Exploring the “Cost” of Socially Responsible Investing (SRI)

Presented by:

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Presentation Outline

History of SRI

SRI Implementation

Investing in Sin

SRI Performance- the “cost”

Monitoring SRI Investments

Summary Conclusions

Questions

My Research on the Topic

Exploring the Cost of Investing in Socially Responsible Mutual Funds: *An Empirical Study*

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Socially Responsible Investing (SRI), also known as sustainable, socially conscious, or ethical investing, describes an investment strategy that seeks to maximize both financial return and social good for an investor. Religious institutions have long been at the forefront of social investing, and while the types of SRI investments vary, they typically exclude investments in things like tobacco, alcohol, weapons/military, and gambling.

According to the 2007 Report on Socially Responsible Investing Trends by the Social Investment Forum, roughly 11% of all investment dollars in the United States are now involved in SRI investing, totaling $201.8 billion across mutual funds, ETFs, closed-end funds, other pooled products, and alternative investments. From 2005 to 2007, SRI assets increased more than 18%, while the broader universe of managed assets increased less than 3%. In fact, according to a January 2006 study conducted by Yankelovich Inc. [2006] and commissioned by Calvert, titled "Attitudes Toward Socially Responsible Investing," 87% of non-SRI investors would consider investing in such funds if they knew the rate of return was the same as other mutual funds.

While SRI may be good from a moral perspective, it is less clear how well SRI portfolios actually perform against their non-SRI peers, on both pure-return and risk-adjusted bases. This article explores the topic, primarily through a comparison of those mutual funds categorized as "Socially Conscious" by Morningstar (both active and passive) to their non-SRI peers to determine if there really is a performance "cost" associated with SRI investing.

LITERATURE REVIEW

A central principle of Modern Portfolio Theory is that diversification reduces the risk in a portfolio. A mandate to exclude types of investments (e.g., tobacco companies) limits a manager's ability to diversify, and should (in theory) result in lower risk-adjusted returns. While this reasoning appears to be sound, it may not actually pan out in reality. It may be that companies typically screened out by SRI investors/portfolio managers (i.e., sin stocks) have lower returns due to their unique business or industry characteristics. There has been a good deal of research on SRI investing, with mixed findings.

Hamilton, Jo, and Statman [1993] compared the returns of socially conscious and conventional funds from 1981 to 1990 and found a relative outperformance of seven basis points that was not statistically significant. Diltz [1995a, 1995b] found in two studies no statistically significant difference in returns for 14 socially screened stock portfolios vs. 14 unscreened stock portfolios generated from a universe of 159 securities during the 1989–1991 period and noted that only environmental and military business screens created a statistically significant difference

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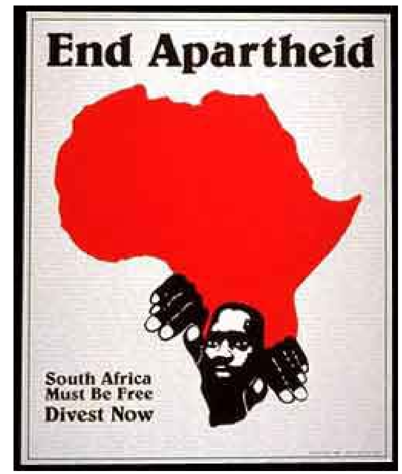
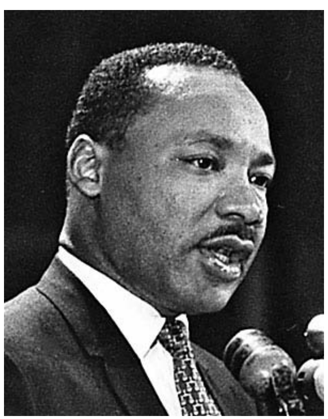
What is SRI?

- Socially Responsible Investment (SRI) is the integration of personal values with monetary investment
- Also referred to as Environmental, Social and Governance (ESG) investing

Early History of SRI

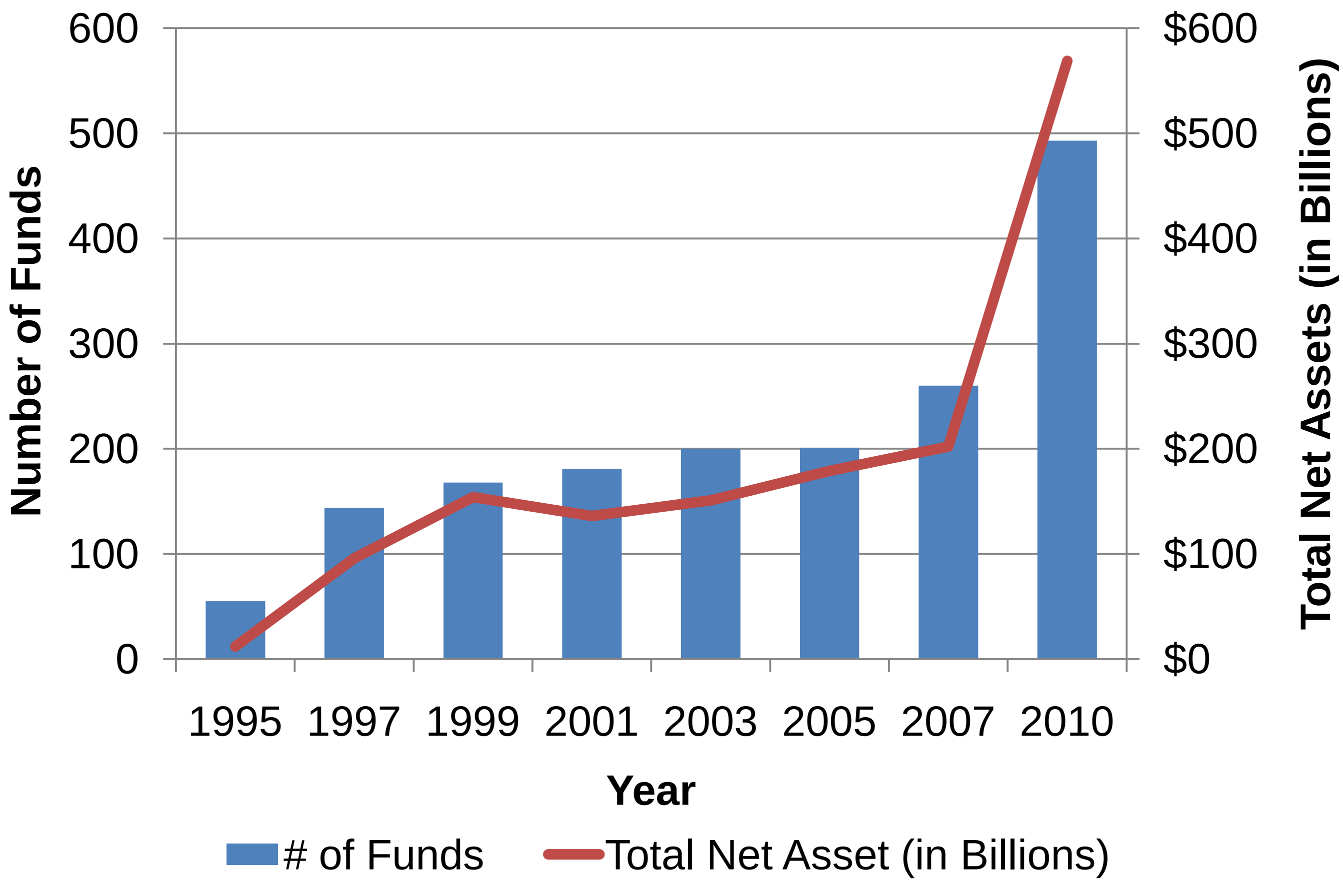
SRI Movement





Domini 400 SOCIAL INDEX

Investment in SRI/ESG Funds



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Source: Social Investment Forum 2010 Report on Trends in SRI Investing

SRI Investments Today

- Nearly one in eight dollars under professional management in the United States today is involved in some socially responsible investing strategy ($3 trillion versus $25 trillion total)
- SRI investments continue to grow at a faster pace than conventional investment assets
- Since 2005, SRI assets have increased more than 34 percent while the broader universe of professionally managed assets has increased only 3 percent

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Source: Social Investment Forum 2010 Report on Trends in SRI Investing

Implementing SRI

(In Billions)	1995	1997	1999	2001	2003	2005	2007	2010
ESG Incorporation	$162	$529	$1,497	$2,010	$2,143	$1,685	$2,098	$2,512
Shareholder Advocacy	$473	$736	$922	$897	$448	$703	$739	$1,497
Community Investing	$4	$4	$5	$8	$14	$20	$25	$42
Overlapping Strategies	N/A	($84)	($265)	($592)	($441)	($117)	($151)	($981)
Total	**$639**	**$1,185**	**$2,159**	**$2,323**	**$2,164**	**$2,290**	**$2,711**	**$3,069**

Overlapping assets involved in some combination of ESG incorporation, filing shareholder resolutions or community investing are subtracted to avoid potential effects of double counting. Separate tracking of the overlapping strategies only began in 1997, so there is no datum for 1995.
Prior to 2010, assets subject to ESG incorporation were limited to socially and environmentally screened assets.

