

Socially Responsible Investment Policies and Their Application with Fixed Income Portfolios

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Survey

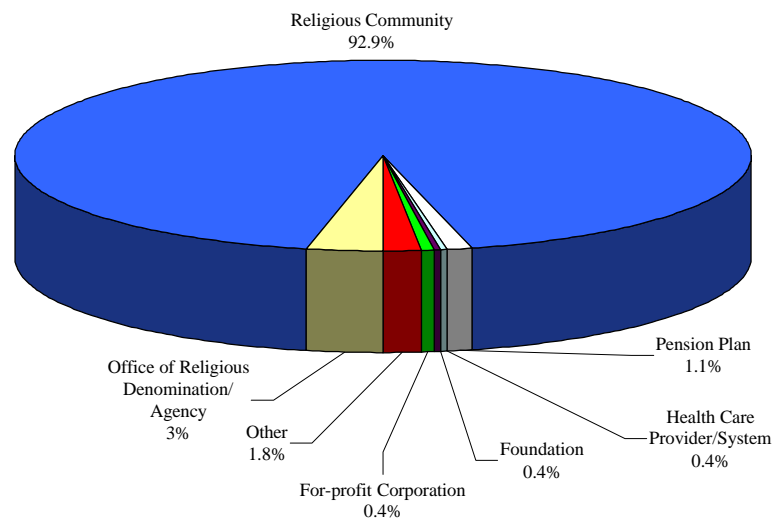
A questionnaire was developed to gauge the use of socially responsible investment (SRI) policies; specifically their application to fixed income portfolios. The survey was to gather the following information:

- characteristics of respondents' profiles
- respondents' allocation to fixed income investments
- common characteristics of portfolio composition
- SRI preferences
- application and adequacy of current SRI policies for fixed income investments

It was expected that an analysis of the survey results would identify patterns between respondent characteristics, portfolio composition and SRI preferences.

The survey was sent to 567 members of NATRI (National Association of Treasurers of Religious Institutes). NATRI serves Roman Catholic institutions and communities of religious. The survey was also sent to approximately 22 non-Catholic members of the ICCR (Interfaith Center on Corporate Responsibility). This was done to avoid duplication with the NATRI distribution.

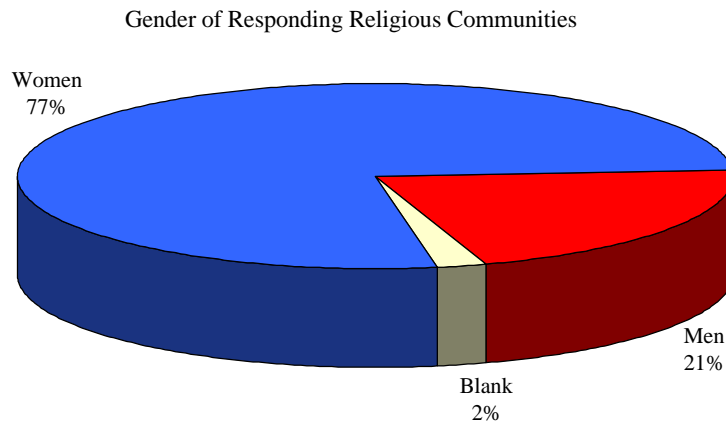
Type of Responding Organizations



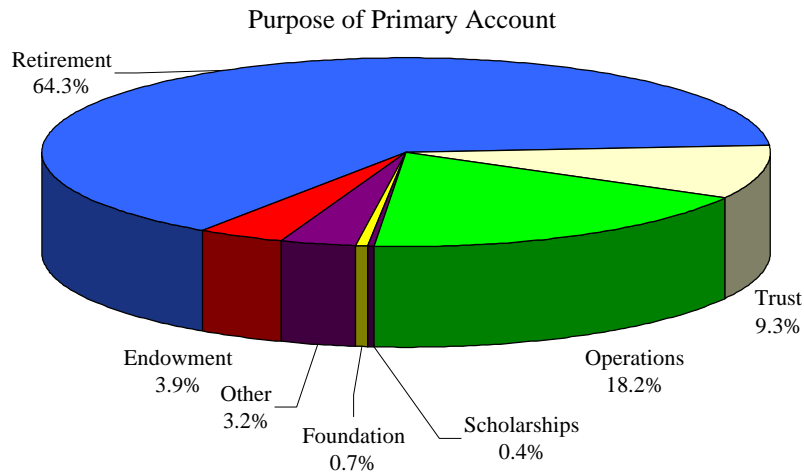
Respondents and Their Characteristics

The identities of the respondents are not known. The questionnaires were received by NATRI or the ICCR and then forwarded to the researchers. A total of 280 completed questionnaires were returned. Of those, 2 came via the ICCR. The total response rate was 48%. Of the responses received, nearly 93% were from religious communities.

