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Socially Responsible Investing: A Comparative Analysis for the Bluegrass Community Foundation

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April 2011

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Executive Summary

In the fall of 2010 the Blue Grass Community Foundation began considering whether an updated investment strategy that included Socially Responsible Investing would be advantageous and in line with the mission of the organization. The question was raised whether this type of investing meant that the return on investment from securities currently held in the Foundation's portfolio had to be sacrificed in order to incorporate this type of investment philosophy into the existing criteria used to invest the organization's assets.

This paper examines literature relevant to the topic and conducts an analysis of a sample of mutual funds currently available in the market, some of which are socially responsible funds and some of which are not. The literature on the topic, while not conclusive, would seem to indicate that social investing has been expanding in recent years, growing even faster than the larger investment universe as a whole. It also seems to be less likely that investor will be forced to give up significant returns in order to satisfy socially responsible motivations. This data analysis, while limited, appears to be in line with this assessment.

Socially Responsible Investing

Socially responsible investing (SRI) goes by several names. It will often be referred to as ethical investing, sustainable investing, mission related investing, or environmental-social-governance (ESG) investing. Regardless of what it is called, it is the practice of filtering one's investments in such a manner as to either include or exclude certain potential investments on the basis of views of the ethical nature of the types of activities and practices of the corporation or organization being vetted. Steve Schueth (2003) believes it is defined most succinctly as "the process of integrating personal values and societal concerns into investment decision making."

One of the key difficulties of defining SRI by a single standard is that it is not defined by the same criteria by different investors. Its history can be traced back hundreds of years. In the mid 1700s John Wesley, founder of Methodism, noted that the use of money was the second most important subject of the New Testament (Schueth 2003). Indeed religious investors often avoid investments that support war, slavery, or any of what Schueth calls "sin stocks"—those that involve alcohol, tobacco, and gambling. By contrast, the ethical issues that an organization like the Sierra Club might take into account when considering investments that do not countermand their mission of environmental protection and advocacy. The Sierra Club might not take any issue with a corporation or organization that profits from the sale or production of alcohol or tobacco, or that provides gaming services to the public. They might, however, take serious issue with large energy companies that allegedly destroy wildlife habitat or pollute the environment in the course of conducting their business. From this example it is easy to see why there is no one definition of SRI that can be applied to all situations.

The filters that investors apply to a potential investment are referred to as screens. SRI screens can fall into many categories. They often include environmental screens for things like clean technology and pollution, social issues like human rights, diversity, and community development, corporate governance, and product screens such as weapons or alcohol (Social Investment Forum website citation needed). Investors can choose restricted investment where they avoid certain companies due to practices they engage in, or positive investment where they seek out companies that are engaging in activities in line with the investors own beliefs and ideas.

For any investor these concerns can bring financial consequences. There are many companies in the world whose practices would not conform to the ethical beliefs of a given investor, but whose profit margins and return on investment would otherwise make them a good addition to a portfolio. The balance between financial and social concerns is referred to as the double bottom line (Denison and Chellman, 2001).

Regardless of the whether SRI is capable of producing similar returns to non-SRI or not, the amount of investments selected through SRI screens has been growing faster than the broader universe of managed assets according to the Social Investment Forum's *2010 Report on Socially Responsible Investing Trends in the United States*. According to that report, as of 2010, investment assets under professional management in the U.S. that follow SRI strategies stood at \$3.07 trillion, a gain of 380 percent since 1995, the first year the trends report was published¹. Over that same period the broader investment universe increased only 260 percent, to \$25.2 trillion. The report also notes that during the recent recession from 2007 to 2010 the broader universe of investment remained flat, while SRI investment continued to grow from \$2.71 trillion to \$3.07 trillion.

¹ This total includes all investment types, not just open-end mutual funds used in this paper's analysis.