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Source: Social Investment Forum 2010 Report on Trends in SRI Investing

Common SRI Investments

Mutual funds: The largest share of funds that incorporate SRI/ESG factors are mutual funds, with $316.1 billion in total assets invested in 250 different funds.

Exchange-traded funds: Twenty-six ETFs with $4.0 billion in total assets were identified as incorporating ESG criteria. Although ETFs accounted for only 1 percent of the total assets of all ESG investment vehicles, their assets have grown 225 percent since 2007, the fastest of all registered investment vehicles.

Closed-end funds: Five closed-end funds with assets of $202 million were tracked as incorporating ESG criteria.

Source: Social Investment Forum 2010 Report on Trends in SRI Investing

SRI Demand

- ***Client demand*** is the most popular reason portfolio managers incorporate SRI/ESG factors into their portfolios. ***Regulation and/or legislation*** is also a common reason
- 19% of 401(k) plan-sponsor respondents currently offer one or more SRI options.
- SRI demand will likely increase as more and more baby boomers retire and "roll out" of 401(k) plans
- Unified Trust has seen increasing demand from plan sponsors and advisors

Source: Social Investment Forum 2010 Report on Trends in SRI Investing

SRI Implementation

Avoidance: choose not to be affiliated with firms engaging in business activities that conflict with values

Positive Investment: seek out firms engaged in business practices consistent with social concerns

Shareholder Advocacy: influence business activities or policies

SRI Screens Include

1. Abortion / contraceptives
2. Agricultural chemicals
3. Alcohol
4. Animal welfare
5. Antitrust
6. Benefits to economically disadvantaged
7. Biotechnology
8. Breast milk and substitutes
9. Bribery
10. Climate / greenhouse gas management
11. Community involvement – charitable donations program, community relations, etc.
12. Compensation for workers
13. Corporate governance / business practices / ethics
14. Defense/military weapons
15. Employment equality / diversity
16. Employee programs and benefits
17. Environment
18. Firearms
19. Food security
20. Gambling
21. Hazardous waste
22. Health and safety
23. Human rights
24. Indigenous peoples rights / Aboriginal relations – impacts/benefits, etc.
25. Investment controversies
26. Labor relations / workplace conditions
27. Management systems
28. Marketing / contracting controversy
29. Minority groups
30. Negative economic impact
31. Non-marital partner benefits
32. Non-representation
33. Nuclear
34. Ozone-depleting chemicals
35. Pollution prevention
36. Political accountability
37. Pornography / adult entertainment
38. Product safety, impact and quality
39. Promotion
40. R&D / innovation
41. Recycling
42. Regulatory problems
43. Repressive regimes (e.g. Burma, Sudan, etc.
44. Religion specific concerns (e.g. Catholic, Islamic, Jewish)
45. Tax disputes
46. Tobacco
47. Transparency
48. Uranium mining
49. Water security
50. Women – treatment of women

Source: Strandberg Consulting

Most Common SRI Factors

Sudan is the top criterion in asset-weighted terms with 47% of ESG mutual funds representing $215 billion in total net assets subject to Sudan-related investment policies — including $198 billion in TIAA-CREF's divestment.

In numerical terms, ***tobacco*** remains the most frequently applied ESG criterion, affecting 64% of ESG mutual funds, with $121 billion in assets. ***Alcohol*** is the next most common criteria, affecting half of ESG mutual funds, with $116 billion in assets.

Gambling, ***defense/weapons*** and the ***environment*** are the remaining most common factors.

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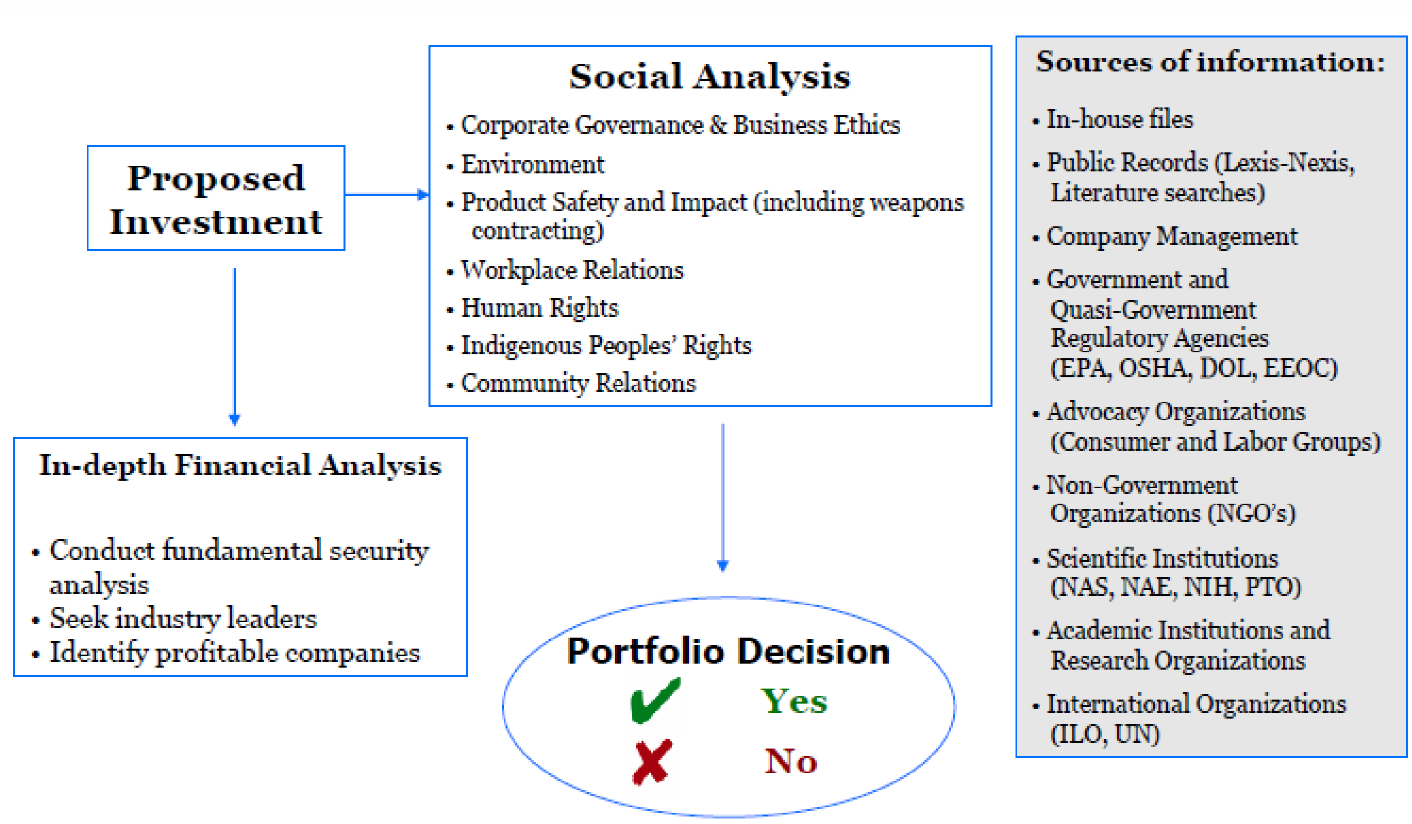
Source: Social Investment Forum 2010 Report on Trends in SRI Investing

Calvert's Screening Process



Source: Calvert

The Costs of Ethical Investing

Is it Good to Be “Bad”?