The gender of the communities represented were 77% women and 21% men. This is approximately the same as the proportion of women to men as represented in the NATRI membership.

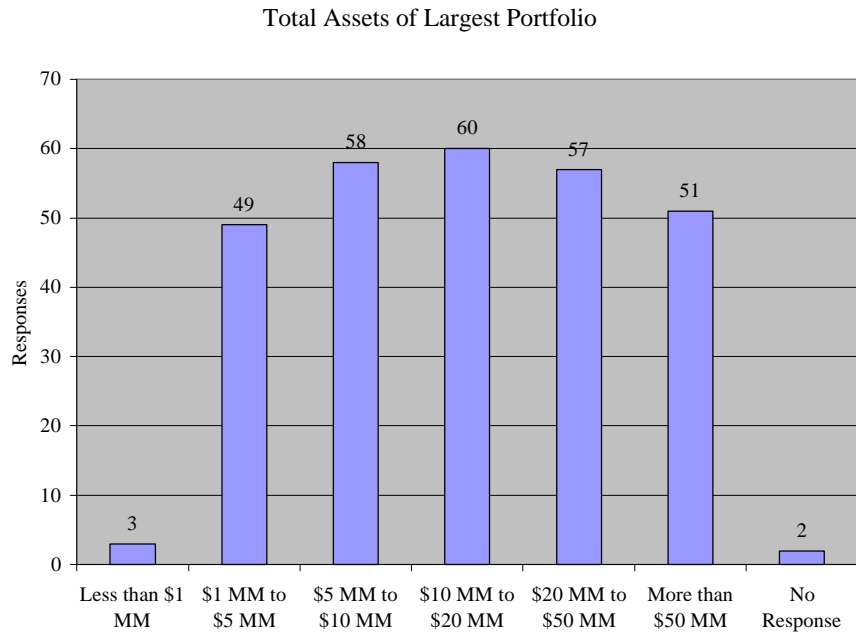


The primary purpose of the largest or “flagship” investment fund was to support community members’ retirement and long-term care.

