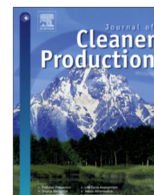
Journal of Cleaner Production 135 (2016) 558–566

Contents lists available at ScienceDirect

Journal of Cleaner Production

journal homepage: www.elsevier.com/locate/jclepro



The performance of US and European green funds in different market conditions

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ARTICLE INFO

Article history:
Received 12 February 2016
Received in revised form
1 June 2016
Accepted 19 June 2016
Available online 23 June 2016

Keywords:
Socially responsible investments
Global green funds
Environmental screening
Performance evaluation
Financial crises

ABSTRACT

The effects of incorporating environmental criteria in investment decisions is of upmost importance to an increasing number of investors. This paper evaluates the performance of US and European green funds that invest globally by using conditional models that consider both time-varying performance and risk measures. The results show that green funds tend to underperform the benchmark, particularly European funds. Fund underperformance is mainly concentrated in times when short-term interest rates are lower-than-normal and in non-crisis periods. Also, the performance of green funds is higher in crisis periods compared to non-crisis periods. Furthermore, although at the aggregate level green funds that are certified with a SRI label perform similarly to green funds without a label, there are less certified funds presenting negative performance compared to non-certified funds. US green funds perform better than other socially responsible funds in times of crisis, whereas European green funds match their performance in crisis periods but underperform them in non-crisis periods. Overall, the results support the importance of using conditional models in evaluating fund performance.

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1. Introduction

The growing number of investors who are willing to incorporate their social and ethical values into the investment process decision has stimulated a rapid growth of socially responsible investments worldwide. Within this trend, the increasing awareness of environmental issues such as global warming, climate changes and shortage of energy resources has motivated the so-called green investing. Green investors are concerned with the negative impact that corporate activities may have on the natural environment and on the ecological system and are therefore committed to consider these criteria when choosing their investments. In this context, there has been an increased demand for green funds, which are socially responsible mutual funds that use environmental criteria in their investment decisions. Green funds therefore provide investors a way to support companies that are actively involved in cleaner production methods, renewable energy, efficient waste management systems and other environmentally responsible technologies. But can green fund investors satisfy their environmental concerns without sacrificing financial performance, i.e., can they do well by doing good? This paper addresses this question by evaluating the performance of US and European green funds that invest globally.

The contribution of this paper is fourfold. First, to the best of our knowledge this is the first study to evaluate the performance of green funds according to conditional models that allow both time varying performance and risk. Three different approaches to incorporate conditioning information are analyzed: the use of continuous information variables, the use of discrete state dummies associated with those information variables and the use of a dummy variable to account for different market states. Second, considering the financial crises that hit the economy in the last decades, an additional contribution of this paper is to distinguish green fund performance in periods of crisis and non-crisis. Third, green fund performance is analyzed both at the aggregate level and at the individual fund level. Information on the behavior of individual funds is important to give a more complete picture of fund performance. Finally, considering that there might be some difficulties in identifying funds that follow "truly" socially responsible criteria, this paper considers additional information on the social responsibility level of the fund and compares the performance of green funds that are certified with a socially responsible investment (SRI) label with those without such label.[1]57.5 To our

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[1] A SRI label aims to provide quality standards and to offer more transparency about socially responsible investment products. A list of the available SRI labels can be found in the yoursri.com website.

http://dx.doi.org/10.1016/j.jclepro.2016.06.112
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knowledge, this is the first study to explore this issue.

The question of whether the inclusion of environmental criteria improves or penalizes corporate financial performance has been widely debated in the literature. Theoretically, there are arguments both in favor of a positive and a negative impact of corporate environmental responsibility practices on financial performance. On the one hand, a more traditional view of corporate social responsibility, inspired in Friedman (1962), advocates that increased environmental performance implies additional costs that are not offset by potential financial gains, therefore having a negative effect on corporate profitability (Walley and Whitehead, 1994). Supporters of this line of thought also claim that companies focusing on environmental responsibility are diverting efforts away from their core business (Molina-Azorín et al., 2009), besides assuming the burden of societal costs (Dixon-Fowler et al., 2013). According to this point of view, to protect shareholder value companies should limit environmental expenses strictly to those that are required by law regulations.

On the other hand, a more contemporary perspective that stems from stakeholder theory (Freeman and Evan, 1990), argues that good practices at the environmental level can enhance corporate financial performance due to a more efficient use of resources, therefore representing a sustained competitive advantage (Porter and Van der Linde, 1995). Specifically, Ambec and Lanoie (2008) suggest that improving environmental protection can lead to lower costs (for example at the level of risk management and relations with external stakeholders; cost of material, energy, and services; cost of capital; and cost of labor) and higher revenues (that can be obtained via different channels such as from better access to markets; differentiating products; or selling pollution-control technology). Also, Martí-Ballester (2015) sustains that companies that engage in corporate social responsibility strategies for cleaner production could benefit from increased productivity due to operational efficiencies, lower costs of attracting top talents to the company, and offering more attractive products to customers.

