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Socially responsible, green, and faith-based investment strategies: Screening activity matters!

Kathrin Lesser, Felix Rößle, Christian Walkshäusl*

University of Regensburg, Center of Finance, Universitätsstraße 31, 93053 Regensburg, Germany

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Analyzing more than 200 internationally-investing sustainably screened funds, we find that socially responsible, green, and faith-based investments have to be considered as different approaches within the broader field of sustainable investing. While socially responsible and green funds tend to underperform in non-crisis markets, faith-based funds perform similar to the market and their conventional peers during any market state. We provide evidence that the funds' specific screening activity significantly impacts the financial performance of sustainable investing vehicles in international markets. In particular, social screens lead to the underperformance of socially responsible funds, while energy screens drive the performance of green funds.

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1. Introduction

Sustainable investing has a significant scale in the global financial markets. The Global Sustainable Investment Alliance (2012) argues that, globally, at least 13.6 trillion U.S. dollars' worth of professionally managed assets incorporate sustainable concerns into their investment selection and management, representing 21.8% of the total assets managed professionally.

In early studies, all kinds of sustainably screened funds were referred to as socially responsible funds and analyzed as one homogenous group. The empirical finding that such funds do, on average, not perform

* Corresponding author. Tel.: +49 9419432729.
E-mail addresses: kathrin.lesser@ur.de (K. Lesser), felix.roessle@ur.de (F. Rößle), christian.walkshaeusl@ur.de (C. Walkshäusl).

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significantly different to the market has become common knowledge (see, Renneboog et al. (2008a) for an overview). In the past few years, however, green and faith-based investments have emerged as new investment strategies within the broader field of sustainable investing (e.g., Lyn and Zychowicz, 2010; Climent and Soriano, 2011; Areal et al., 2013). Muñoz et al. (2014) are the first study explicitly examining the financial performance of socially responsible, green, and faith-based funds separately. In particular, they analyze the financial performance of these three approaches during different market states. Based on the four-factor model of Fama and French (1993) and Carhart (1997), Muñoz et al. (2014) find that U.S. socially responsible, green, and faith-based strategies perform similar to the market in crisis periods, but underperform in non-crisis periods. Thus, their results reveal huge performance differentials between different market regimes.

While socially responsible funds predominantly screen for firms with high environmental, social, and governance practices, green funds are characterized by firms that are active in industries as alternative fuels, clean technologies, renewable energies, and waste management, amongst others. Faith-based funds, on the other hand, represent funds that are composed in line with Islamic, Catholic, and other religion's law. Previous literature argues that screening activity considerably impacts the performance of screened investments (e.g., Renneboog et al., 2008b; Capelle-Blancard and Monjon, 2012). Most recently, Nofsinger and Varma (2014) analyze U.S. funds that incorporate environmental, governance, or social screens separately and find that different screening foci lead to different financial performance.

Investigating a comprehensive sample of internationally-investing socially responsible, green, and faith-based equity funds during different market regimes, we aim to extend the findings of both Muñoz et al. (2014) and Nofsinger and Varma (2014) to international markets. In particular, we intend to contribute to the literature by examining the financial performance of the three approaches relative to the market and their conventional peers during crisis and non-crisis periods and by exploring the impact of screening activities on the financial performance afterwards. To do so, we apply standard and novel multi-factor performance measurement models. Besides the state-of-the-art four-factor model, we employ the quality factor model of Asness et al. (2013) and the q-theory factor model of Hou et al. (2015) that incorporate the firm's quality, investment, and profitability into the asset pricing process.

The remainder of the paper is organized as followed. Section 2 provides information on our data and the methodologies. Section 3 reports our empirical results. In Section 4, we present some concluding remarks.

2. Data and methodology

2.1. Summary statistics

To investigate the financial performance of socially responsible, green, and faith-based investment vehicles, we analyze 213 internationally-investing equity funds in a period from January 2000 to December 2012.[1] All performance-based data, denominated in U.S. dollars, are taken from Datastream, holdings data are taken from Morningstar and the fund's annual reports, respectively. Taking into account the latest trends in research, we focus on analyzing separate crisis and non-crisis period alpha estimates (see Muñoz et al. (2014) and Nofsinger and Varma (2014)). During the period from January 2000 to December 2012, we identify two crisis periods in the international stock market based on the peak and trough of the MSCI AC World Index. The first crisis period is from March 2000 to October 2002, and is characterized by the technology bubble burst. The second crisis period is from October 2007 to March 2009 and represents the global financial crisis.

Table 1 presents summary statistics for the socially responsible, green, and faith-based funds. The table reports monthly performance data over crisis and non-crisis markets and several fund characteristics, including the average number of constituents, the average constituent market capitalization in million U.S. dollars, the average total net assets in million U.S. dollars, and the average total expense ratio.

[1] To provide a reasonable sample and ensure that there is no country-specific and in particular no U.S. bias in our data, we controlled the country allocation of our funds by checking the prospectus of each fund. Furthermore, we explicitly searched for dead funds to avoid a survivorship bias.

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