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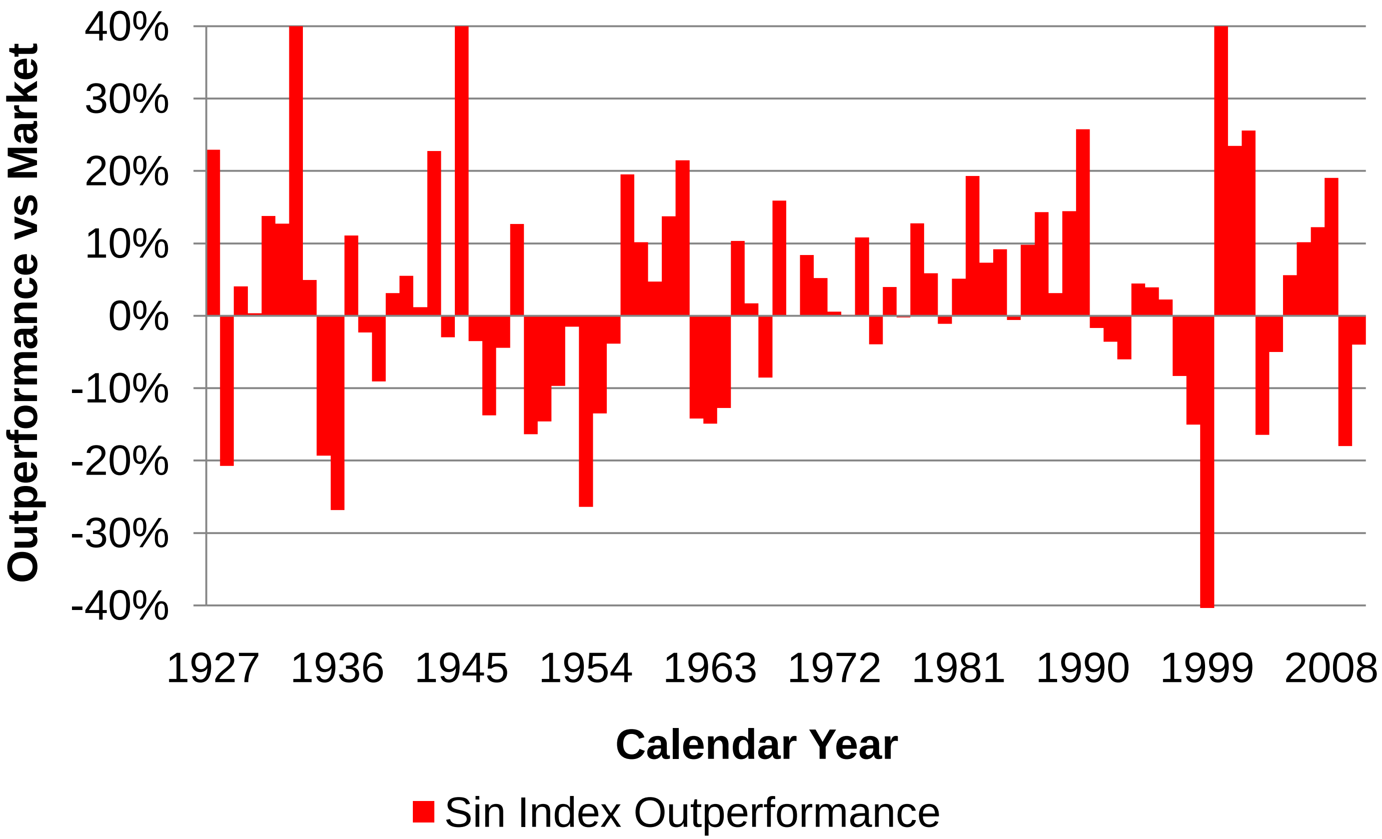
Sin Research

Hong and Kacperczyk (2007) note that sin stocks also have higher expected returns than otherwise comparable stocks, consistent with them being neglected by norm-constrained investors and facing greater litigation risk.

Fabozzi, Ma, and Oliphant (2007) find that a portfolio of sin stocks outperforms common benchmarks both in terms of magnitude and frequency.

Relative "Sin Index" Performance



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Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Relative Performance of Sin

	Market	Sin Index
Return	9.63%	12.63%
Std Dev	20.50%	24.42%
Sharpe	0.291	0.367
Correlation	0.700	

Higher Return

But more Risk…

Similar to Small Caps…

Separating β and α

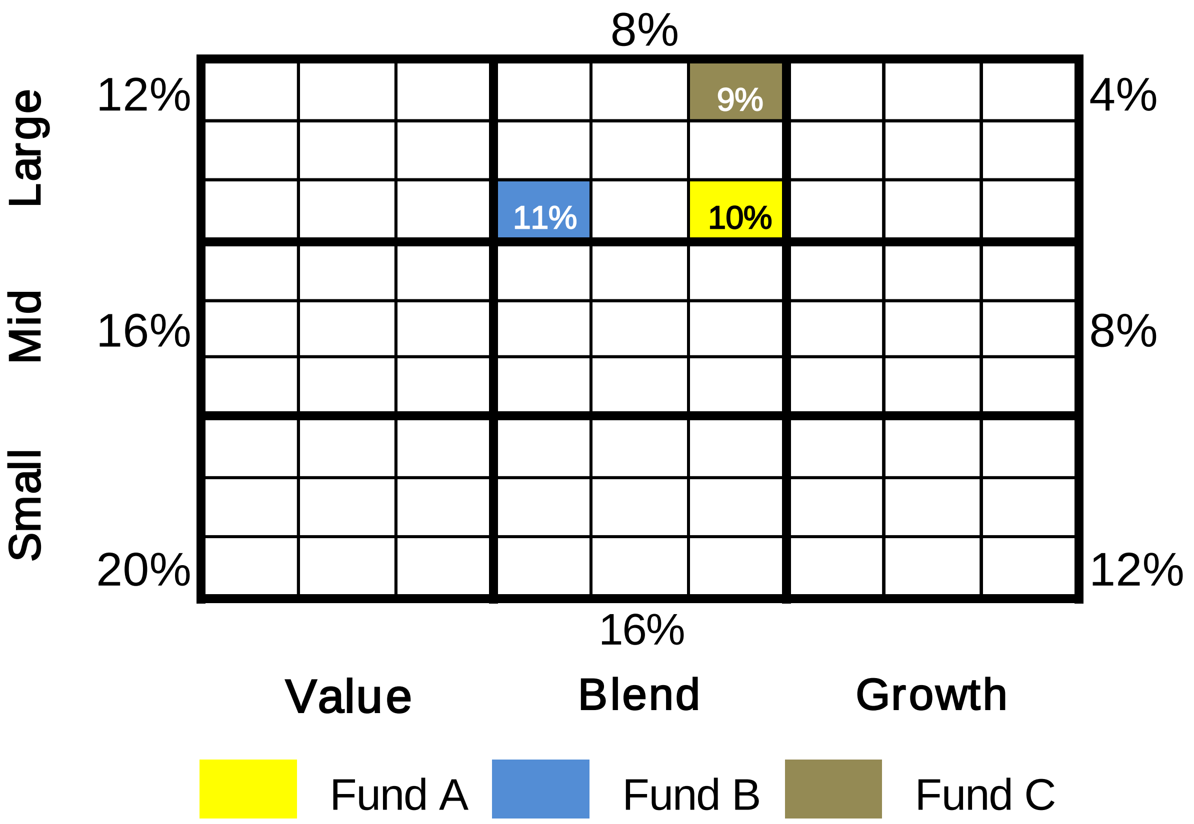
A four factor regression, using the Fama/French factors and Carhart's Momentum.