Many empirical studies have analyzed the relationship between environmental performance and financial performance at the corporate level and document a positive link between them (e.g., King and Lenox, 2001; Derwall et al., 2005; Montabon et al., 2007).[2] Other studies find that environmental performance contributes negatively to financial performance (e.g., Cordeiro and Sarkis, 1997; Wagner, 2005; Di Giuli and Kostovetsky, 2014). Despite the mixed results,[3] several review studies conclude that a positive link between environmental performance and financial performance seems to predominate (e.g., Orlitzky et al., 2003; Molina-Azorín et al., 2009; Dixon-Fowler et al., 2013).

Although the financial performance of companies that pursue good environmental practices has been extensively explored, the performance of mutual funds that expressly use environmental criteria to select green companies is far less analyzed. Nevertheless, for some time the literature has been debating the performance of socially responsible mutual funds that use broader ethical and social screens, which of course can include environmental ones. Theoretically, the debate on the impact of including socially responsible criteria in the performance of mutual funds has been centered on the arguments of diversification versus the benefits of corporate social responsibility. Motivated by portfolio theory, the first argument implies that the imposition of non-financial screens reduces the potential for diversification, therefore reducing portfolio's risk-adjusted performance (Rudd, 1981). In contrast, the corporate social responsibility argument suggests that social screens, by enabling portfolio managers to identify better managed companies, will enhance portfolio performance in the long run (Bollen, 2007).

Empirically, most studies on the performance of socially responsible funds show that their performance is not statistically different from that of conventional mutual funds (e.g., Bauer et al., 2005; Renneboog et al., 2008; and Cortez et al., 2009). However, the majority of these studies do not distinguish socially responsible funds by the types of screens used, despite the fact that there is some evidence that different screens that represent specific dimensions of corporate social responsibility may contribute in different ways to the performance of mutual funds, as documented by Barnett and Salomon (2006) and Renneboog et al. (2008). Additionally, a strand of literature that investigates the link between specific dimensions of corporate social performance and financial performance at the firm level documents a positive relationship between both.[4] Thus, one might question whether the neutral performance documented in the literature on socially responsible funds may simply reflect the aggregation of different effects associated to specific dimensions of social responsibility that may impact performance in different ways (Galema et al., 2008; Derwall et al., 2011). Following this line of reasoning, socially responsible funds should be evaluated according to the types of screens and criteria of social responsibility used. The evaluation of the performance of green funds might therefore shed light on the existing relationship between the environmental dimension of corporate social responsibility and fund performance.

There are additional motivations to focus on the performance of funds that employ specific environmental criteria in relation to the performance of socially responsible funds in general. First, there is the diversification issue. If, on the one hand, one assumes that green funds employ more restrictive screens and are more concentrated within certain industries (Climent and Soriano, 2011), then these portfolios will be less diversified and bear higher risks than general socially responsible funds. If, on the other hand, green investing involves a broader investment universe, by including companies that are environmentally conscious but that would not comply with other social criteria (Mallett and Michelson, 2010), then there would be diversification advantages of green funds compared with general socially responsible funds. Second, besides the growing awareness of consumers and investors on environmental issues, the fact that government policies and regulations play an important role in stimulating the development of green industries (Chang et al., 2012) might also enhance the opportunities for profitable businesses in this sector, making green funds different from other types of funds (Climent and Soriano, 2011).

Despite the increasing importance of these issues, there are few studies that evaluate the performance of green funds. Mallett and Michelson (2010) analyze the performance of US green funds and find no differences in their returns relative to socially responsible funds and index funds. In contrast, Chang et al. (2012) document that US green funds show lower risk-adjusted performance compared to conventional funds. These two studies, however, are (somewhat) limited as they evaluate performance by means of raw returns or traditional measures of performance. Climent and

[2] The references mentioned are not intended to be exhaustive. For a review of the literature on the link between environmental responsibility and financial performance, see Molina-Azorín et al. (2009).

[3] The main reasons pointed out for the discrepancy of empirical findings are discussed in Horváthová (2010).

[4] For example, good practices of social performance in terms of labor relations (Brammer et al., 2009; and Edmans, 2011), community relations (Simpson and Kohers, 2002) and environment (such as the papers mentioned previously) have been shown to be positively related to firms' financial performance.

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