Organizational Overview

The Blue Grass Community Foundation (BGCF) is a 501c(3) non-profit organization based in Lexington, Kentucky. It is one of over 700 community foundations in the United States. The Foundation's current President and CEO is Lisa Adkins. The mission of the Foundation is²:

“... to improve the quality of life in the Blue Grass region by increasing charitable giving, connecting donors to community needs they care about and leading on critical community issues.”

Community foundations are public charities created by groups of citizens within a specific region for the purpose of bettering the local community. The Ford Foundation, the Knight Foundation, and the Bill and Melinda Gates Foundation are examples of private, charitable foundations founded by wealthy individuals for the purpose of granting money to various causes nationally, or even globally. Community foundations give many small donors an opportunity to pool their donations and have those funds managed by experienced, foundation employees, all the while knowing that the proceeds will stay in the region. The BGCF uses the proceeds from their endowment pool to offer grants and other community services to the Blue Grass region.

Community foundations can range in size from a few million dollars to well over a billion dollars in assets. The BGCF currently has approximately \$42 million in assets under management according to Anne Ehl, its Chief Financial Officer. Most of that pool is managed by the Fund Evaluation Group, LLC (FEG), of Cincinnati, Ohio, a firm of investment advisors with expertise investing for non-profit organizations. During the course of my research I have been aided at several points by Tim O'Donnell, a Senior Vice President at the FEG Indianapolis office.

² Referenced from 2008 IRS 990-form

According to Ms. Ehl the Foundation's board has not set any formal policies in place regarding the types of investments in which the Foundation's assets must be held from an SRI standpoint. There are guidelines for items such as minimum return on investment and types of asset class diversification, but these do not speak to any ethical guidelines regarding the investments.

Questions

The genesis of this project stems from a meeting with the Ms. Adkins and Ms. Ehl in the fall of 2010. At this meeting several potential avenues of research were discussed. The question posed to them was: Is there a topic you have wanted researched, but had neither the time nor staffing to do so.

Of the topics discussed, socially responsible investing was chief among them. As stated previously, the Foundation has until now had no official philosophy regarding SRI. As a new option for their donors they had been considering it, but the executives wanted more information. Was there a negative impact on returns associated with SRI? Were there inherent benefits to potential donors by SRI options being available? The interest in the topic was spurred by the recent interest of FEG in offering SRI options to their clients, including the BGCF.

The two executives proposed that I do a review of SRI and offer them an evaluation of my findings. This paper will attempt to offer the BGCF relevant analysis of the topic of SRI, specifically regarding the question of whether the Foundation's return on investment would be compromised if a portion of the investment pool was moved into socially responsible securities. The question of inherent value to donors will not be a focus of this paper. I will however address it to some degree in the *Further Research* section.

Methodology

The methodology used in this paper centers primarily on a review of relevant literature and other sources pertaining to SRI. These sources provided an understanding of the fundamental history and current state of SRI, geared toward making a recommendation to the BGCF. They were chosen for their value in providing background information of potential issues faced when considering investing in a socially responsible manner, and different strategies used by investors once a decision has been made. The sources include websites, journal articles, and books.

A data analysis was also conducted using an existing list of SRI mutual funds maintained by the Social Investment Forum, a US membership organization for those who engage in socially responsible investing, and a randomly selected list of similar types of mutual funds that are considered not to be socially responsible. This list was chosen using the premium mutual fund screener available at the website of Morningstar, Inc., and a random number generator from the website www.random.org. A data set with a total of 296 observations (147 SRI and 149 non-SRI) was compiled and a t-test was performed to test whether there was a significant difference in the means of the two sets based on their one, three, and five year annual returns.

Literature Review

The primary question this paper attempts to answer is whether the BGCF should consider a strategy of socially responsible investing. In answering this question we must examine the reasons behind socially responsible investing, and whether those reasons might induce the Foundation to create a new investment policy, or at the least amend their existing one.