The equation:

$$R_{index} - R_f = \alpha_{index} + \beta_{index}(R_{market} - R_f) + \beta_{SMB}(SMB) + \beta_{HML}(HML) + \beta_{MOM}(MOM) + \varepsilon_{asset}$$

Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Which Fund is Best?



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Pure Market Returns

						8%					
Large	12%	12%	11%	10%	9%	8%	7%	6%	5%	4%	4%
		13%	12%	11%	10%	9%	8%	7%	6%	5%	
		14%	13%	12%	11%	10%	9%	8%	7%	6%	
Mid		15%	14%	13%	12%	11%	10%	9%	8%	7%	
	16%	16%	15%	14%	13%	12%	11%	10%	9%	8%	8%
		17%	16%	15%	14%	13%	12%	11%	10%	9%	
Small		18%	17%	16%	15%	14%	13%	12%	11%	10%	
		19%	18%	17%	16%	15%	14%	13%	12%	11%	
	20%	20%	19%	18%	17%	16%	15%	14%	13%	12%	12%
						16%					
			Value			**Blend**			**Growth**		

Fund A Fund B Fund C

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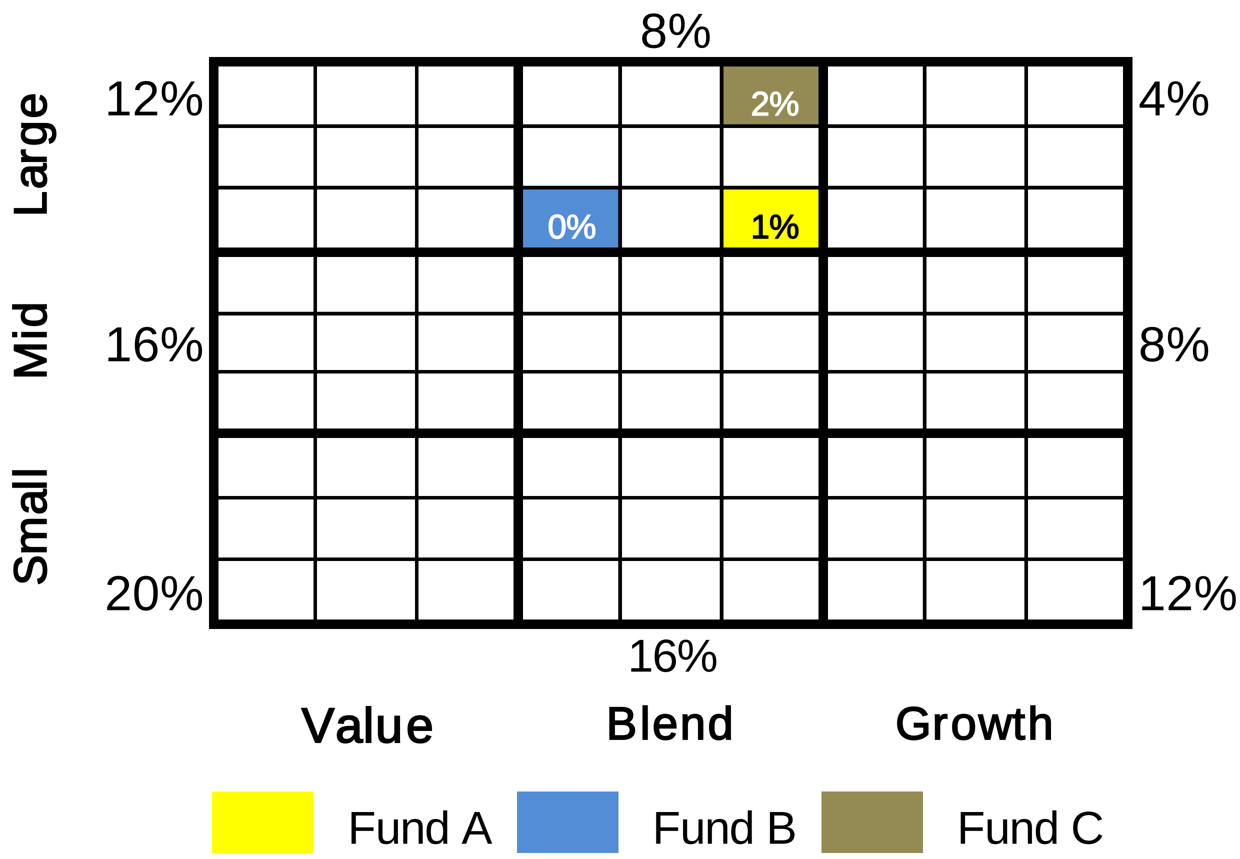
"Alphas"



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Risk-Adjusted Sin Index

4 Factor Test

	Coefficients	*t Stat*
Alpha	1.33%	0.556
Market	0.702	7.381
SMB	0.380	2.729
HML	0.349	2.642
MOM	0.129	1.120

Adjusted R^2 55.21%

Alpha is still positive, but smaller

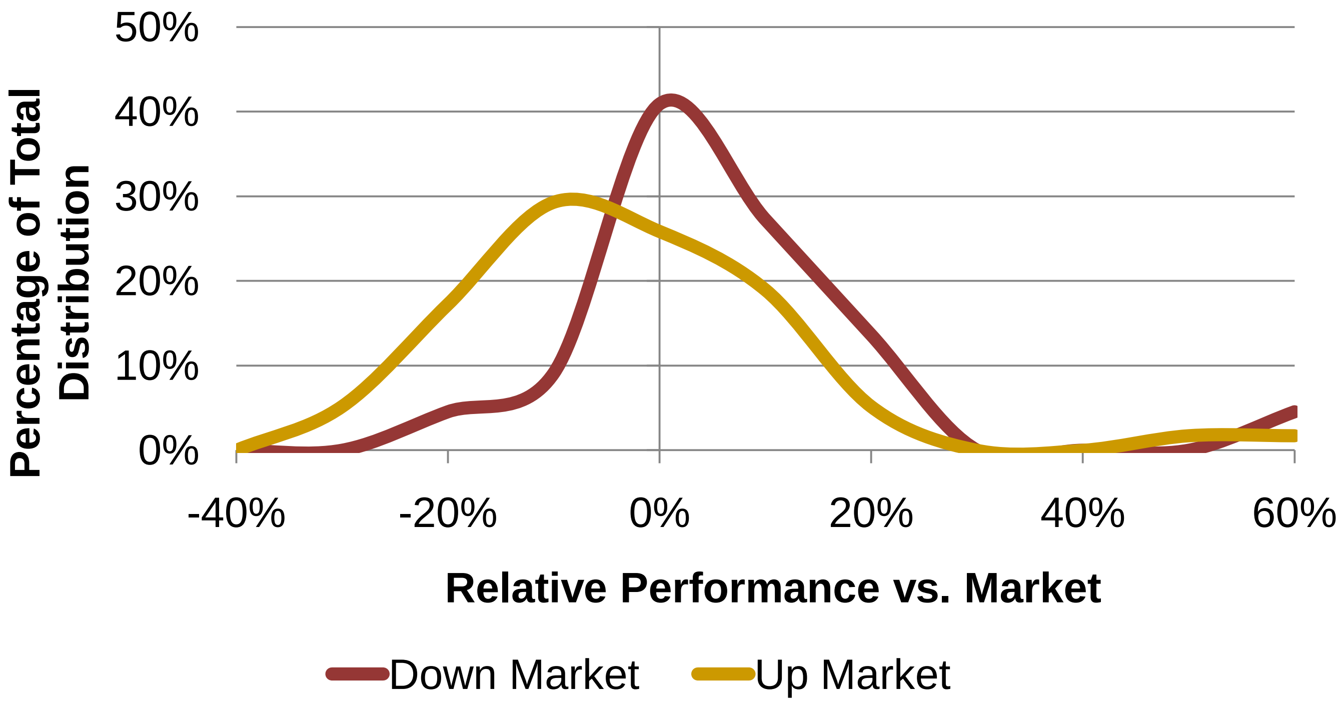
Small Cap tilt

Value tilt

Overall low goodness of fit for the regression

Sin in Bad Markets

	vs Mkt	Correlation	% Beat Mkt	# periods
Down Market	9.68%	0.545	86.4%	22
Up Market	-0.91%	0.616	50.0%	62



