
- **How should the information be evaluated?**
- **Is it possible to rank companies?**
- **What data should be collected?**
- **How can these data be evaluated?**
- **In what ways does social screening differ from environmental screening?**
- **How does one handle the acquired data?**

### 1.2 Delimitation

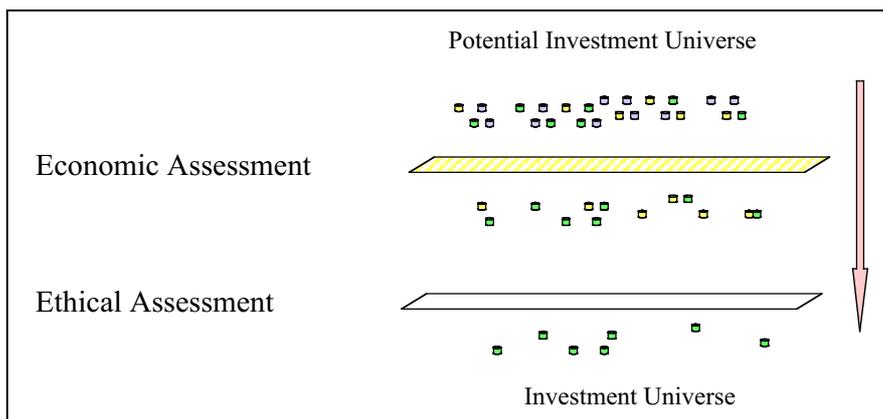
This study concerns what is commonly called Ethical Investments (EI). We are almost exclusively dealing with portfolio selection and methods for the assessment of companies for investment purposes. However, we recognise that this is not universally accepted as a comprehensive definition of EI. Other activities, most notably Shareholder Advocacy and Community Investments are by some investment managers considered just as relevant in the EI concept as portfolio screening. Those activities are not treated in this study, not because we dispute that

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\* In this report we use the term "ethical fund", which covers as a common nominator all fund products that are ethically, environmentally and or socially screened.

they may indeed have a place within the definition of EI, but because they simply fall outside the scope of this study.

In this study, we assume that ethical screening is separated from the financial screening (see figure 1.1 below). It is not evident that this is the best way of including ethical issues in the screening of a company, but it is the approach most commonly used by financial institutions. The financial screening was therefore not included in this work.



### 1.3 The Project's Research Process

First, the literature on ethical screening and decision making has been studied. Also, the current international practices were described and analysed. In the next step, a basic theoretical flowchart for ethical screening was developed. This flowchart was tested, including several sub-methods for the different steps in the screening process. Three case studies were conducted, where the screening process was performed on a hypothetical investment universe.

### 1.4 Structure of the Report

As a result of our research, the screening process has been structured into a flowchart of four universal steps. All steps of the screening process were studied, and for each step, different methods and approaches were tested and analysed. As the characteristics of the problems encountered in the screening steps differ, each step is covered within a separate chapter in the report.

As the case studies are important for the results of the study, they have been described in the text where appropriate. The report is structured as follows:

#### Chapter 2

Background material on how ethical screening is conducted today, to what extent, and by who is presented. Four major and interesting actors and their methods are mapped and analysed. Financial return from ethical funds is also discussed.

#### Chapter 3

In a theoretical description, important concepts and theoretical standpoints are defined. The problems of ethical knowledge and decision making are discussed, and the structure of the proposed screening process flowchart is defined and motivated.

#### **Chapter 4**

The first step of the screening process, the establishment of the screening objective, is treated. The main distinction is between whether the objective of the ethical screening is to save the world or to maximise profit.

#### **Chapter 5**

The operationalisation of the screening objective development, i.e. the establishment of issues of relevance and development of screening criteria, is the second step of the screening and is treated in this chapter.

#### **Chapter 6**

The third step of the screening flowchart, the issue of data gathering, is dealt with, through the description of the first case study: data collection.

#### **Chapter 7**

In a second case study, a simplified evaluation method was tested.

#### **Chapter 8**

The subject of evaluation is developed in full. Several approaches are analysed, and a preferred line of assessment is suggested.

#### **Chapter 9**

In this chapter uncertainties in the screening process are discussed.

#### **Chapter 10**

In a discussion chapter, the central issue of the decision making process in ethical screening is treated.

#### **Chapter 11**

The conclusions are presented as answers to the questions posed in the scope of the study in this chapter.

### **1.5 Our Research Context**

The research presented here is part of a larger research context in which environmental and corporate social responsibility plays a central role. Several studies and projects have influenced us in writing this particular report.

In 1999 the research team completed an international study of some 110 environmental funds. We were interested in understanding a.) how environmental funds are composed, b.) what criteria portfolio managers used and c.) whether and why these funds were financially successful or not. This study showed that so-called “environmental funds” were differently structured than ordinary funds. Criteria for selection of investments were basically and foremost based on “environmental” aspects. Financial performance was very often a neglected demand and financial performance of environmental fund products very often was poor. Especially technology oriented funds were volatile due to the fact that the companies that were included very often acted in “political” markets, that is they were dependent on

subsidies and when these subsidies were withdrawn from the markets, company performance was poor.

In 1996 we initiated and were involved in a project within the oil industry, including five global companies (Amoco, BP, Conoco, Shell and Statoil). This study attempted to understand environmental impacts and social responsibilities of these companies and what management processes that are needed to implement sustainable operations and products. We developed a methodology that dealt with these issues along the value chain and came up with a system for capturing, assessing and comparing CSR in the oil industry (Wolff/Zaring, 2000).

From 1996 through 2001, we have developed methods that allow banks to assess environmental risks. These assessments are used as a part of a larger credit risk assessment.

In 1997, we developed a method to assess the economical burden carried by a company due to environmental issues. The method was tested in a case study involving two Swedish companies.

In 1998 we started a study on defining and developing environmental performance indicators for Swedish industries, across business sectors. One main finding of that study was that it is possible to find a common ground for environmental indicators across and within business sectors.

Finally, a study on how and if environmental information can influence investors has been conducted the last years. One finding of that study is that the structure of the financial market in itself has an influence on whether and how environmental information is used in the investment decision process (Zaring, 2001, forthcoming).

In conclusion, we claim that an understanding of the overall context is crucial for the ethical screening of companies. Understanding companies' ethical practices is a basis for financial evaluation. The structure of the financial market in itself has an influence on the dissemination of environmental information. Depending on the screening process, little or much knowledge is required with regard to how a financial actor evaluates a company. Relatively little in depth knowledge is required when it comes to the negative exclusion of a company; much more substantial knowledge and information is required when it comes to selection of "best-in-class" companies. It is in this context that we believe we can make a unique contribution. In our research during the last eight years we have covered areas that are relevant for the understanding of the context in which screenings are conducted.



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