Three basic objectives should be considered in an investment policy: liquidity, security, and yield (Denison and Chellman, 2001). Liquidity is the ease with which the investment can be

converted back to cash. Security is a measure of how much risk is involved with a particular investment. Yield is the return on investment that can be expected. For mission driven organizations it might be just as important to incorporate social or ethical parameters as an additional objective. Taking this into account with the Blue Grass Community foundation as an example, a screen might be applied to some stocks or funds that would seek positive investment in organizations or businesses that have heavy influences in the area of community development. Considering that one of the primary missions of community foundations is to foster community development and keep local money flowing to those in the local community, this might seem a logical fit. So on top of their current policies governing liquidity, risk versus reward, and return on investment, they might add a social screen for community development as their fourth criterion.

Schueth (2003) believes that community development is not just a criterion for choosing investments, but along with screening and shareholder advocacy is a strategy in itself. He defines shareholder advocacy as when investors actually try to use their money to have an influence on corporate behavior. Social investors can work cooperatively to steer management on a course that will not only improve financial performance, but make things better for employees, customers, communities, and the environment (Schueth, 2003).

Regardless of their motivation or strategy, social investors seem to have similar goals. They want their investments to align with a certain set of values and ideas that play a role in the rest of their decisions. Schwartz (2003) indicates several factors since the 1980s that may have contributed to the recent growth in SRI. These factors include such things as growing concerns over environmental issues, labor issues, and repressive regimes, the growth of the corporate responsibility movement, greater media exposure and advertising about SRI, and perhaps most

importantly, the growing evidence that SRI investments can produce similar returns to those that are not SRI.

Schwartz goes on to discuss a fundamental issue surrounding ethical or socially responsible investing that many SRI investors struggle with: Are my allegedly ethical investments really ethical? It is a question not easily answered, in part due to practical, financial concerns, and in part because of the interconnected nature of businesses in a global economy. In his 2003 piece *The "Ethics" of Ethical Investing* he explores several questions regarding the application of SRI standards in the investment world. The first that was of particular interest was whether screens were being applied in an ethical manner. The first concept he discusses involves indirect infringement. This is when a company may not directly infringe on an SRI screen, but may do so indirectly. For example, a paper company may supply paper to a tobacco company, or an aluminum company may supply cans to a beer company (Schwartz, 2003). This goes to the heart of how companies in the modern world are so interconnected and dependant on each other. Can any one company, or investment, truly be called an ethical one when that company has to depend on so many others in order to function?

Also discussed are percentage limits that some mutual funds put in place, defining how much they will allow certain investments to profit from outside the screen. For example a fund might place a screen for green energy over their investments, but allow an energy company in that fund to earn a certain percentage, say 10 percent, of their income from non-green sources. It's like saying if someone behaves in a morally acceptable manner most of the time, but not so 10 percent of the time, it's ok because the good far outweighs that bad (Schwartz, 2003). Is that morally and ethically acceptable? The question is one that anyone considering this type of investing must give serious thought to.

The question of what motivates a company or companies to act in an ethical manner is also up for debate. Is it really because they share the values an investor is looking for, or is it due to some external source such as government regulation or other legal action. A socially responsible investor would likely want the substance of what a company or set of companies is doing regarding their SRI screen to be internally motivated. Goodpaster (2003) addresses this somewhat when he talks about an inside versus outside viewpoint. According to him the perspective of the social investor is inevitably third-person. They are reliant in most circumstances on information that is empirically available to all outsiders. Companies care about this view for superficial reasons, but often it is not enough to truly direct behavior. Goodpaster goes on to cite the philosopher Thomas Nagel in contrasting this to what he refers to as the inside, or first-person viewpoint.

This would be the perspective of someone on the inside of the organization in a leadership position. This person would look at social benchmarks in a very different way. And this perspective, using information that is not available to the public, will have more weight in the decision making process of the organization (Goodpaster, 2003). It can be difficult to know sometimes why a company behaves the way it does. The question an investor would have to ask themselves is: Do I care why, or do I just care that they act in a way I believe is right regardless of internal motivations.