Source: http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

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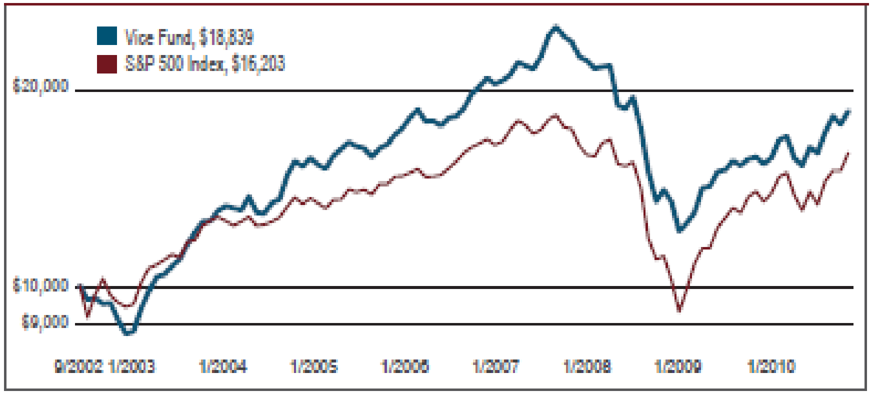
The Anti-SRI Fund: VICEX

The Vice Fund (VICEX) invests "in companies, both domestic and foreign, engaged in the aerospace and defense industries, owners and operators, gaming facilities as well as manufacturers of gaming equipment, manufactures of tobacco products and producers of alcoholic beverages."

VICE FUND

hypothetical **growth of $10,000 investment** as of 12/31/10



Source: http://www.usamutuals.com/vicefund/fund_perf.aspx

The “Cost” of Being Good

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Three Possible Impacts of SRI

1. **Doing Good but Not Well:** Where the expected returns of socially responsible securities are lower than the expected returns of conventional stocks.
2. **Doing Good While Doing Well:** Where the expected returns of socially responsible securities are higher than those of conventional stocks.
3. **No Effect**

Should there be a cost?

Minor (2007) argues that while there is has been no consistent documented net financial cost to SRI, three economic properties require an SRI cost that total 50 bps to 100 bps per annum.

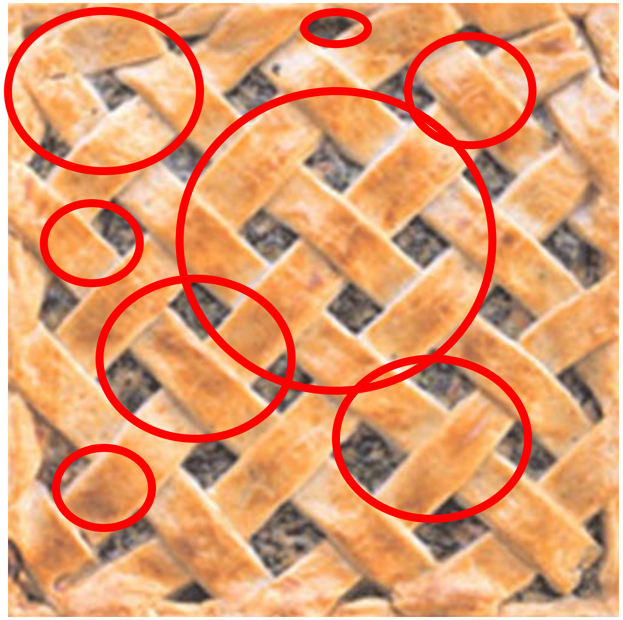
However, Minor do not expect a true cost to exist when considering the ***utility*** of SRI investing.

A Market Efficiency Perspective

- Most fund managers don’t care about SRI, they care about outperforming peers
- Most assets are not in SRI funds (7/8 of all)
- Can we, therefore, reasonably expect some market segment to have a higher expected return?

Unique Market Exposures

Total Market



SRI Portfolio

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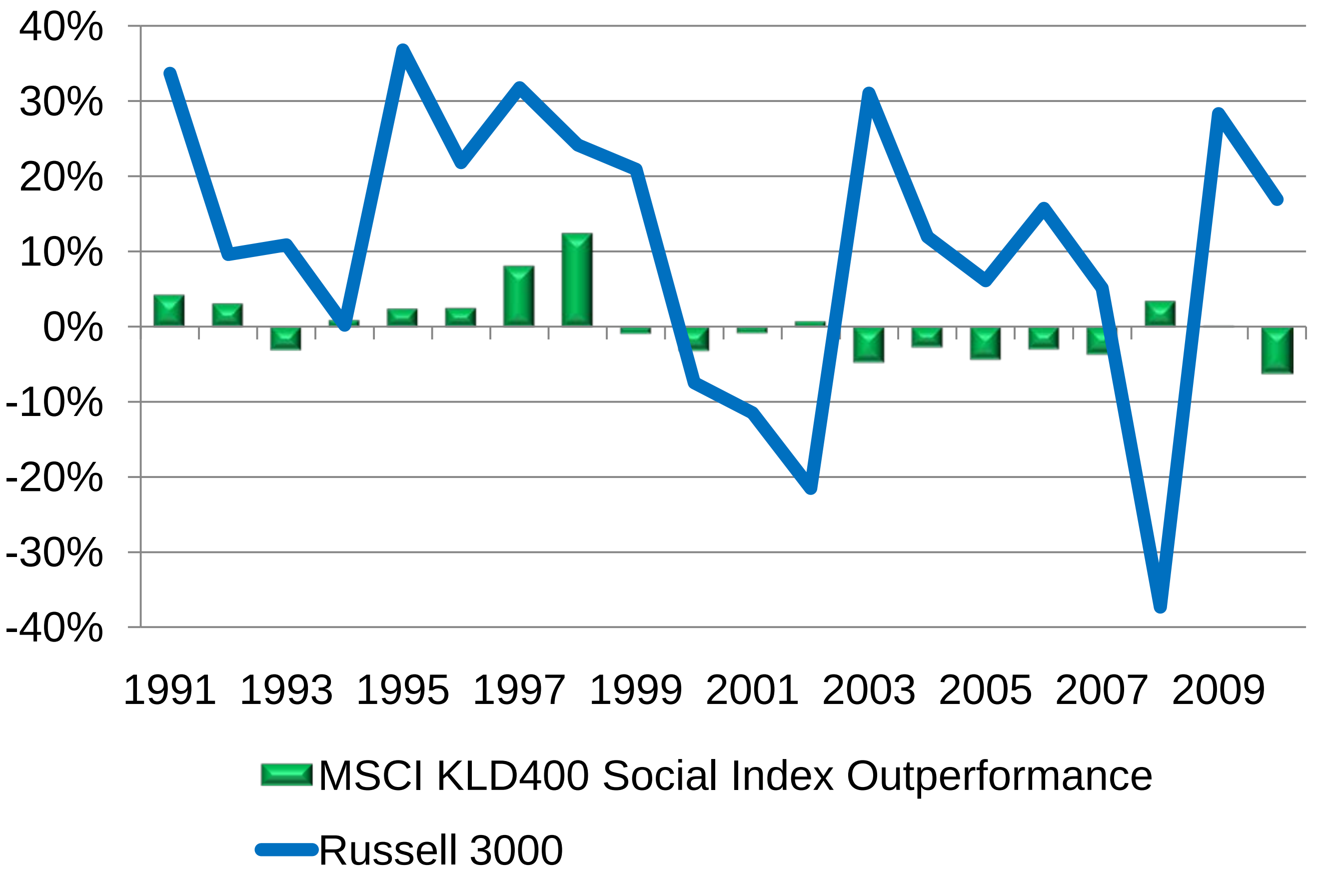
SRI Index

In May of 1990, Kinder, Lydenberg, Domini & Co. (KLD) developed the Domini Social Index (DSI) by eliminating S&P 500 companies that failed to pass South Africa, product, environmental, military, nuclear power, and employee relations screens and including 50 non-S&P 500 stocks with “good” records on corporate citizenship, product quality, board representation of women and minorities.