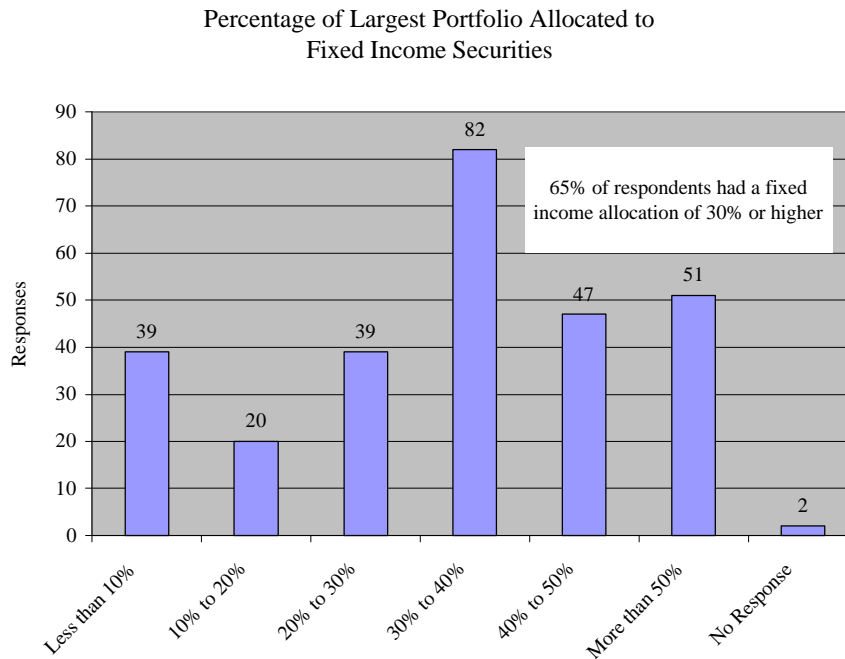


Portfolio Composition

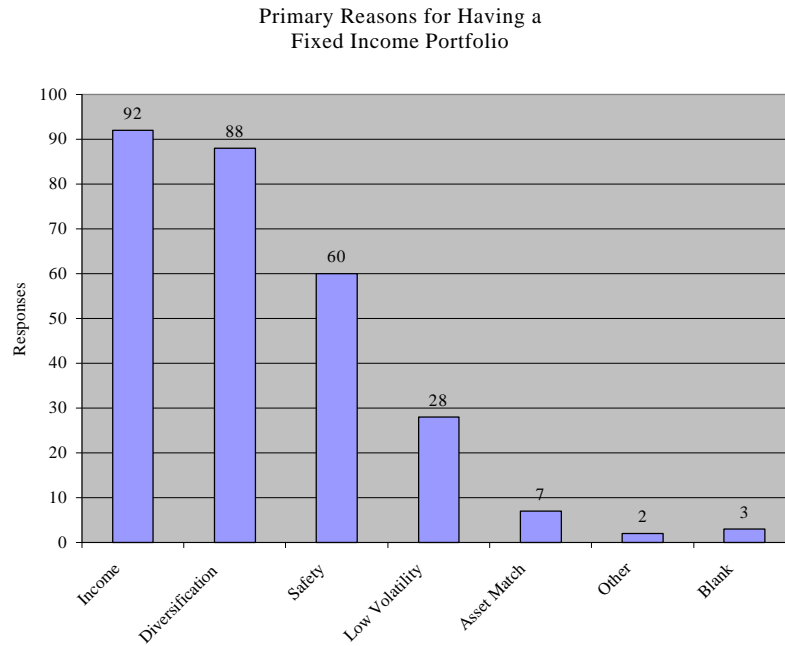
Asset Size -- The total market value of the largest of “flagship” portfolio (including cash bonds and stocks) is broken down as follows:



Fixed Income Asset Allocation -- Of the total assets, fixed income securities (cash, CD's, commercial paper, notes and bonds) make up a significant proportion of the “flagship” portfolio.



Respondents were asked to rank their top reasons for having a fixed income portfolio. No surprises here as the answers were consistent with standard practices. One interesting aspect is that the demand for safety was lower than income or diversification. It may indicate that the respondents are willing to accept some, but modest degree of risk in their fixed income portfolios.

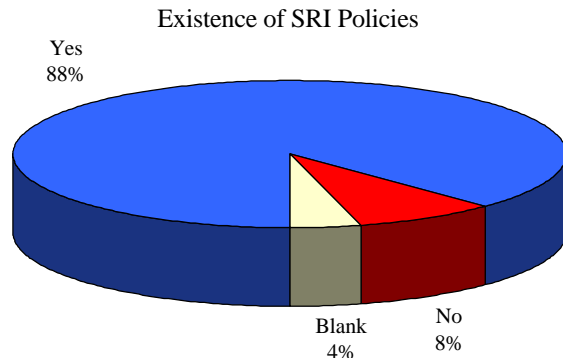


In spite of the demand for income, the respondents generally were not willing to accept low credit quality. Respondents' average credit quality was generally high with 227 institutions reporting credit quality of "AAA" or "AA" – the highest two credit rating categories. Only five respondents reporting using high-yield, below investment-grade bonds. Of those that did, the average allocation within the fixed income portfolio was 7.2%.