An organization like the Blue Grass Community Foundation which is contemplating a program of socially responsible investing will not likely be thinking about the factors discussed so far when making their decision about SRI. The initial barrier to entering this market is the question of how yield will be affected. Godeke and Bauer (2008) describe this as a threshold issue. Once SRI, or MRI as they refer to it, becomes a serious consideration, trustees may turn

their attention to the fiduciary and tax implications. The caretakers of any foundation have a fiduciary responsibility to the organization, and thus owe fundamental duties of care, loyalty, and good faith to the organization. They are required to act as a prudent person would in similar circumstances. This duty requires they perform due diligence concerning any new types of investment strategies to insure against preventable losses. Among this and other duties, the trustees of any foundation must take into account the particular tax rules that govern SRI. Specifically, they must observe the “jeopardy investment rules.” These rules provide that a foundation may only invest in a manner that does not imperil its ability to carry on its exempt purposes (Godeke and Bauer, 2008).

To be clear, Godeke and Bauer are referring in some part to the grant-making capabilities that foundations have. From that perspective the BGCF can already be called a social investor. It is after all their mission to make grants to local groups in order to foster community development. But these principles and the threshold issue, as it is called above, can be applied to their interest earning investments as well. They must still think about their fiduciary responsibility when moving to new investment strategies that may affect their organizations ability to effectively carry out its mission.

In some sense this is where the strategy of shareholder advocacy comes into play. It is also an area where the granting power of foundations intermingles with their own asset investment strategies. Cooch et al. in the 2007 report on mission investing for the Packard Foundation discuss how foundations can use below market-rate investments, sometimes called program-related investments (PRI), as a way of fulfilling their mission in addition to making grants, and in a way that is allowed by the IRS outside the jeopardy rule. For instance, a foundation may elect to offer a loan to a small non-profit as a way of supporting that non-profits

mission, and helping the non-profit build a positive credit history in the eyes of banks and other lenders. The foundation will likely get a small return on this investment, but it reflects positively on the mission they have set out to achieve. This is just one example of what the PRI might look like. It can also take the form of things like venture capital and real estate investment. This is another avenue of investing that is considered socially responsible, to an extent, that the BGCF might consider entering, or expanding.

We are still left with our initial question regarding returns on investment in the trading market, specifically with regard to mutual funds. The following section will address findings of a data analysis that was performed for this paper. The only previous research identified that addressed the topic directly was by Kempf and Osthoff in 2007. Although they were looking at individual stocks, they were asking the same question regarding return on investment and whether SRI affected portfolio performance. Their findings were based on data examined between 1992 and 2004 on stocks that were included in the S&P 500 and the DS 400. The results of their analysis indicated that highly-rated³ SRI funds performed abnormally well, therefore causing them to conclude that SRI information can be a valuable asset to investors⁴.

³ Ratings in this study were based on KLD (KLD Research & Analytics, Inc) rating system for socially responsible investments.

⁴ Authors used the Carhart model (2007) for their analysis.

Data Analysis

A series of 147 SRI mutual funds monitored by the Social Investment Forum was used with a random sample of 149 non-SRI mutual funds to perform a difference of means test of the one, three, and five year investment returns of the funds in question.

To obtain the random sample of non-SRI mutual funds the Premium Mutual Fund Screener on the website of Morningstar, Inc. was utilized. An effort was made to choose funds of the same general type as the funds listed in the SRI group obtained from the Social Investment Forum. For example, there were 10 funds listed in the SRI series categorized as *Balanced*. The Morningstar website allowed for screening mutual funds in the category of *Balanced*. Once the screen was set and all funds listed on the Morningstar site meeting the screen criteria were returned, there were 87 pages of funds listed as *Balanced* with 25 line items on each page.

Utilizing the random number generating website www.random.org a series of 10 random page numbers was selected between one and 87. Since the random number generator resets after each selection, it was possible that a page number could be repeated. Following this the generator was set between one and 25 in order to select the 10 line items from the random pages. This procedure was repeated with all fund types listed, adjusting for the number of funds needed in each category. Those categories after balanced were: bond funds, equity large-cap funds, equity small/mid-cap funds, equity specialty funds, and international/global funds. In addition to the criteria above the screen was also set to show only funds that received at least one star on the zero to five star, Morningstar rating system.

