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Style and performance of international socially responsible funds in Europe

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This paper analyses the performance and investment styles of internationally oriented Socially Responsible Investment (SRI) funds, domiciled in eight European markets, in comparison with characteristics-matched conventional funds. To the best of our knowledge, this is the first multi-country study, focused on international SRI funds (investing in Global and in European equities), to combine the matched-pairs approach with the use of robust conditional multi-factor performance evaluation models, which allow for both time-varying alphas and betas and also control for home biases and spurious regression biases.

In general, the results show that differences in the performance of international SRI funds and their conventional peers are not statistically significant. Regarding investment styles, SRI and conventional funds exhibit similar factor exposures in most cases. In addition, conventional benchmarks present a higher explaining power of SRI fund returns than SRI benchmarks. Our results also show significant differences in the investment styles of SRI funds according to whether they use "best-in-class" screening strategies or not. When compared to SRI funds that employ simple negative and/or positive screens, SRI "best-in-class" funds present significantly lower exposures to small caps and momentum strategies and significantly higher exposures to local stocks.

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1. Introduction

The considerable growth of socially responsible investments around the world has motivated an intense debate on the implications of incorporating social and ethical criteria in the portfolio selection process. The issue of whether it is possible to "do well by doing good" has attracted the attention of academics worldwide, in an attempt to provide evidence if the use of social screens comes at the cost of financial performance or if it enhances the opportunities for higher returns. In particular, a strand of the literature has focused on the performance of SRI mutual funds versus conventional funds.

Theoretically, there are arguments put forward both in favour of SRI mutual fund under and over-performance relative to conventional funds. One view follows from portfolio theory (Markowitz, 1952), according to which portfolios formed on the basis of a restricted universe of investments will be unable to diversify appropriately. As a consequence, the risk-adjusted performance of these funds will be penalised relative to conventional funds. Additionally, the costs associated to the screening and monitoring process of socially responsible funds will also contribute to their lower performance.

A second view argues that portfolios of socially responsible stocks will benefit from higher financial performance. The underlying argument is that the screening process results in the identification of firms that are actively engaged in Corporate Social Responsibility (CSR) and therefore represent better investment opportunities. In this context, social filters are tools for selecting companies with higher management quality (Bollen, 2007). This viewpoint, also known as "good management theory" (Waddock and Graves, 1997), is consistent with stakeholder theory (Freeman, 1984), according to which the integration of all stakeholders' interests creates value for shareholders, and suggests that performing well along several dimensions of social responsibility will result in higher financial performance.

Pioneered by the seminal paper of Moskowitz (1972), the relationship between corporate social and financial performance at the firm level has been extensively explored. Although empirical research over four decades has produced somewhat conflicting results, some meta-analysis studies (e.g., Margolis and Walsh, 2003; Orlitzky et al., 2003; Margolis et al., 2009) indicate a tendency for a positive link between corporate social and financial performance. One must note, though, that even if a positive relationship between corporate social and financial performance exists, it does not necessarily imply that the performance of mutual funds that select stocks of socially responsible companies will be higher than that of conventional funds (Mill, 2006). First, tests of mutual fund performance are joint tests on the quality of the fund management and the performance of the underlying assets (Schröder, 2004). Second, the selection process of conventional funds grants them the same opportunities of benefiting from a good performance of socially responsible companies (Mill, 2006). Additionally, the distinct characteristics associated to typical investment policies from both categories of funds constrains their potential for diversification, the prosecution of active management strategies (e.g., timing and selectivity) and transaction costs, which can be reflected in differentiated performance.

Most empirical studies conducted so far on the performance of SRI funds, covering many worldwide markets, have not found statistically significant differences between the performance of SRI and conventional funds.[2] In this way, the inclusion of ethical restrictions into a fund's investment policy does not seem to penalise nor improve portfolio performance.

However, most of extant studies focus on funds that invest in their domestic markets. The performance of internationally oriented SRI funds is a far less explored issue,[3] but undoubtedly a very interesting one. In fact, one the main arguments that is used in favour of SRI fund underperformance is related to their restricted investment universe. In this context, as Cortez et al. (2012) point out, international diversification may help SRI funds achieve additional diversification benefits, which can be reflected on their performance.

[2] See, for example, Gregory et al. (1997) and Gregory and Whittaker (2007) for the UK market, Hamilton et al. (1993) and Statman (2000) for the US market, Bauer et al. (2007) for the Canadian market, Bauer et al. (2006) for the Australian market and Scholtens (2005) for the Dutch market.

[3] A few recent single-country studies that include internationally oriented SRI funds are Chang and Witte (2010), in relation to the US market, Amenc and Le Sourd (2010) and Le Sourd (2010), in relation to the French market, and Gregory and Whittaker (2007), in relation to the UK market.