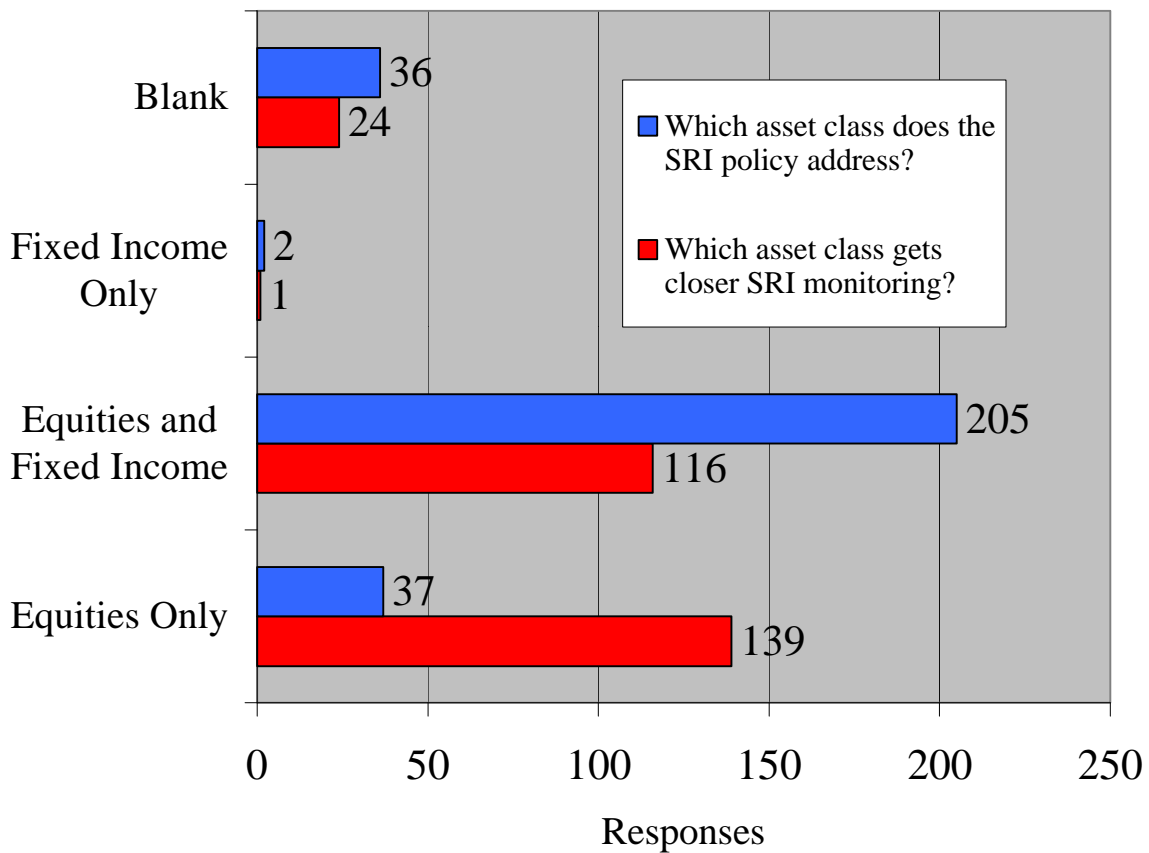


Existing SRI Policies

The vast majority of respondents – 245 out of 280, indicated that there were SRI policies in place. However, the implementation of these policies may be considered uneven. Many respondents report the SRI policies cover only the equity portfolio or that the equity portfolio gets the closer SRI monitoring.



Application of SRI Policy and Monitoring Practices



Screening

In developing SRI policies, investors typically employ *avoidance screens* (language that prohibits investment in certain industries and companies) or *positive screens* (language that promotes investment in certain industries and companies).

The survey asked respondents to indicate which type of screening process was utilized and to check from a menu of issue topics. Eighty-two percent of the respondents who have a SRI policy use an avoidance screen while fifty percent use a positive screen.

Certain topics such as “defense/weapons production” scored highly in that it was the most commonly selected issue. The respondents were relatively uniform in their selection of the top three or four issues, but then the issue support became more fragmented.

Rank	Avoidance Screen	Percentage of Responses	Rank	Positive Screen	Percentage of Responses
1	defense/weapons production	91.0	1	positive to labor	84.9
2	tobacco	71.7	2	environmentally friendly	84.9
3	abortion	71.2	3	affirmative action in hiring	56.9
4	production of birth control products	54.9	4	affordable housing	43.1
5	exploitation of labor	52.4	5	affirmative action in promotions	32.8

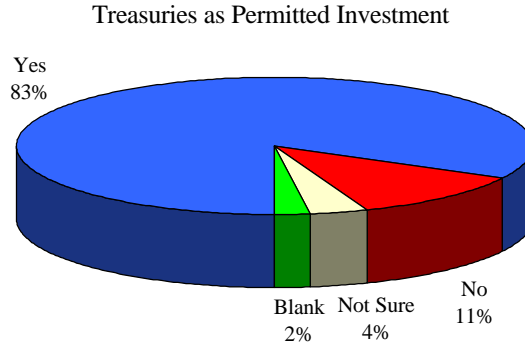
In addition to having an SRI policy that covers traditional marketable securities, 55% of the responding institutions employ an “alternative investment program” that invests directly in community development, micro lending and housing development. Seventy-seven percent of those that do have alternative investments devote less than 3% of assets to these programs.

