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## Socially responsible funds and market crises

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## ABSTRACT

Compared to matched conventional mutual funds, socially responsible mutual funds outperform during periods of market crises. This dampening of downside risk comes at the cost of underperforming during non-crisis periods. Investors seeking downside protection would value the asymmetry of these returns. This asymmetric return pattern is driven by the mutual funds that focus on environmental, social, or governance (ESG) attributes and is especially pronounced in ESG funds that use positive screening techniques. Furthermore, the observed patterns are attributed to the funds' socially responsible attributes and not the differences in fund portfolio management or the characteristics of the companies in fund portfolios.

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## 1. Introduction

Sustainability requires that organizations strive for financial success while accepting responsibility for their impact on society and relationships with a diverse group of stakeholders (AON, 2007). One of the key drivers behind sustainability practices is the increasing investor demand for socially responsible investing (SRI) strategies, which includes ethical investing and green investing. SRI funds historically began by excluding firms producing socially undesirable products (sin stocks) like alcohol, tobacco, weapons, gambling, etc. As this niche of the investment industry developed, money managers began incorporating environment, social, and governance (ESG) factors into their investment analysis, decision-making, and portfolio construction. While there is much literature on whether investors pay a price for investing in socially responsible investments funds or obtain superior returns, we specifically explore if SRI fund managers add value by delivering superior performance during periods of economic crisis/stress. In other words, we test if SRI funds limit downside risk, particularly relevant during crisis periods. Controlling for various fund characteristics, we attempt to further understand the role of SRI

fund foci (ESG and Product related) and screening strategies (positive versus negative) in relation to performance of socially responsible funds during crisis and non-crisis periods.

Renneboog et al. (2008a) and others report that investors largely do pay a cost for ethics. And yet, the SRI industry has grown substantially over time. The USSIF (2010) report finds that professionally managed assets following SRI strategies grew by 380% since 1995 to \$3.07 trillion in 2010. In comparison, the broad universe of professionally managed assets grew by 260% to \$25.2 trillion in 2010. Even during the financial crisis (2007–2009), the broad universe of professionally managed assets remained roughly flat, while assets using SRI strategies enjoyed healthy growth of more than 13%. To explain the increasing popularity of SRI when it mostly generates negative abnormal returns, Statman (2004) and Bollen (2007) argue that investors must gain some utility from the externalities of investing in a manner consistent with their beliefs. Hood et al. (2013) empirically link individual investors' ownership of firms with socially and religiously expressive characteristics.

We propose another explanation. Although SRI investing may generate negative abnormal returns over time, they hold up better during market crisis periods. That is, the nature of SRI and ESG dampens the downside risk. Companies that exhibit environment, social, and governance responsibility are less likely to suffer large, negative events in ESG areas during both bull and bear market periods. For example, disastrous pollution events are less

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likely in firms with strong environmental green programs. Firms with high social concerns are less likely to undergo employee-related lawsuits. These socially responsible firms may find themselves suffering less from legal prosecutions and fines and enjoying more stable relations with communities and governments, including regulators (McGuire et al., 1988; Maxwell et al., 2000; Innes and Sam, 2008). Though these costs lag the negative events themselves, stock prices in efficient markets would react in advance. Also, Verwijmeren and Derwall (2010) find that firms with high measures of employee satisfaction exhibit lower bankruptcy risk. Lastly, strong corporate governance practices are perceived to be associated with lower corporate agency costs, thus laws like Sarbanes–Oxley Act are enacted after every period of corporate malfeasance (see Romano, 2005). While these aspects of lower risk occur all the time, investors tend to pay greater attention to them during bad economic times. Specifically, in Hirshleifer's (2008) legal psychological attraction theory and Shefrin and Statman's (1993) liberalism/paternalism pendulum, people take more notice of negative corporate behaviors during the poor economic times than in the good times. Therefore, investors, politicians, regulators, etc. have more attention on downside risks during bear markets relative to bull markets. This explains the findings of Oikonomou et al. (2012) that socially responsible behavior is weakly negatively related to systematic risk while irresponsible behavior is strongly positively related to systematic risk.

Would investors be willing to give up some return in non-crisis market periods to gain some higher returns during crisis periods? Glode (2011) finds that strong investor demand for actively managed funds could be explained by the ability of active managers to deliver a superior performance during bad times than good times. Under Kahneman and Tversky (1979) Prospect Theory, investors are more negatively impacted by losses than they are positively impacted by a gain of similar magnitude. Thus, they are likely to choose a portfolio with asymmetric performance because the gain in utility for doing better in falling markets is larger than the loss in utility for underperforming in rising markets. Cox et al. (2004) study 600 of the largest UK firms and find that long-term institutional investors, like pension plans and life insurers, favor firms with strong corporate social performance.

