Risk-Adjusted Performance and Socially Responsible Investing

Note: This article is part of a three part series on Socially Responsible Investing (SRI). Part 1 looks at current trends in SRI, and Part 3 looks at SRI investing in the Advisor Perspectives universe.

A key question with respect to Socially Responsible Investing (SRI) is whether these mutual funds can deliver returns that are equal or better than the market, on a risk-adjusted basis. There are many reasons for SRI investing and our purpose here is not to evaluate or pass judgment on those reasons. But we believe it is very important for advisors and investors to understand whether they are making a financial sacrifice, or gaining a financial benefit, from SRI, as these decisions have the potential to significantly impact their financial futures.

With SRI the range of potential investments is restricted, either through positive selections or negative screening. Investment theory suggests that these restrictions, and the smaller set of securities from which to select, should lead to either higher risk or lower returns, and researchers have sought to quantify the cost of socially responsible investing in this context.

Fortunately, this is a topic that has been studied extensively. A paper by three European researchers (Luc Renneboog, Jenke ter Horst, and Chendi Zhang), just released in June of 2007, provides extensive data on this very question. Their conclusion, which concurs with that of other researchers, is that "there is little evidence that risk-adjusted returns of SRI funds are different from those of conventional funds."

To arrive at this conclusion, Renneboog et. al. looked at the data from three perspectives:

(1) Risk-adjusted returns of SRI funds – Renneboog et. al. cite a study[1] that compared the performance of SRI funds to non-SRI funds. This study, covering 32 SRI funds and 320 randomly-selected non-SRI funds, over the period 1981-1990, showed that the two groups had alphas that were similar, with a difference that was not statistically significant. Another study[2], covering 31 SRI funds and 62 non-SRI funds, over the period 1990-1998, reached essentially the same conclusion – there is no statistically significant difference in risk-adjusted returns between the two groups of funds.

(2) Diversification cost of investing in SRI funds – In addition to understanding the risk-adjusted return implications of SRI investing, advisors must also understand whether there is a cost due to lack of diversification: If an investor chooses to invest only in SRI funds, what impact will this have on the overall diversification of their portfolio? Renneboog et. al. cite a study which looked at constructing an optimal portfolio using 35 SRI funds, versus using 894 non-SRI funds, over the time period 1963-2001. The result is that there are "significant financial costs of imposing the SRI constraint on mean-variance optimizing investors." In laymen's terms, an SRI-only investor cannot get as good a risk-return tradeoff as a non-SRI investor – SRI investors cannot get as close to the efficient frontier as non-SRI investors. To quantify this cost, the study suggests that passive (index) investors might incur a penalty of just 5 basis points per month. For investors that do not believe they can identify skillful active managers, but do believe that inefficiencies exist with respect to size, value, and momentum factors, the penalty is approximately 30 basis points per month. But for active investors that believe in identifying skillful managers, the penalty is more than 1.5% per month.

(3) Impact of investment screen on SRI performance – Renneboog et. al. note that the above results look at SRI funds in general, but do not differentiate between funds with different screens. They note that few academic studies have looked at this question. They cite one study[3] which looked at 29 equity SRI funds over the time period 1981-1997, which showed that funds using positive screens outperform those that do not by 70 basis points per month, at a statistically significant level.

The third question – the impact of specific screens – has been investigated more recently by Anne-Marie Anderson and David Myers of Lehigh University. We spoke with Professor Myers about his research. Myers research shows that there is no statistically significant cost (loss of return) to utilizing most positive screens, with the exception of those screens that resulted in portfolios of ten of fewer stocks – these portfolios could not achieve adequate diversification. As long as the resulting portfolio has at least 50-100 securities, Myers concludes that "socially responsible investing does not come at a cost."

Some other interesting observations from the Renneboog et. al. paper include:

- There is evidence that SRI investors are motivated by non-monetary concerns. While this point should be intuitively obvious, the interesting observation is the supporting data – for example, during the market downturn of the first nine months of 2001, there was a 94% drop in money inflows into all US mutual funds, but only a 54% drop in inflows to SRI

funds. This implies that SRI funds are 'stickier' and less likely to shift in response to market movements.
- The volatility of money flows in SRI funds is lower than that of non-SRI funds. Flows are less likely to be affected by negative past performance, but more likely to be affected by positive past performance, as compared to non-SRI funds.
- Fund flows are also affected by the number of screens employed by SRI funds. Funds employing more screens attract more funds.
- Interestingly, SRI fund flows are less sensitive to expenses and load fees than non-SRI funds. Renneboog et. al. hypothesize that this may attract new entrants into the SRI management arena, eyeing the opportunity to earn enhanced fees.
- The SRI funds attracting the most flows are not the ones generating the higher returns. As with non-SRI funds, there investors can expect a decrease in returns as the size of the fund grows. SRI investors may not be smart in their ability to reallocate their funds at the appropriate times.
- The number of SRI screens used seems to improve performance. An SRI fund with eight or more screens outperforms a fund with only a few screens by 4.6% per year, all else being equal.
- The average expense ratio of SRI funds is higher than non-SRI funds (1.33% v. 1.10%)
- Annual turnover in SRI funds is lower than non-SRI funds (81.5% v. 175.4%)
- SRI funds are smaller than non-SRI funds (average AUM of $149 v. $257 million)

Renneboog et. al. also looked at SRI investing outside the U.S. and advisors interested in those findings should consult their paper, cited above.

In conclusion, the key findings are that SRI investing does not impose a cost on the investor, on a risk-adjusted basis. Advisors should be particularly mindful of the research on passive versus active SRI investing, as it shows that passive SRI investing results in markedly superior risk-adjusted results. Advisors should also be aware of the findings on the diminishing returns in SRI funds, as the size of a fund grows, and should monitor these parameters over time and reallocate funds as necessary.

Advisors interested in more research on this topic should consult www.sristudies.org, which is a site managed by Lloyd Kurtz, a fund manager and Research Fellow at the Haas Business School at Berkeley, CA. The Haas School houses the Center for Responsible Business, which administers the Moskowitz Research Program which, among other things, awards an annual prize that recognizes outstanding quantitative research in the field of SRI.

Notes:

(1) Hamilton, S., H. Jo and M. Statman, 1993, Doing well while doing good? The investment performance of socially responsible mutual funds, Financial Analysts Journal 49 (6), 62-66.

(2) Statman, M., 2000, Socially responsible mutual funds, Financial Analysts Journal 56 (3), 30-39.

(3) Goldreyer, E. F., P.Ahmed, and J. D.Diltz, 1999, The performance of socially responsible mutual funds: Incorporating sociopolitical information in portfolio selection, Managerial Finance 25, 23–36.