

# DC FOCUS

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## Socially Responsible Investing

How green is your 401(k) plan? The question is no longer so unusual, thanks to the mainstreaming of socially responsible investing trends and an increased focus on environmental, social, and governance (ESG) issues on the part of analysts, investment managers, and consumers.

In fact, this past May marked the tenth anniversary of the Department of Labor giving its nod of approval to socially responsible investments in defined contribution plans, after the Calvert Group sought an advisory opinion as to whether socially responsible investments undermined ERISA fiduciary standards. The Department of Labor affirmed that the fiduciary standards of ERISA didn't preclude socially screened funds as long as "the investment was expected to provide an investment return commensurate to investments having similar risks."<sup>1</sup>

### ASSET GROWTH

Today, roughly 11% of assets under professional management in the United States—nearly \$1 out of every \$9—is committed to socially responsible investing, according to the most recent data from the Social Investment Forum. "Socially responsible investing (SRI) is thriving in the United States, growing at a faster pace

than the broader universe of all investment assets under professional management," touts the executive summary of the Forum's *2007 Report on Socially Responsible Investing Trends in the United States*.<sup>2</sup>

The *Trends* report identifies \$2.71 trillion in total assets under management that use one or more of three strategies: screening, shareholder advocacy, and community investing. That's up from \$639 billion in 1995 (the year of the first report), and represents an increase of more than 324%. In the last two years alone, from 2005 to 2007, socially responsible investing assets increased more than 18%, compared to less than 3% for the broader universe.

### INVESTMENT VEHICLES

The largest share of socially and environmentally screened assets is in separate accounts. Mutual funds that employ social and environmental screens account for \$171 billion in total net assets invested across 173 different funds, according to the *Trends* report. This is up from 55 funds with \$12 billion of assets in 1995. Whereas early funds incorporated screens to exclude certain types of companies (avoiding alcohol or weapons, for example) to suit the investment practices of faith-based and religious groups, some newer funds identify companies with positive ESG factors. Firms that invest in alternative energy or multinationals that apply fair labor practices are but two examples of the types of investments found in funds that exercise a positive screening approach.

1. Jennifer Byrd, "Socially Conscious Investing Blossoms with DOL's Blessing," *InvestmentNews*, June 23, 2008. Quotation attributed to the Department of Labor.

2. Social Investment Forum, *2007 Report on Socially Responsible Investing Trends in the United States* (Washington, DC, 2008).

Socially responsible investments are not a separate asset class; they provide an alternative way to invest in existing asset classes. A June 2007 survey of 129 defined contribution plan sponsors released by the Social Investment Forum and Mercer found that the most popular socially responsible investing option is a large cap domestic equity fund (69%), with the remainder spread almost equally among fixed income funds (12%), global equity (10%), and balanced funds (9%).<sup>3</sup> This distribution largely still reflects what KLD Research & Analytics director of indexes Tom Kuh terms the “silo effect” that the investment category has historically suffered from.

#### SOCIAL CORE STRATEGIES

Dimensional offers two Social Core Portfolios to meet the social investing needs of investors seeking diversified equity exposure. The US Social Core Equity 2 Portfolio focuses on US stocks, while the Emerging Markets Social Core Equity Portfolio invests in emerging markets equities. Dimensional has engaged an independent third party, KLD Research and Analytics, to monitor the social issue screens for each portfolio. KLD has been researching companies’ ESG behavior since 1988 and is a leading provider of SRI information. These social screens evaluate the business activities of companies across several areas of interest

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“Many 401(k) sponsors think of SRI funds in terms of a single asset class and may find one or two they might put into a 401(k) program to meet the demand of participants. But one of the important developments, as this market becomes more mainstream, is that there are many funds covering many more asset classes available to investors interested in ESG issues than in the past,” Kuh says.<sup>4</sup>

“The next stage in the integration of SRI into the 401(k) platform is funds covering a broader range of asset classes so that investors can implement an asset allocation plan,” Kuh adds.

#### DIMENSIONAL'S OFFERING

Dimensional Fund Advisors offers two different types of socially responsible investment strategies: Social Core and Sustainability Core. The Social Core strategies employ various social issue screens, while the Sustainability Core strategies focus on environmental issues. Each strategy utilizes Dimensional’s Core Portfolio construction methodologies, which ensure broad diversification, reliable and consistent equity exposure, and cost-effective execution.

among investors with social concerns and may include screens designed to identify and exclude from investment companies involved in the following activities:

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Gambling

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Tobacco or alcohol

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Pharmaceutical manufacturers, including abortive agents and contraceptives

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Abortions

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Pornographic materials

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For-profit health care providers

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Military weapons or weapons of mass destruction

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For-profit business activities in Sudan

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Child labor

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Although social issue screens can result in a reduction in diversification relative to the overall market, Dimensional’s core equity technology gives the Social Core Portfolios reliable and well-diversified equity market exposure compared to other SRI strategies.

3. Mercer Investment Consulting, *Defined Contribution Plans and Socially Responsible Investing in the United States: A Survey of Plan Sponsors, Administrators and Consultants* (Washington, DC: Social Investment Forum, 2007).

4. Tom Kuh, personal communication, August 2008.

SUSTAINABILITY CORE STRATEGIES

Dimensional has addressed its clients’ increasing interest in incorporating environmental responsibility into their investment choices by introducing two new strategies that focus on environmental sustainability issues and complement the firm’s Social Core Portfolios. The US Sustainability Core 1 Portfolio invests only in US-based companies, while the International Sustainability Core 1 Portfolio invests in developed international markets.

