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Performance of European socially responsible funds during market crises: Evidence from France

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ABSTRACT

This paper investigates the performance, investment styles and managerial abilities of French socially responsible investment (SRI) funds investing in Europe during crisis and non-crisis periods. Our results show that SRI funds significantly underperform characteristics-matched conventional funds during non-crisis periods, but match the performance of their peers during market downturns. The underperformance of SRI funds during good economic states is driven by funds that use negative screens, since funds that use only positive screens perform similarly to conventional funds across different market conditions. SRI and conventional funds show significant differences in risk exposures during non-crisis periods but exhibit much more similar investment styles during crises. Furthermore, we find little evidence of significant differences in managerial abilities during bad economic states. Yet, during non-crisis periods, SRI and conventional fund managers exhibit significantly different style-timing abilities and these differences are also related to screening strategies.

1. Introduction

Most empirical studies regarding the performance of Socially Responsible Investment (SRI) funds show that they tend to exhibit similar performance to their conventional peers. Despite this general conclusion, extant studies usually analyse SRI fund performance throughout an entire evaluation period without distinguishing performance in different market states. The comparison of fund performance across different market conditions has been addressed and found relevant by some studies on the performance of conventional funds (e.g., Glode, 2011; Kacperczyk, Van Nieuwerburgh, & Veldkamp, 2014; Kosowski, 2011; Wang, 2010). With respect to SRI funds, this issue is even more relevant, particularly considering the high growth of this type of funds during the latest financial crisis. In fact, according to Vigeo (2012), during the period of 2007 to 2010 the number of European SRI funds increased from 437 to 879, which represents an impressive growth rate of 101%, and assets under management grew from €48.74 billion to €75.27 billion. During the same time span, the number of SRI funds in the US has increased from 260 to 497, while assets under professional management grew from $202 billion to $569 billion (SIF, 2012). Additionally, there are arguments in favour of SRI funds performing better than conventional funds in times of crisis. Indeed, as pointed out by Areal, Cortez, and Silva (2013), we might question whether the higher reputation of socially responsible companies might protect their stocks from general price declines in times of crisis. If so, in downturn periods portfolios of socially responsible stocks should yield better performance relative to unscreened portfolios.

However, empirical evidence on the performance of SRI funds during crisis and non-crisis periods is scarce and mostly focused on the US market (e.g., Areal et al., 2013; Nofsinger & Varma, 2014). Since this research topic remains practically unexplored in the context of European fund markets, the main contribution of this paper is to fill this gap by comparing the performance of French SRI funds that invest in European markets relative to characteristics-matched conventional funds across different market states.

We focus on the French market because it is currently the leading European SRI fund market both in terms of number of funds and assets under management. Recent statistics show that, from 1999 to 2012, the weight of the UK SRI market on the total European assets under management has decreased from 42% to 14%, while the weight of the French market has increased from 1% to 44% (Vigeo, 2012). In the period of 2007 to 2012 alone, despite very difficult times for the financial markets, the growth rate of SRI assets under management in France reached 361%, rising from €8.9 billion to €41 billion. The dynamics of the French SRI market is also reflected in the number of SRI funds, which grew

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173% in just five years, from 93 in June 2007 to 254 in June 2012.[2] Yet, despite its size and importance, the French market has not received much attention in the SRI fund performance literature. The only studies that we are aware of that focus on the performance of French SRI funds are those of Le Sourd (2010) and Amenc and Le Sourd (2010). However, besides some methodological limitations, these studies only evaluate the performance of SRI funds in relation to market indices, without comparing them to conventional funds.[3]

Moreover, recent studies on SRI funds (e.g., Areal et al., 2013; Nofsinger & Varma, 2014) suggest that different types of screens do impact fund performance differently across crisis and non-crisis periods. We also address this issue that is especially relevant because screening practices vary considerably from one country to another. As pointed out by Renneboog, Horst, and Zhang (2008, 2011), while US and UK funds are considerably more focused on negative screens, intended to exclude companies from SRI portfolios, SRI funds in continental Europe use mostly positive screens and, in particular, "best-in-class" screening strategies that consist of selecting leader companies on environmental or Corporate Social Responsibility (CSR) issues within each sector. In this context, the French market is quite appealing to researchers because it is by far the European SRI fund market where "best-in-class" strategies are used to a larger extent (EUROSIF, 2012).

Besides evaluating performance, another contribution of this paper is to investigate and compare the investment styles of French SRI and conventional funds across crisis and non-crisis periods. For this purpose, we use a multi-factor performance evaluation model that extends the one proposed by Nofsinger and Varma (2014) by allowing not only performance but also risk exposures to vary across different market states. Additionally, our model also controls for potential home biases in portfolio composition, a common finding in studies involving SRI funds investing internationally (e.g., Bauer, Otten, & Rad, 2006; Cortez, Silva, & Areal, 2012; Gregory & Whittaker, 2007; Leite & Cortez, 2014b).