Application of SRI for Fixed Income Assets

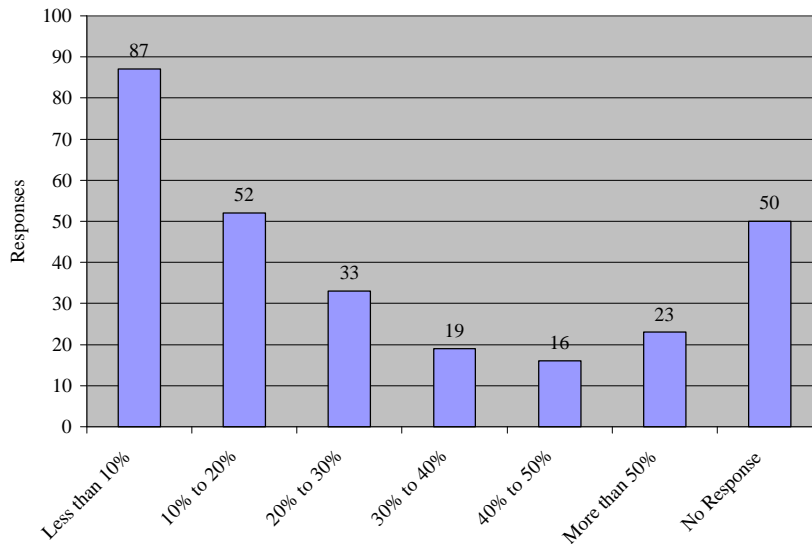
In this section, we will examine commonly used sectors within the fixed income market and how SRI policies address, or fail to address the nuances of the particular segment.

U.S. Treasuries

Generally, U.S Treasury securities (T-bills, Notes and Bonds) are a permitted holding in respondents' fixed income portfolios. U.S. Treasuries have the highest credit quality and excellent liquidity. However, a significant portion of the budget of the U.S. Government is used for weapons development, weapons procurement and other defense-related issues. Even though this was the number one response for avoidance screens in SRI policies, institutions may not have addressed this potential conflict.



Percentage of Fixed Income Portfolio Allocated to Treasury Securities



When asked if this were indeed a conflict, the 235 responses were as follows:

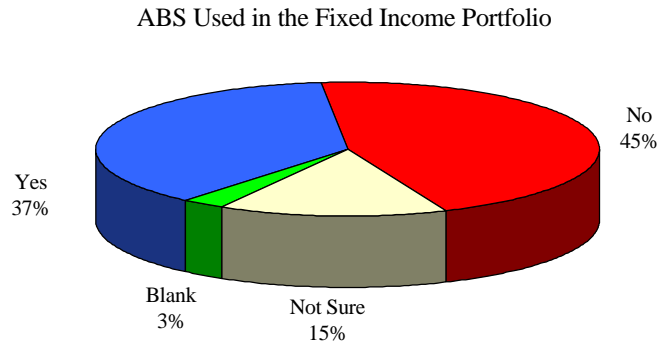
Answer	Percentage
Yes	22
No	41
Not Sure	36

Of those that affirmed that there was a conflict, 42% said that they have not focused on the issue or that it is not a priority. Another 36% indicated that government spending on

social programs offsets the defense-related activities and 12% answered that the need for liquidity and safety outweighs the SRI objective.