Using a unique dataset of US domestic equity SRI funds for the period 2000–2011, we investigate the performance of SRI funds during crisis and non-crisis periods to empirically test the hypothesis that SRI funds dampen downside risk for investors during poor economic conditions. SRI funds differ substantially in their foci, such as avoiding unwanted products, evaluating environmental activities, social issues and governance standards. Also, SRI funds further differ in their use of positive (seeking out stocks with good ESG performance) versus negative (weeding out poor ESG performance) screening techniques. We investigate differences in performance across SRI foci and screening strategies to document if particular classes of SRI investing strategies potentially drive our results. One could argue that SRI and conventional funds are managed differently or that there may be differences in the characteristics of the companies picked for the portfolios beyond the socially responsible attributes. For example, some may believe that SRI funds are perhaps more (or less) actively managed than conventional funds or that SRI funds seek out larger (or smaller) firms. Thus, using quarterly fund holdings data available for a smaller sample period, we control for various fund level trading (e.g., fund turnover) and stock portfolio (e.g., capitalization of firms held in portfolio) characteristics to reconfirm all our results observed with multi-factor asset pricing models.

## 2. Literature review and hypothesis development

### 2.1. Literature review

Early research suggests that SRI funds either exhibit no performance difference from conventional funds (Hamilton et al., 1993; Goldreyer et al., 1999; Statman, 2000; Shank et al., 2005) or underperform (Girard et al., 2007). Adler and Kritzman (2008) contend that some cost must be associated with SRI because they exclude some attractive firms from their portfolios. Using Monte Carlo simulation, they estimate the cost of SRI to be giving up somewhere between 0.17% and 2.4% return per year due to the self-imposed restrictions. Using an international set of SRI mutual funds, Renneboog et al. (2008a) find that investors largely pay a price for ethics. Specifically, SRI funds in the United States, the United Kingdom, and in many continental European and Asia–Pacific countries underperform their domestic benchmarks by –2.2% to –6.5%. However, the risk-adjusted returns of SRI funds are generally not statistically different from the performance of conventional funds.

Another method of examining this issue is to study the SRI firms themselves, rather than SRI mutual fund portfolios or indexes. Different aspects of social responsibility have been examined. For example, Derwall et al. (2005) provide evidence of positive abnormal returns for environmentally clean firms. Other studies find positive, though not statistically significantly, abnormal returns (Kempf and Osthoff, 2007; Statman and Glushkov, 2009) using different measures of environmental performance. Positive abnormal returns have been identified for some types of SRI, specifically for firms with high employee satisfaction (Edmans, 2011; Statman and Glushkov, 2009; Derwall et al., 2011) and good corporate governance (Bebchuk et al., 2009). On the other hand, positive abnormal returns have been found in some firms that are avoided by SRI investors. Hong and Kacperczyk (2009) empirically analyze sin stocks and find that they earn positive annual abnormal returns of about 3% (see also Kim and Venkatachalam, 2011).

How can many of the SRI firms outperform the market and yet SRI mutual funds do not? Guenster (2012) describes that while SRI portfolios include some positive alpha firms, they also exclude some positive alpha firms like sin stocks, thus ending with normal performance. However, Guenster also notes that positive alphas in SRI favored firms have been disappearing recently. Bebchuk et al. (2013) documents a learning effect for corporate governance and show that abnormal returns in those firms have diminished over time and recently ceased to exist. Similar declines of abnormal returns have been reported in recent years for the social dimension of SRI favored firms (Derwall et al., 2011). Borgers et al. (2013) find that stocks with high stakeholder index ratings (an ESG measure) outperformed stocks with low ratings during the period 1992–2004, but failed to find significant results during the period 2004–2009. They attribute this to pricing errors associated with investors' expectation prior to 2004, which ultimately dissipated as attention for stakeholder issues increased post-2004.

Our data shows that the total net assets in U.S. domestic SRI equity mutual funds grew 305% from 2000 to 2011, while the asset growth rate of U.S. domestic non-SRI equity funds grew only 65% during the same period. The growth in assets being managed in SRI mutual funds may seem puzzling considering their marginal relative performance. Bollen (2007) resolves this puzzle by suggesting that investors have a multi-attribute utility function that does not just include risk-reward optimization, but also incorporates personal and social values. Renneboog et al. (2008b) argue that this social value aspect of the utility function reduces the value of financial characteristics to SRI investors. Consistent with this conjecture, Renneboog et al. (2011) and Benson and Humphrey (2008) find that SRI investors may be more loyal to SRI mutual

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