One-Year Returns

Table 1 contains the results of the two-sample t-test with equal variances performed on the one-year returns.

Table 1: One-Year Returns

Two-sample T-test with Equal Variances						
Group	Num. of Funds	Mean	Std. Error	Std. Dev.	95% Conf. Interval	
Non-SRI Funds	149	13.9298	0.7028871	8.57983	12.54081	15.31879
SRI Funds	147	19.24721	0.7806904	9.465368	17.7043	20.79012
					t=-5.0652	
					Deg. of	
					Freedom=294	
Ha: Diff<0	Ha: Diff =0	Ha: Diff>0				
Pr=0.0000	Pr=-0.0000	Pr=1.0000				

The SRI funds in this case are considered the program funds. Indicated in this first table is a mean of 13.9 for non-SRI funds and 19.2 for SRI funds. This would seem to indicate a difference of approximately five percentage points in favor of SRI funds for the last year. The extremely small P-value for the single-tail test in the center of the chart would seem support that conclusion that the difference is statistically significant.

Three-Year Returns

Table 2 contains the results of the two-sample t-test with equal variances performed on the three-year returns.

Table 2: Three-Year Returns

Two-sample T-test with Equal Variances						
Group	Num. of Funds	Mean	Std. Error	Std. Dev.	95% Conf. Interval	
Non-SRI Funds	149	2.264765	0.3107135	30792741	1.650757	2.878773
SRI Funds	121	1.87405	0.5324537	5.85699	0.8198284	2.928271
					t=0.6614	
					Deg. of	
					Freedom=268	
Ha: Diff<0	Ha: Diff =0	Ha: Diff>0				
Pr=0.7455	Pr=-0.5089	Pr=0.2545				

This table shows much smaller means for the three year period as opposed to the one-year returns. This is not surprising given the current recession began roughly three and half years ago, and in the last year the market has recovered significantly. This test also shows the non-SRI funds having a larger average return than SRI funds, the inverse from the one-year returns. However, given the large P-values on all three hypothesis tests, we are unable to reject the null hypothesis in this case that SRI has no effect on returns. This test, as opposed to the one-year return test, would seem to show that there is no statistical difference in the means between the two samples, therefore indicating that being an SRI fund does not make a difference.

Five-Year Returns

Table 3 contains the results of the two-sample t-test with equal variances performed on the five-year returns.

Table 3: Five-Year Returns

Two-sample T-test with Equal Variances						
Group	Num. of Funds	Mean	Std. Error	Std. Dev.	95% Conf. Interval	
Non-SRI Funds	132	2.814091	0.2518583	2.893631	2.315855	3.312327
SRI Funds	86	2.759302	0.311245	2.886367	2.140464	3.378141
					t=0.1368	
					Deg. of	
					Freedom=216	
Ha: Diff<0	Ha: Diff =0	Ha: Diff>0				
Pr=0.5543	Pr=-0.8913	Pr=0.4457				

As in Table 2, this table indicates smaller returns over the last five years opposed to the last year. The means in this case are much closer together with non-SRI funds having a slight advantage. As with the three-year returns, the P-values indicated from the table do not allow us to reject the null hypothesis that SRI has no effect. This would again seem to indicate that being an SRI fund should not have a statistically significant difference in the returns gained as opposed to non-SRI funds.

Potential Data Issues

There are some potential issues with the given data that could have an influence on the results and therefore must be addressed. First, only the non-SRI half of the sample was chosen randomly. As stated in the section on methodology, the original SRI data set came from the website of the Social Investment Forum. The SRI funds in the data set are those offered by the

Forum's institutional member firms. Criteria for why the member firms chose these particular funds were not available. Regardless of the criteria we can be certain that the choices were not random.