Asset-Backed Securities / Credit Card Issues

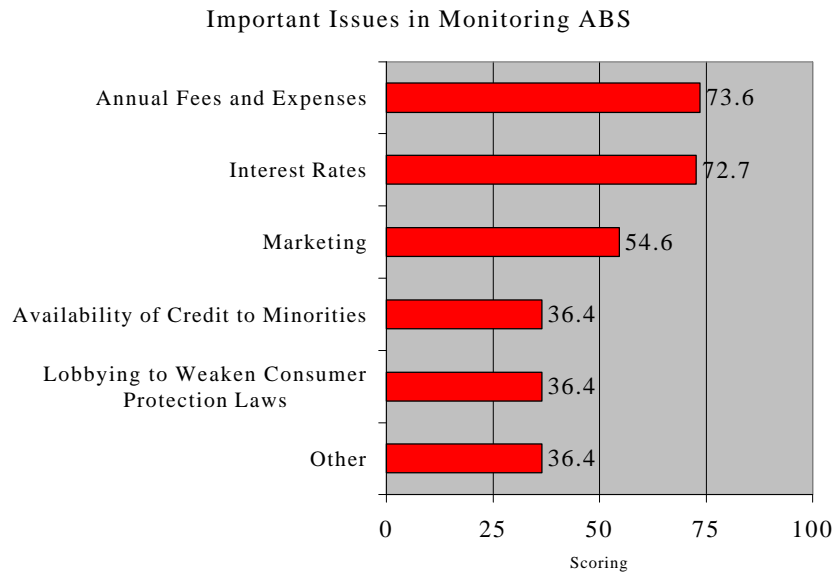
Asset-backed securities (ABS) are bonds usually backed by the payments on consumer debt such as auto loans, boat loans, home equity loans, debt consolidation loans and credit cards. The business practices of these consumer lenders are varied and some may draw criticism as more American households file for bankruptcy and debt relief.



The use of ABS by participants in their bond portfolios is not as widespread when compared to Treasuries. What stands out is the number of participants who may not know if they own this security type. In addition, there is little monitoring of the business practices by ABS issuers. Of those institutions that indicated they owned ABS in the portfolios, only 15% indicated that business practices are monitored.

A historical concern for institutions with SRI policies was the practice of some banks and loan companies in “redlining” – the failure to extend credit to poor persons and/or minorities. However, a developing concern is not the availability of credit, but predatory lending practices. ACORN (Association of Community Organizations for Reform Now) is a grass roots organization that charges that a number of ABS issuers engage in predatory lending practices to sub-prime borrowers.

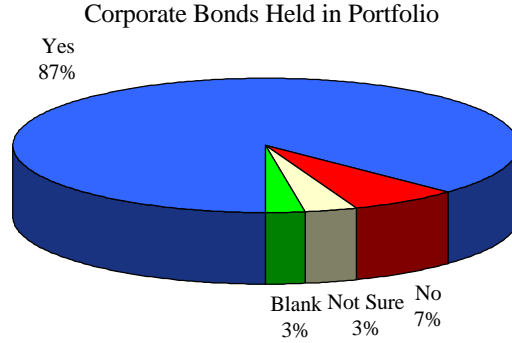
Respondents who did monitor business practices of ABS issuers were asked to indicate the top three areas for review. The scoring is shown below:



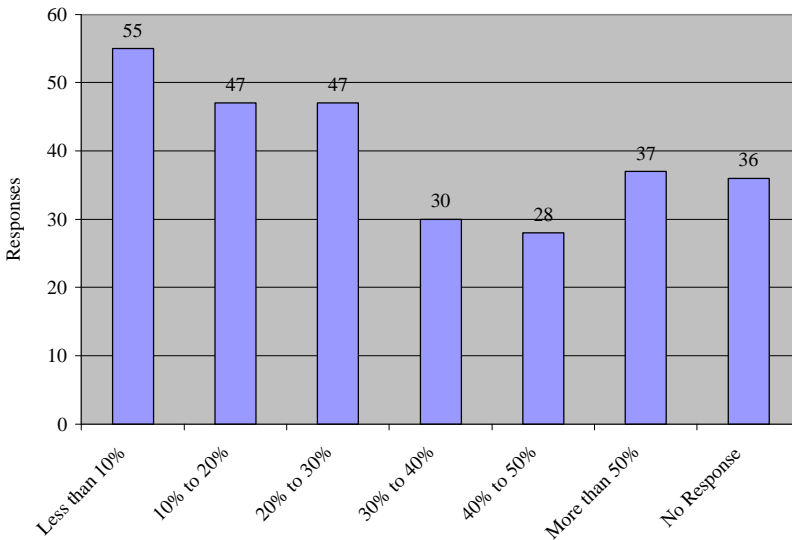
Corporate Bonds

Corporate Bonds (commercial paper, notes and bonds) are the debt instruments of U.S. and foreign corporations. The industries and companies that issue corporate bonds are varied and diverse. Bond investors do not have the same rights and privileges of company ownership that owners of stock have. Bond investors have no rights or input on matters of corporate governance or corporate responsibility issues.