Dimensional’s Sustainability portfolios are designed to support environmental and investment goals simultaneously, with a rigorous focus on prudent investment design. Companies are scored for their sustainability efforts by applying a state-of-the-art methodology that includes research and ratings information from an independent third party, Sustainable Holdings, LLC. Sustainable Holdings utilizes data from KLD Research and Analytics, Sustainable Investment Research International, and the Carbon Disclosure Project to evaluate the environmental sustainability practices of major corporations. Sustainable Holdings’ ratings are based on thirteen key aspects of the environmental sustainability of a company, which are organized into three broad categories:

<p><b>Environmental Vulnerability</b> 35% of Overall Sustainability Score</p> <p>Hazardous waste</p> <p>Substantial toxic chemical emissions</p> <p>Environmental regulatory problems</p> <p>Environmental controversy</p> <p>Environmental negative economic impact</p>
<p><b>Environmental Strength</b> 35% of Overall Sustainability Score</p> <p>Environmental management system</p> <p>Pollution prevention</p> <p>Recycling</p> <p>Environmental initiatives</p> <p>Beneficial products and services</p>
<p><b>Climate Change</b> 30% of Overall Sustainability Score</p> <p>Carbon intensity</p> <p>Climate change solutions</p> <p>Climate change reporting</p>

Dimensional then applies its own proprietary methodology that incorporates the overall sustainability scores into the funds’ investment process in a way that is consistent with Dimensional’s investment principles. Dimensional’s methodology excludes companies with the worst sustainability scores and gradually under-weights or over-weights companies based on their relative sustainability ratings. This continuous ranking system takes into account idiosyncrasies specific to each industry, avoids sector concentrations, and minimizes security-specific risks and portfolio turnover. While all SRI screening and ranking methodologies result in reduced diversification to some degree, Dimensional’s methodology limits the financial risks associated with industry and sector biases often found in other socially responsible investment strategies.

ADVANTAGES OF CORE PORTFOLIOS

Dimensional’s Social Core and Sustainability Core strategies apply ESG overlays to the firm’s core equity investment architecture. The portfolios target return premiums across equity markets and weight all eligible securities based on their risk/return characteristics. Empirical research has shown that small cap stocks have historically outperformed large cap stocks, and low-priced value stocks have outperformed high-priced growth stocks. These return premiums are evident in US as well as international markets. Like Dimensional’s other core equity portfolios, the Social Core and Sustainability Core funds are broadly diversified to provide consistent and reliable equity exposure, and they incorporate tilts for increased exposure to small cap and value stocks—stocks with higher expected long-term returns. Referencing Dimensional’s SRI strategies, Dimensional’s chief investment officer and head of research Eduardo Repetto noted, “Our goal is socially responsible investing with an emphasis on investing.”

While SRI funds are generally more expensive to manage due to the screens incorporated in the investment process, Dimensional’s Social Core and Sustainability Core funds have low fees relative to other socially responsible investment options and are efficiently managed to minimize portfolio turnover and transaction costs. These features make the funds appealing long-term investment options—and highly appropriate for retirement investing.

## MULTIFACTOR ENGINEERING IN DIMENSIONAL'S CORE PORTFOLIOS

*For illustrative purposes only.*

The table below shows how Dimensional's US Social Core and US Sustainability Core Portfolios compare to the overall stock market. Dimensional's unique methodology ensures that core equity portfolios are broadly diversified, with tilts toward small cap and value—stocks that have higher expected returns.

As of June 30, 2008	US Social Core Equity 2 Portfolio	US Sustainability Core 1 Portfolio	Russell 3000 Index
Number of Holdings	1,543	1,851	2,982
Weighted Average Market Cap (millions)	\$40,534	\$54,618	\$72,996
Weighted Average Book-to-Market	0.64	0.52	0.47

Market cap is a measure of company size: Small company stocks have lower market caps.  
Book-to-Market is a valuation measure: Low-priced value stocks have higher book-to-market ratios.

### GROWING DEMAND FROM RETIREMENT PLANS

In its June 2007 survey of plan sponsors, administrators, and consultants, the Social Investment Forum and Mercer Investment Consulting found a strong demand for socially responsible investing options—with 60% of respondents either currently offering a socially responsible option or intending to offer one within three years. According to the report, the primary reasons for adding this type of option include alignment with organization goals, recommendations from management and investment staff, and response to participant requests. Consultants have seen a substantial increase in socially responsible investing fund search activity and requests for proposals. “From where I sit,” says Mercer’s Craig Metrick, “we’re certainly seeing a greater frequency in inquiries.”

What will the future bring? The outlook for socially responsible investing appears to be a rosy version of green. The SIF/Mercer study found that more than 70% of consultant and advisor respondents and 48% of plan sponsors predict that the demand for socially responsible investing options will increase or remain steady over the next five years.

Dimensional vice president Pat Carter has a commonsense view of the connection between responsible investing and retirement plans. “More and more investors today,” he says, “are looking for ways to do two things: ensure that they accumulate enough money for their retirements, and try to make a positive contribution to the environment and other social causes they believe in. To the extent that plan sponsors can offer socially responsible investment options that are fundamentally good investments, they are serving their plan participants extremely well.”

Dimensional Fund Advisors is an investment advisor registered with the Securities and Exchange Commission. Consider the investment objectives, risks, and charges and expenses of the Dimensional funds carefully before investing. For this and other information about the Dimensional funds, please read the prospectus carefully before

investing. Prospectuses are available by calling Dimensional Fund Advisors collect at (310) 395-8005; on the internet at [www.dimensional.com](http://www.dimensional.com); or, by mail, DFA Securities LLC, c/o Dimensional Fund Advisors, 1299 Ocean Avenue, Santa Monica, CA 90401. Dimensional funds are distributed by DFA Securities LLC.

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