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Performance and performance persistence of socially responsible investment funds in Europe and North America

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ABSTRACT

We analyze, and compare, performance and performance persistence of Socially Responsible Investment (SRI) funds in Europe and North America. We use a broad sample of 500 European and 248 North American SRI funds for the period January 2001–December 2011. We find that SRI funds outperform the market benchmark in Europe and North America over this period and that North American SRI funds perform better than European SRI funds. We find little evidence of performance persistence in either region using a ranked portfolio approach; however, there is more evidence of performance persistence in European SRI funds than in their North American counterparts using a non-parametric ranked portfolio approach.

1. Introduction

Socially responsible investment (SRI) is not a new investment concept. According to Berry and Junkus (2013), both SRI and non-SRI investors consider environmental factors to be important when deciding how to invest. The uniqueness of SRI is that it allows investors to manage their funds in a sustainable way that satisfies their concerns with environment, social and governance factors in a

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manner consistent with what Hamilton, Jo, and Statman (1993) describe as 'doing well while doing good'.

The major potential problem with SRI is that it contradicts the central tenants of modern portfolio theory. Modern portfolio theory suggests that an efficient portfolio should consist of diversified, non-correlated, stocks, in order to maximize the expected return of the portfolio by spreading risk. However, an SRI portfolio represents a less diversified portfolio due to the screening process during portfolio formation. Therefore, an SRI portfolio is deemed to be a risky investment portfolio (Chegut, Schenk, & Scholtens, 2011).

This study examines performance and performance persistence of European and North American SRI funds. The study has two objectives. The first is to compare the relative performance of SRI funds in both regions with market benchmarks. The second is to ascertain whether performance persistence exists in SRI funds for both regions.

Much research has considered whether lack of diversification in SRI funds affects performance by comparing the performance of SRI funds with the market benchmark. Empirical evidence has been mixed. On the one hand, Jones, van der Laan, Frost, and Loftus (2008) and Renneboog, Ter Horst, and Zhang (2008a) found that an SRI portfolio underperformed relative to a conventional portfolio. Gil-Bazo, Ruiz-Verdú, and Santos (2010), Climent and Soriano (2011) and Humphrey and Lee (2011) found that SRI funds performed on a par with conventional portfolios. Alam and Rajjaque (2010), Gil-Bazo et al. (2010) and Lyn and Zychowicz (2010) found that an SRI portfolio outperformed the conventional portfolio.

Performance persistence is defined as the ability of a fund/portfolio to maintain its performance ranking, relative to other funds, over a period of time. This occurs where investors purchase funds that are performing well at the time they bought and continue to perform well in the future. Hence, investing in funds exhibiting performance persistence can be a very important strategy to earn abnormal returns (Humphrey & O'Brien, 2010).

Few studies have examined performance persistence of SRI funds and those which exist are for SRI funds in Europe (Gregory & Whittaker, 2007; Leite & Cortez, 2013) and the Asia Pacific (Lean, Ang, & Smyth, 2014). This paper is the first to examine performance persistence in North American SRI funds, the first to examine performance persistence in European SRI funds as a whole (as opposed to studies for individual countries) and the first to compare performance persistence of SRI funds across regions.

The issue of whether SRI funds are persistent has important theoretical and practical implications. From a theoretical perspective, if performance is persistent, this will challenge the validity of the weak form of the efficient market hypothesis (EMH) (Fama, 1970). The EMH states that if the market is efficient, then no investor will have the opportunity to gain from abnormal returns. This, in turn, has important practical relevance. If performance is persistent over time, past performance will serve as an important guide for future investment decisions. Alternatively, if there is no persistence in performance, investors can opt to apply passive asset management strategies in making investment decisions, subject to mitigating agency problems.

The existence, or otherwise, of performance persistence in SRI funds is also important given that investors are increasingly taking ethical and social considerations into account when deciding where, and how, to invest. To make informed choices, investors need evidence on performance of SRI funds over time (Gregory & Whittaker, 2007). A natural extension of investors becoming increasingly concerned with ethical and social issues in deciding where to invest is that firms can make strategic decisions along these lines to make their stocks more attractive to ethically minded investors. Thus, the evolution of positive screening makes performance persistence of SRI funds relevant for company strategy in terms of investment decisions (Gregory & Whittaker, 2007).

We focus on European and North American SRI funds for two reasons. First, SRI as a concept originated in Europe and North America. For example, Belgium, Italy, Sweden and United Kingdom were the first countries in Europe that required their pension funds to disclose levels of participation in social, ethical and environmental aspects of investment (Renneboog et al., 2008a). Second, there is growing interest in SRI in both regions, reflected in the size of SRI assets in both regions. SRI has become big business in both regions. According to Eurosif (2014), total SRI assets in Europe in 2013 were €9,884,966 million. According to the US Sustainable Investment Forum, the total SRI assets in