Also to be taken into account is the time frame of the two data sets. There is a slight mismatch in the time periods for the observations. The SRI fund information is current as of 28 February, 2011. The non-SRI data was drawn and is current during the latter part of March, 2011. Although this should have little effect on the three-year and five-year data, the one-year data could be significantly impacted. The three weeks in question from the end of February through the end of March 2011 saw the global investment markets take some dramatic swings due the disaster in Japan, the crisis in Libya, and the spike in crude oil prices. Given that the SRI data was drawn before the market reflected these incidents, the returns for SRI could be abnormally high. This would seem to be the case given the positive difference in means in favor of SRI funds indicated in Table 1.

Further Research

The potential for further research in this area is vast. If the time and resources were available to conduct a large scale, random sample of all the existing mutual funds traded globally, differentiating between SRI and non-SRI, a much more detailed statistical analysis could be conducted. If additional information such as fund size, fund inception date, associated fees, expense ratios, and other data could be collected with information on returns, a full regression analysis might be possible to establish whether certain variables within the investment world make one SRI fund more likely to be successful over another.

Another consideration that must be weighed is the type of securities observed in this paper. The focus here was strictly on a sampling of traditional, open-end mutual funds that met the criteria necessary for the analysis. Further research could be conducted on one or more of the other investment grade securities available to firms and individuals such as exchange-traded funds (ETFs), individual stocks, real estate, closed-end funds (CEFs), and others. When the breadth and complexity of investment markets is taken into account, one realizes the full measure of SRI cannot be known without considering all these factors, and not just one part. Although traditional mutual funds are one of the more commonly understood investment vehicles, the others take up a considerable share of the country's, and the world's investible assets.

Another question that had been initially posed to this researcher by the BGCF was that of inherent value to potential donors. Basically, was there a value in offering socially responsible options outside of just a monetary return on investment? Does having an option such as this available in itself make it more likely that a prospective donor would take the final step of signing assets over to the Foundation? These are very difficult questions to answer. Empirical data on what motivated a person to donate money to one cause and not another is not readily available. In a future project a survey could be designed that would allow researchers to gather information from a vast array of investment firms, foundations, and donors themselves. This type of information could potentially help us identify what the key factors are that make an individual donor put their money into various foundations or investment firms, and whether any social or ethical concerns played a role. It is important to note that this inherent value, if it exists, would lie with donor. From the Foundation's perspective it is still a monetary issue. This inherent value felt by a donor could drive capital resources into the Foundation's coffers.

Recommendation

It seems clear that socially responsible investing as a model for investing organizational assets is growing. This factor alone warrants any organization with a presence in the investment market to examine their current investment strategy, be they a foundation, a non-profit, a for-profit business, or a private investment firm. Based on the review of literature on the topic, and on the limited analysis of data performed for this paper I would conclude that the Blue Grass Community Foundation is correct in wanting to offer this option to their donors and potential donors. However, it is not as simple as switching their entire portfolio over to SRI investments.

The process starts in the BGCF board room. The executive staff of the Foundation would challenge the board members to actively evaluate the current policies in place regarding investment philosophy, and decide in what direction future avenues of investment should go. With close to \$42 million in assets currently under management it would not be feasible, nor would it be prudent, for this entire portfolio to be moved into investments outside the current parameters being followed. If the board of the foundation decides that an investment strategy involving socially responsible screens is in the best interests of the organization going forward, it would need to define what that strategy would look like. With such a large number of investors coming from a diverse population the wishes of those who do not feel the need to invest in so called ethical manners must still be considered.

I would suggest designating a portion of the Foundation's portfolio, in consultation with investment advisors, which could be designated for socially responsible ends. A timetable could then be devised to incrementally move existing assets out of their current investment positions and into new socially responsible instruments.

It will be up to the board of the Blue Grass Community Foundation to decide whether they feel the mission of their organization going forward would benefit from being more socially responsible, not only in their ability to bestow money to the community at large, but also in how investment gains that help in funding community activities are achieved.

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