Source:http://www.socialinvest.org/pdf/research/Moskowitz/1996%20Winning%20Paper%20-%20Moskowitz.pdf

“Good” Investing



Good Investing Relative

	R1000	KLD400
Return	9.50%	9.88%
Std Dev	18.94%	20.38%
Sharpe	0.308	0.304
Correlation	0.976	

Higher return, but more risk, virtually identical risk-adjusted performance

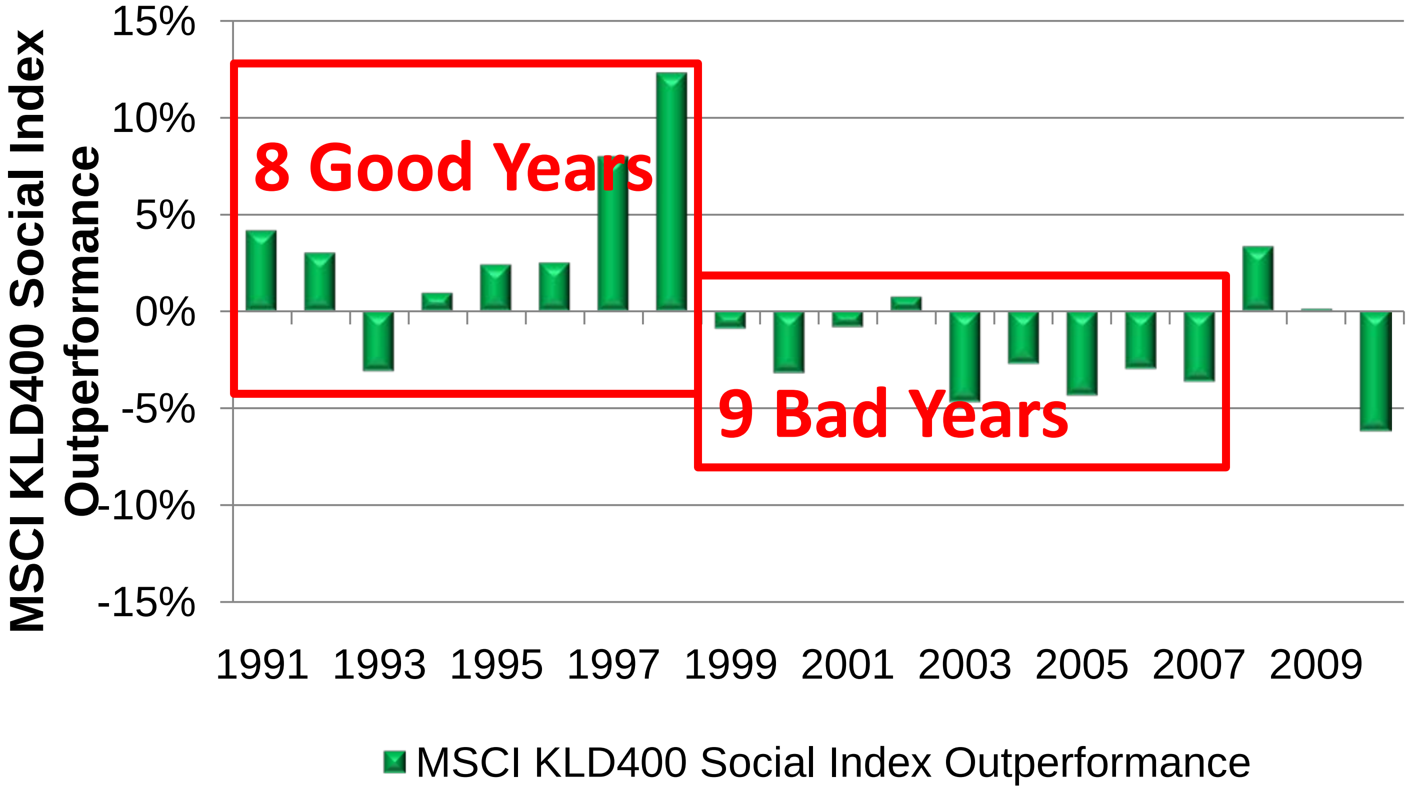
4 Factor Test

	Coefficients	*t Stat*
Alpha	1.09%	1.335
Market	0.992	62.176
SMB	-0.170	-8.444
HML	-0.045	-2.063
MOM	-0.021	-1.586

Adjusted 94.97%

Positive alpha… "Larger" and more "Growthy" than the market, overall good regression fit

Importance of Test Period



My Study Methodology

- Studied mutual funds classified as “Socially Conscious” by Morningstar
- From 1990 to 2008
- Annual independent test periods, therefore no survivorship bias or lookback bias
- Analyzed both Net and Gross returns, versus peers and indexes, as well as alpha tests

My Findings by Test

	Net Return vs Category Median		Gross Return vs Category Median	
	Outperf	% Beat	Outperf	% Beat
Average	-0.23%	46.5%	-0.22%	48.1%
Weighted Average	-0.17%	46.9%	-0.14%	47.6%

	Net Return vs Index Return		Gross Return vs Index Return	
	Outperf	% Beat	Outperf	% Beat
Average	-0.46%	44.2%	0.88%	55.6%
Weighted Average	-0.88%	40.9%	0.40%	52.4%

	Net Alpha vs Category Median		Gross Alpha vs Category Median	
	Outperf	% Beat	Outperf	% Beat
Average	0.10%	49.4%	0.23%	51.4%
Weighted Average	0.01%	48.5%	0.10%	50.1%

Summary Findings

- Average net SRI fund outperformance =

  -27 bps
- Average gross SRI fund outperformance = +21 bps
- Differences were neither statistically or economically significant

Meta-Analysis

	Authors	Title of study	Time period of study	E, S or G	RI approach	Findings on ESG factors
1	Abramson, L. & Chung, D. (2000)	Socially responsible investing: Viable for value investors?	Sep 1990 - Mar 2000	ESG	Screening	positive
2	Barnett, M. & Salomon, R. (2006)	Beyond dichotomy: The curvilinear relationship between social responsibility and financial performance.	Jan 1972 - Dec 2000	E and S	Screening	neutral-positive
3	Bauer, R., Otten, R. & Rad, A. (2006)	Ethical investing in Australia: Is there a financial penalty?	Nov 1992 - Apr 2003	ESG	Screening	neutral
4	Bello, Z. (2005)	Socially responsible investing and portfolio diversification.	Jan 1994 - Mar 2001	Mainly S	Screening	neutral
5	Benson, K.L., Brailsford, T.J. & Humphrey, J.E. (2006)	Do socially responsible fund managers really invest differently?	Jan 1994 - Dec 2003	Mainly S	Screening	neutral
6	Brammer, S., Brooks, C. & Pavelin, S. (2006)	Corporate social performance and stock returns: UK evidence from disaggregate measures.	Jun 1997 - Jun 2002	E and S	Screening	neutral-negative
7	Chong, J., Her, M. & Phillips, G.M. (2006)	To sin or not to sin? Now that's the question.	Sep 2002 - Sep 2005	Mainly S	Screening	negative
8	Core, J., Guay, W. & Rusticus, T. (2006)	Does weak governance cause weak stock returns? An examination of firm operating performance and investors' expectations.	Sep 1990 - Dec1999	G	Activism	neutral
9	Derwall, J., Guenster, N., Bauer, R. & Koedijk, K. (2005)	The eco-efficiency premium puzzle.[1]	Jul 1995 - Dec 2003	E	ESG integration	positive
10	Geczy, C., Stambaugh, R. & Levin, D. (2005).	Investing in socially responsible mutual funds (working paper).[2]	Jul 1963 - Dec 2001	S	Screening	negative
11	Gompers, P., Ishii, J. & Metrick, A. (2003)	Corporate governance and equity prices.	Jan 1990 - Dec 1999	G	Activism	positive
12	Hong, H. & Kacperczyk, M. (2006)	The price of sin: The effects of social norms on markets (working paper).	Jan 1965 - Dec 2004	S	Screening	negative
13	Opler, T.C. & Sokobin, Jo. (1995)	Does coordinated institutional activism work? An analysis of the activities of the Council of Institutional Investors.	Jan 1991 - Dec 1993	G	Activism	positive
14	Orlitzky, M., Schmidt, F.L. & Rynes, S.L. (2003)	Corporate social and financial performance: A meta-analysis.[3]	Jan 1972 - Dec 1997	S, and E to a lesser extent	Screening	positive
15	Schröder, M. (2004)	The performance of socially responsible investments: Investment funds and indices.	Varied start date: mid-1990s - Sep 2002	ESG	Screening	neutral-positive
16	Shank, T. M., Manullang, D.K. & Hill, R.P. (2005)	Is it better to be naughty or nice?	Dec 1993 - Dec 2003	ESG, with more S than E and G	Screening	positive
17	Smith, M.P. (1996)	Shareholder activism by institutional investors: Evidence from CalPERS.	Jan 1987 - Dec 1993	G	Activism	positive
18	Statman, M. (2000)	Socially responsible mutual funds.	May 1990 - Sep 1998	Mainly S	Screening	positive
19	Statman, M. (2006)	Socially responsible indexes: Composition, performance, and tracking error.[1]	May 1990 - Apr 2004	Mainly S	Screening	positive
20	Van de Velde, E., Vermeir, W. & Corten, F. (2005)	Corporate social responsibility and financial performance.	Jan 2000 - Nov 2003	ESG	ESG integration /Screening	positive