Respondents reported owning corporate bonds – more than any other fixed income sector. Respondent’s also have significant concentrations of corporate bonds.



Percentage of Fixed Income Portfolio Allocated to Corporate Bonds

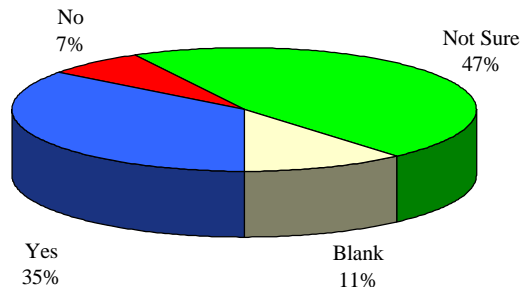


Sixty-seven percent of respondents report that the SRI guidelines and restrictions that are applied to the equity portfolio are applied to the corporate bonds as well.

Thirteen percent of the respondents report that the same equity SRI restrictions are not applied to corporate bonds and another 20% were not sure or left the question unanswered.

A question in the survey asked, “Would your organization prefer to own securities issued by not-for-profit organizations if credit quality and yield were similar to that of corporate bonds”? The responses are shown to the right.

Prefer Bonds of Not-for-Profit Organizations

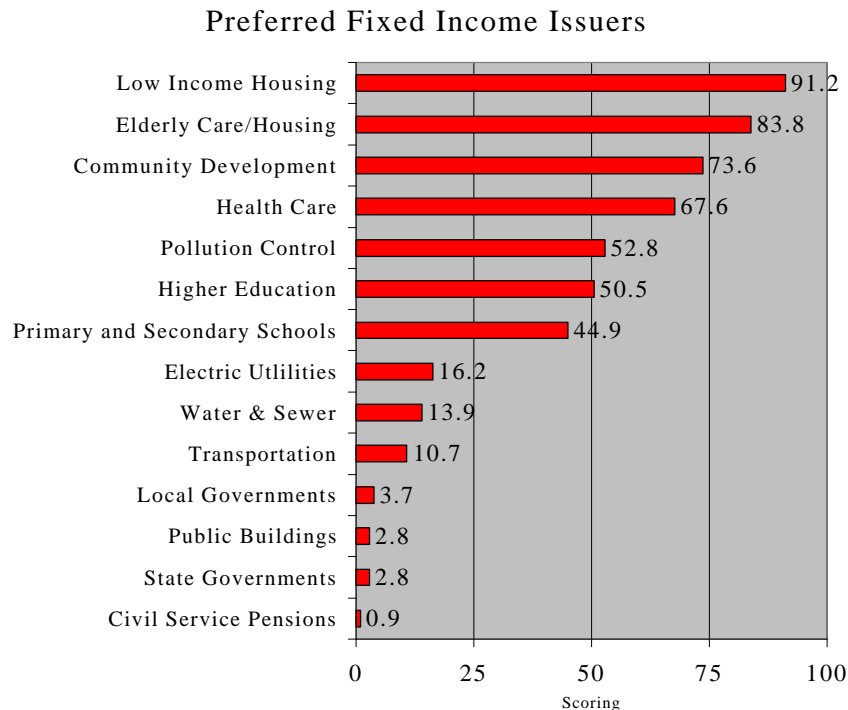


Taxable Municipal Bonds

The previous question was asked to provoke a discussion about an overlooked sector within the fixed income market known as taxable municipal bonds. Taxable municipal bonds were created as a result of the Tax Reform Act of 1986. That legislation from Congress imposed limitations on the amount and type of municipal securities issued by state and local governments and governmental authorities. As a result, some municipal issuers have to raise capital in the taxable bond market. (Note: The income on taxable municipals is taxable to tax-paying investors but like other forms of income, it is non-taxable for tax-exempt organizations.)