Another issue we address is the decomposition of fund performance into selectivity and timing abilities and, in particular, how these managerial abilities are related to different market states and screening strategies. We investigate not only market timing but also style-timing abilities during crisis and non-crisis periods, which is a research topic that remains largely unexplored in European SRI fund markets.

In this way, we contribute to the international mutual fund performance literature by performing a comprehensive investigation of the performance, investment styles and managerial abilities of 40 French SRI funds investing in European equities, compared to 120 characteristics-matched conventional funds, during the crisis and non-crisis periods that occurred from January 2001 to December 2012. Additionally, we analyse if different screening strategies lead to significant differences in terms of performance and risk exposures across different market states.

The paper is organized as follows: Section 2 presents a brief literature review on mutual fund performance across different market states. Section 3 describes the methodology for identifying crisis periods, as well as the performance and timing models used. Section 4 describes the data. Section 5 presents and discusses the empirical results and Section 6 summarizes our main findings and presents some concluding remarks.

2. Literature review

The literature on the performance of SRI funds has increased considerably over the last decade, following the development of SRI fund markets around the world. Theoretically, two competing arguments attempt to explain the type of impact social screens have on the financial performance of investment portfolios. On the one hand, modern portfolio theory posits that portfolios constructed on the basis of a restricted universe of stocks will yield lower risk-adjusted returns. On the other hand, supporters of SRI claim that the use of social screens allows fund managers to identify and select companies with better management skills (e.g., Bollen, 2007), ultimately improving portfolio performance.

Most empirical studies in the finance literature show no statistically significant differences between the performance of SRI and conventional funds in many world markets (e.g., Bauer, Derwall, & Otten, 2006, 2007, Bauer et al., 2006; Gregory & Whittaker, 2007; Leite & Cortez, 2014b; Scholtens, 2005; Statman, 2000), suggesting that the inclusion of ethical criteria in funds' investment policies seems to have no impact on performance. The vast majority of these studies, though, do not distinguish performance across different market states, despite recent evidence showing that conventional mutual funds perform differently across different market states. Indeed, Wang (2010), Glode (2011) and Kosowski (2011) show that conventional mutual funds tend to perform better during recessions than during expansion periods, suggesting that fund managers' abilities may be state-dependent. This argument is reinforced by Kacperczyk et al. (2014) that show that skilled fund managers exhibit better selectivity abilities during expansions and better timing abilities during recessions. A possible explanation for these findings is that mutual fund managers may increase their efforts to deliver higher performances when investors' marginal utility of consumption is high, i.e., during bad states of the economy (Glode, 2011). Other explanations for time-varying performance relate to the possibility of managers' risk shifting incentives being state-dependent (Wang, 2010) or to fluctuations in managers' attention allocation (Kacperczyk et al., 2014).

Nevertheless, empirical evidence on the performance of SRI funds across different market conditions is scarce. Areal et al. (2013) study the performance of religious, socially responsible and irresponsible[4] US funds, based on a Markov-switching conditional model. Their results show that different kinds of ethical screens seem to lead to different performance patterns across different market regimes. However, they do not compare the performance of SRI and conventional mutual funds. In turn, Nofsinger and Varma (2014) show that US SRI funds outperform conventional funds with similar characteristics during crisis periods and underperform them during non-crisis periods. Additionally, they also find that the outperformance of SRI funds during crisis periods is driven by funds that use positive screens, in particular those related to Environmental, Social and Governance (ESG) issues, whereas funds using negative screens, such as "sin" screens or faith-based screens, do not exhibit a similar performance pattern. In this way, their results support the idea that SRI funds offer some additional protection to investors in times of crisis.

In relation to European markets, the performance of SRI funds across crisis and non-crisis periods is a research topic that is largely unexplored. The only contributions we are aware of are the studies of Muñoz, Vargas, and Marco (2014) and Becchetti, Ciciretti, Dalò, and Herzel (2015). Muñoz et al. (2014) focus on environmental/green mutual funds, which are a very specific subset of SRI funds. Therefore, they do not compare the performance of typical European SRI funds with that of conventional funds across different market states. Becchetti et al. (2015) compare the performance of SRI and conventional funds from several markets in the Morningstar investment funds universe. Their results show that SRI funds played an insurance role during the 2007 global financial crisis,

[2] Another important aspect to mention is that France was the first European country to make ethical reporting mandatory. In fact, since 2001, all listed companies in France must publish information regarding their ESG initiatives in their annual reports. Besides, recently approved laws (specifically, the "Grenelle II de l'environnement" Law) require asset managers to describe in their annual reports and on their websites how ESG criteria is taken into consideration in their investment policy and which funds are concerned (EUROSIF, 2012).

[3] There are also a few multi-country studies that include SRI funds domiciled in France as part of a larger sample (Cortez, Silva, & Areal, 2009; Leite & Cortez, 2014b; Renneboog et al., 2008).

[4] Areal et al. (2013) consider one irresponsible fund: the "Vice Fund".