Benefit to SRI

Not conclusive

Cost to SRI

"Demystifying Responsible Investment Performance" A joint report by The Asset Management Working Group of the United Nations Environment Programme Finance Initiative and Mercer

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Notable Research

Stone, Guerard, Gultekin, and Adams (2001): “no (statistically) significant cost to social screening… in risk-adjusted return for the performance possibility cross-section” from 1984-1997

Bauer and Koedijk (2002): “After controlling for investment style, we find little evidence of significant differences in risk-adjusted returns between ethical and conventional funds for the 1990-2001 period.”

Kempf and Ostoff (2007) find: “Buy(ing) stocks with high socially responsible ratings and sell stocks with low socially responsible ratings… leads to high abnormal returns of up to 8.7% per year”

Guerard (1996) finds that returns in socially-screened and unscreened universes do not differ significantly.

International SRI

Renneboog, Horst, and Zhang (2006) find that SRI funds in many European and Asia-Pacific countries strongly underperform domestic benchmark portfolios by about 5% per annum, although UK and US SRI funds do not significantly underperform their benchmarks.

Bauer, Koedijk, and Otten (2005) find little evidence of significant differences in risk-adjusted returns between their international database of103 SRI mutual funds and their non-SRI peers from the 1990 to 2001 period.

Asset Stability

Peifer (2010) notes that after isolating the population of religiously affiliated funds, stark differences in asset stability across SRI funds.

Religious SRI funds are less responsive to lagged performance and experience less fund flow volatility than secular SRI funds, although SRI funds are less responsive than regular funds

Online Resources

www.socialinvest.org

The Social Investment Forum (SIF) is the US membership association for professionals, firms, institutions and organizations engaged in socially responsible and sustainable investing.

http://www.socialfunds.com

SocialFunds.com features over 10,000 pages of information on SRI mutual funds, community investments, corporate research, shareowner actions, and daily social investment news.

socialfunds.com Example

Calvert Social Index A (CSXAX)

Social Issues 02/28/11

Shareholder activism:	YES
Community investment:	YES
Environment:	P
Human rights:	P
Employment:	P
Products and Services:	P
Weapons:	X
Animal testing:	R
Nuclear power:	X
Alcohol, tobacco & gambling:	X/X/X
Other:	Governance

P =	Positive screen: fund seeks companies with a positive record or achievement.
R =	Restricted investment: the fund has minimum criteria related to this issue.
X =	Exclusionary screen: fund avoids companies involved with this issue.
"-"	Fund does not screen for this criteria.

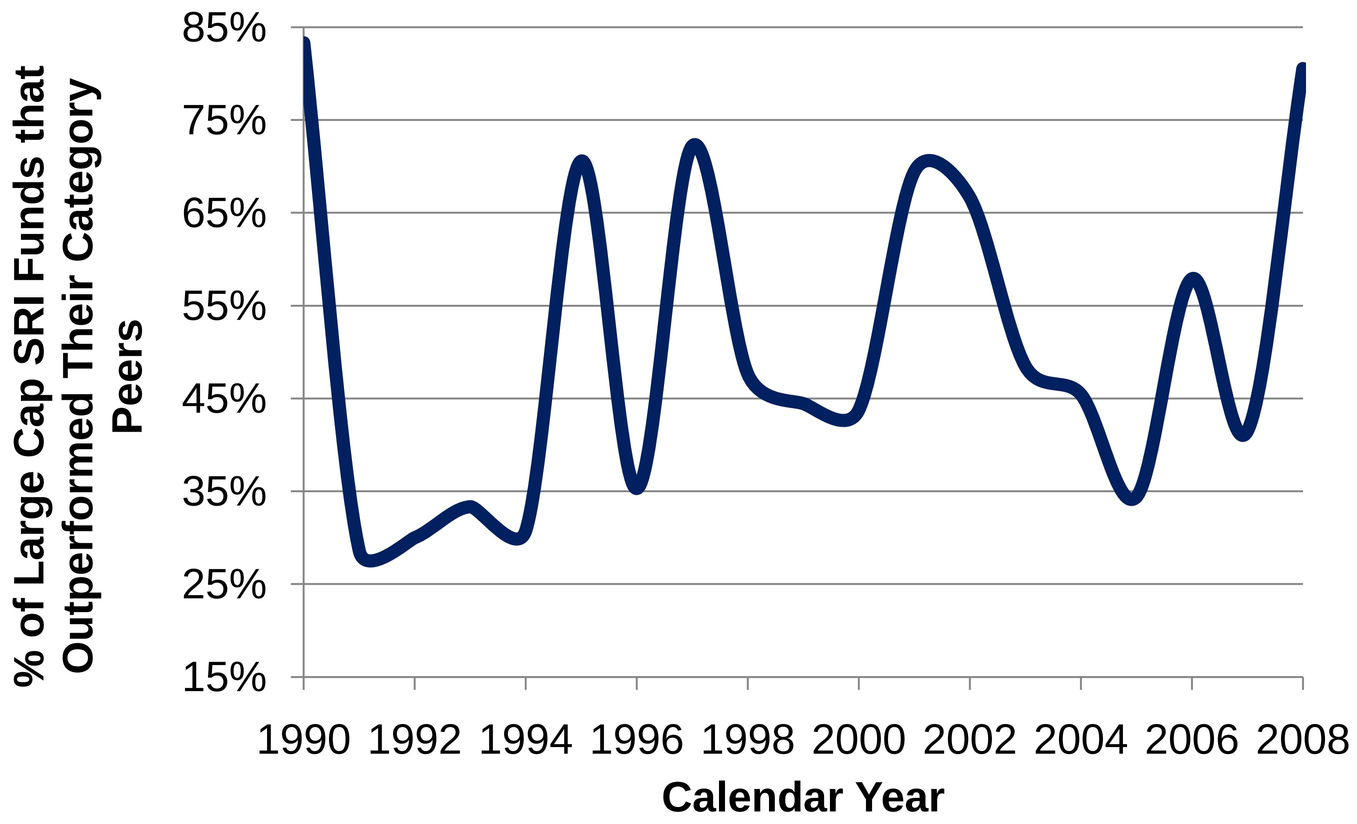
A Riddle

How is that Sin has outperformed but SRI hasn't underperformed?

