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Solving the SRI puzzle? A note on the mainstreaming of ethical investment

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ABSTRACT

Previous research on the relationship between societal and financial performance has yielded ambiguous results. This letter seeks to put forth an explanation for this puzzle. We argue that the difference in returns between ethical and conventional indices may, in fact, be insignificant due to the 'mainstreaming' of ethical investment. Using a database of 24 international indices over the 2008–2014 time periods, we calculate rolling daily returns, develop a robust test for difference in Sharpe ratios, and compare alfas across EGARCH asset pricing models with endogenous volatility breakpoints. Results converge to indicate no significant difference in financial performance between conventional and ethical indices. This validates the 'mainstreaming' hypothesis and opens avenues for future research.

1. Introduction

Socially responsible investment (SRI) has now become a global financial industry. According to Morgan Stanley, the capitalization of global SRI amounted to 13.6 trillion US$ in 2012, accounting for 22% of global assets (and 65% of European assets). The financial performance of SRI products relative to conventional financial products has been widely debated over recent years, with most research falling into one of the following two categories. On the one hand, modern portfolio theory argues that the extra-financial screening of assets is detrimental to portfolio diversification: allocating investment on the basis of social and environmental criteria amounts to shifting the minimum variance frontier to the left (Lagoarde-Segot 2011). On the other hand, management scholars argue that socially responsible firms tend to be more innovative, more cost-efficient, attract and retain more qualified personnel, and thereby post higher profits. A branch of empirical research therefore indicates that 'socially responsible' stocks tend to generate higher alfas than conventional ones (Epstein and Roy 2001).

The above controversy has been the object of much empirical analysis over recent years. However, the literature, taken as a whole, has yielded inconclusive results. In a meta-analysis covering 61 articles, Revelli and Viviani (2015) highlighted that the sign and significance of the observed effect depend on ad hoc factors, such as sample choice and econometric methodology. The link uniting social responsibility and financial performance hence remains to be elucidated.

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Table 1
Database.

Market	Country	Indexe type	Index name	Ticker
Developed	Australia	Conventional	MSCI Australia	MXAU
		Islamic	MSCI Australia Islamic	MIAU
		SRI	MSCI Australia SRI	MXAUSI
	Canada	Conventional	MSCI Canada	MXCA
		Islamic	MSCI Canada Islamic	MICA
		SRI	MSCI Canada SRI	MXCASI
	Japan	Conventional	MSCI Japan	M3JP
		Islamic	MSCI Japan Islamic	MIJP
		SRI	MSCI Japan SRI	MXJPSI
	U-K	Conventional	MSCI United Kingdom	M3GB
		Islamic	MSCI United Kingdom Islamic	MIGB
		SRI	MSCI United Kingdom SRI	MXGBSI
	United-States	Conventional	MSCI USA	MXUS
		Islamic	MSCI USA Islamic	MIUS
		SRI	MSCI USA SRI	MXUSSI
Emerging	Brazil	Conventional	MSCI Brazil	MXBR
		Islamic	MSCI Brazil Islamic	MIBRO
		SRI	MSCI Brazil ESG	MXBRSI
	India	Conventional	MSCI India	MXIN
		Islamic	MSCI India Islamic	MIIN
		SRI	MSCI India ESG	MXINSI
	South Africa	Conventional	MSCI South Africa	M3ZA
		Islamic	MSCI South Africa Islamic	MIZA
		SRI	MSCI South Africa ESG	M3ZASI

This letter seeks to offer a potential explanation for this puzzle. We argue that the difference in performance between SRI and conventional portfolios may, in fact, be insignificant due to the 'mainstreaming' of ethical investment. We borrow the term 'mainstreaming' from the microfinance literature (Gimet and Lagoarde-Segot, 2014) and define it as a *double process of upstreaming 'ethical stocks' into conventional indices and portfolios, and 'downstreaming' conventional stocks into ethical indices and portfolios*. The potential impact of mainstreaming on the difference in returns is discussed below.

The 'upstreaming' of ethical assets refers to the fact that all constituents of SRI indices are included in conventional indices. SRI assets actually make up a large proportion of the market capitalization of their parent indices.[1] It follows that such assets are traded by both 'ethical' and 'conventional' portfolio managers. Consequently, the rates of returns (excluding dividends) of the individual constituents of SRI and parent indices should be very similar. Other things equal, any difference in portfolio returns – positive or negative – should result from different portfolio weights, rather than different constituent performance.

Nevertheless, the impact of different portfolio weights effect is mitigated by the 'downstreaming' of conventional stocks into SRI indices. Indeed, most SRI indices (such as MSCI indices) are constructed using a *best in class* screening methodology (as opposed to exclusion screening).[2] This approach allows portfolio managers to include all sectors (including high environmental footprint sectors such as mining, fossil energy, fast food, etc…) in SRI portfolios. The rationale for using this methodology is to achieve a level of sectoral diversification compatible with pre-established financial performance targets.

In addition, most SRI indices are designed to cover at least 50% of each sector's market capitalization in the parent index. In cases where social ratings requirements do not permit to meet this capitalization target, *ad hoc* companies are added to the SRI portfolios. Index factsheets do not provide any information regarding how these added companies are selected. Taken together, these observations suggest that 'downstreaming' allow SRI portfolio managers to eliminate a large portion of screening-related potential diversification losses.

The alternative argument is that SRI indices outperform conventional investment due to smarter managerial models of the constituent companies. The management literature has indeed established this to be true on a case by case basis. Nonetheless, we argue that this relationship may not necessarily translate into higher returns for SRI portfolios, for three main reasons. First, downstreaming blurs the border between 'conventional' and 'socially responsible' assets: as discussed above, *best in class* screening methods imply that inclusion in an SRI index does not always signal societal performance strictly defined. Second, societal performance is difficult to ascertain due to the current lack of a coherent, unified and integrated international framework for extra-financial performance reporting (Sharfman 1996). Relevant data is scarce, unevenly distributed, and imprecise, which sometimes lead SRI portfolio managers to adopt opaque, 'in house' classification systems (Lagoarde-Segot, 2014). Third, the management literature has identified many cases of greenwashing, whereby corporations attempt to cover up poor social and environmental performance through large scale communication programs, resulting in

[1] 90% of the *Fortune Global 500* companies are included in SRI indices (Hawken 2004).
[2] See, for instance, MSCI's screening methodology: http://www.msci.com/resources/factsheets/MSCI_USA_ESG_Index.pdf.