The yields on taxable municipal bonds are similar to those of corporate bonds. In many cases yields on taxable munis are slightly higher relative to corporate bonds of similar credit quality. Investors with SRI policies can use taxable municipals as a surrogate for some or all of their corporate bond exposure. Taxable municipals pass many of the avoidance screens as well as positive screens.

The questionnaire listed a number of municipal bond sectors and asked “Which of the following fixed income issuers and sectors would your organization support through the purchase and investment of bonds”?

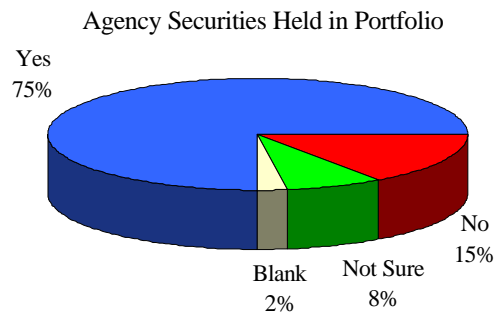


Government Agencies

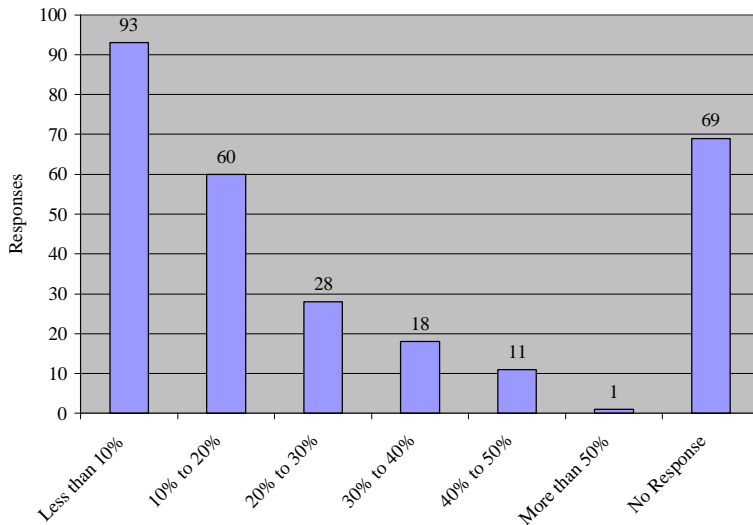
Government Agencies is a broad category that encompasses issuers, which are actual agencies of the U.S. Government such as the Federal Home Loan Bank and the Federal Farm Credit Bank. The category also includes government-sponsored enterprises (GSE) which are public, shareholder-owned corporations chartered by the U.S. Congress. The U.S. government guarantees some agency bonds, while others may have only the implied or moral support of the U.S. Government. Some managers may combine agency bonds together with Treasury securities under the banner of “Governments” or “Government Bonds”.

The missions of the agencies and GSEs vary widely. Several agencies may be viewed positively by organizations with SRI policies. Examples may include Fannie Mae (formerly the Federal National Mortgage Association) which helps facilitate home ownership for low and middle-income persons, and the Student Loan Marketing Association helps to provide capital for student loans.

Agency bonds are widely held according to the number of respondents, but it appears that their usage in a portfolio is modest. Over



Percentage of Fixed Income Portfolio Allocated to Agency Securities



one third of the respondents report owning less than 10% agencies in their fixed income portfolios.

Some agency issuers may be viewed negatively in terms of SRI. For instance, the Tennessee Valley Authority utilizes coal and nuclear plants to generate electric power. The Agency for International Development may back loans to countries that may have internal policies that may be viewed as repressive.

A sharp contradiction arises when over 54% of the respondents report that the agency bonds are subject to the same SRI restrictions and guidelines, yet only 27% report that the mission and purpose of the specific agencies are reviewed.

Summary

There was an expectation that there would be a correlation between investor traits and survey responses or between the answers themselves. For instance, there was the belief that an institution with a relatively large portfolio would have an extensive SRI policy that covered some of the particular nuances of fixed income sectors. Another perception was that communities of men might have slightly different responses or SRI priorities than communities of women. There were no such connections or inferences that could be made.

What we did find was that the fixed income portfolios of the respondents had modest market risk and were of high credit quality. However, though the fixed income portfolios represent a significant proportion of invested funds, the equity-oriented SRI policies do not address significant sectors of the fixed income market.

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