…My best guess is that the additional screens for other companies "ethical" practices" (i.e., non-tobacco/ guns/alcohol/etc) may have added value to offset the loss of the strong historical return of "sin" securities

Benchmarking SRI Funds

Consistent Inconsistency



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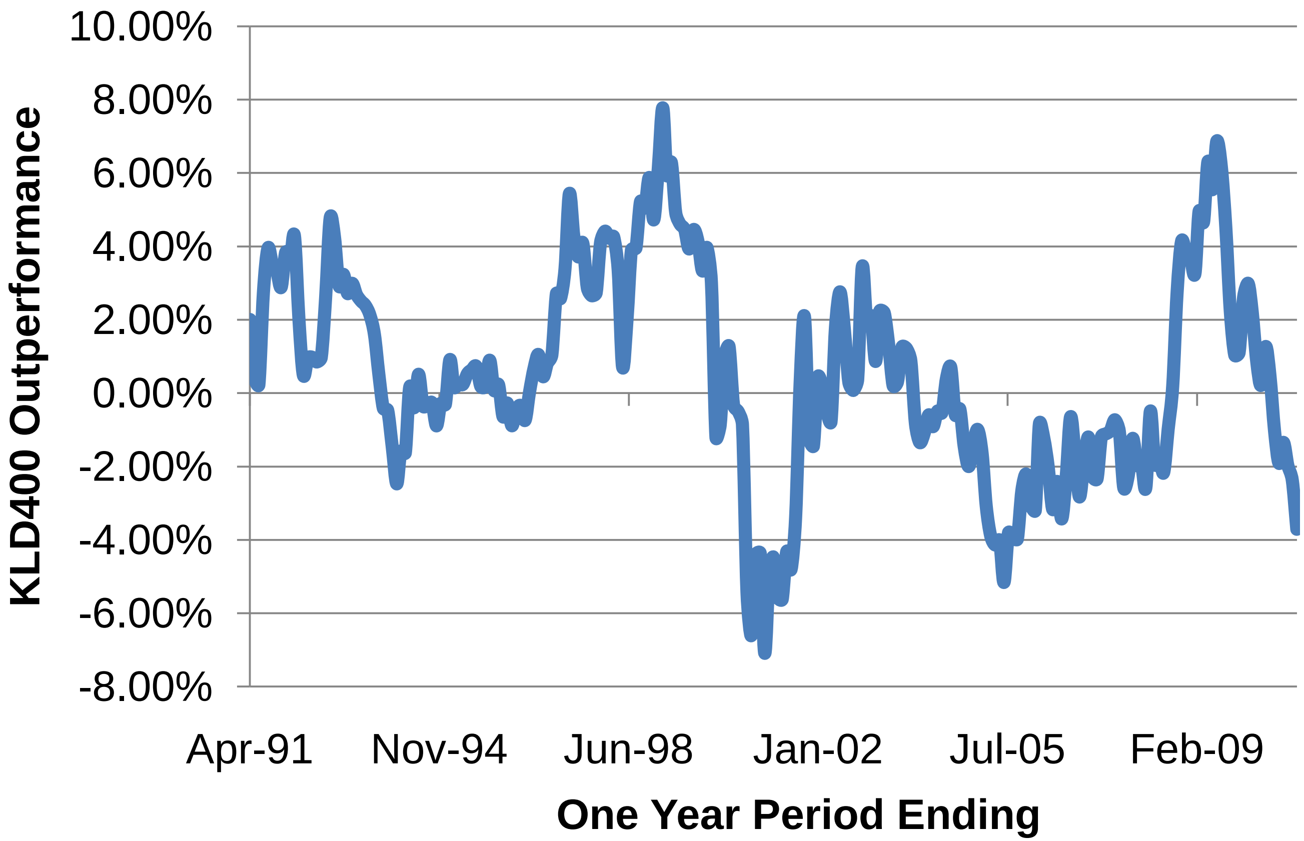
KLD400 vs R1000



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Fiduciary Implications

Richardson (2010) debates whether SRI may also be legally permissible if it fulfills the will of the beneficiaries in a fiduciary relationship.

He argues that by reframing fiduciary finance as an active relationship rather than merely the mechanical application of legal duties, we may allow trustees to invest socially pursuant to the wishes of beneficiaries.

However, there are considerable legal and practical obstacles confront this path to SRI.

401(k) Prudence

The Prudence requirement under ERISA §404(a)(1)(b) states that a Fiduciary:

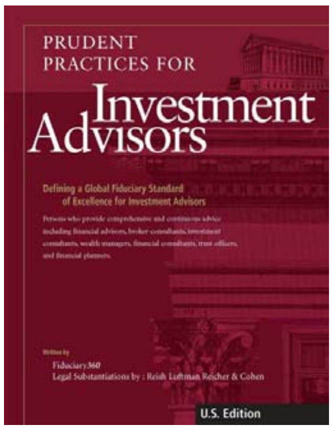
> *Shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.*

DoL Guidance

The U.S. Department of Labor’s Employee Benefits Security Administration (EBSA) stated in a 2008 news release that a plan fiduciary may never increase expenses, sacrifice investment returns, or reduce the security of plan benefits to promote legislative, regulatory, or public policy goals with no connection to the payment of benefits or plan administrative expenses.

“Fiduciary consideration of non-economic factors should be rare and, when considered, must comply with ERISA’s rigorous fiduciary standards” said an EBSA official.

Fi360 Guidance



- "Generally speaking, fiduciary standards of care cannot be abrogated to accommodate the pursuit of a SRI strategy."
- Use as a secondary screen
- For ERISA clients, the key to successfully incorporating an SRI strategy is to demonstrate that prospective investment results are not negatively impacted.

Sample Language for the IPS

The manager is instructed to evaluate all investment options according to objective economic criteria established by the manager and, if there are equally attractive investments, social factors may be considered.

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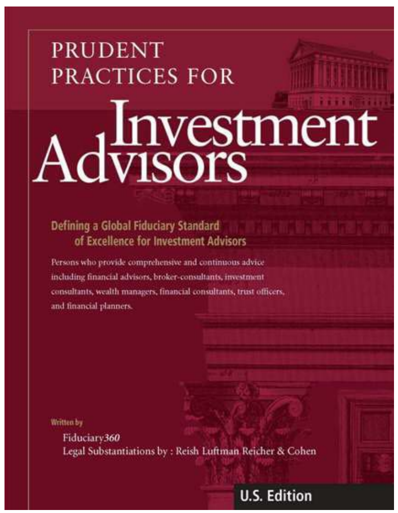
Source: Prudent Practices for Investment Advisors

No SRI Could be a Breach…



In the case of fiduciary clients that fall under the UPIA (personal trusts, foundations, and endowments), failure to consider an SRI strategy could be a breach if:

1. The establishing trust document states use is preferred
2. Donor directs use as a condition of the donation
3. A reasonable person would deduce from the foundation's/endowment's mission that SRI should be considered (i.e., it is reasonable to assume that the American Cancer Society would seek to avoid investing in tobacco companies)

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My Thoughts

SRI funds have different/unique market exposures compared to non-SRI funds

There appears to be little or no cost associated with SRI (those differences)

There have been / can be prolonged periods when SRI funds out or under perform peers

Therefore, a fiduciary may need to consider factors when assessing the "quality" of an SRI investment

Ideal Approach

Ideally, the best metric to compare SRI funds would be a methodology that takes into account the investment's unique characteristics by either creating a sub-sample of SRI funds or using a unique factor when assessing their relative performance.

Given the limited number of SRI investments, though, and the diverse screens employed across SRI investments, it may be difficult to implement an approach using a specific SRI sub-sample.

Therefore, creating a unique SRI factor may be a better approach, since it would allow the user to create a custom factor for different SRI investments.

Thinking Out Loud…

Create a market neutral factor like SMB that captures the expected divergence of fund based on its screens…

Broad versus specific… specific may be what's most often needed

Run a five factor regression

Imperfect solution

401(k) Implementation Thoughts

- If applying standard monitoring criteria what if an SRI fund fails and there is no replacement either available or one that meets the requested SRI/ESG criteria?
- Might not be smart to have just one equity fund as the SRI option
- Using a balanced fund, i.e., the Morningstar Moderate Allocation Category, may be more appropriate

Conclusion

Given the unique considerations with investing in SRI funds, some adjustment needs to be made when determining relative performance versus simply comparing the performance to the category median or traditional benchmark.

Questions?

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