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THE EFFECT OF SOCIALLY RESPONSIBLE INVESTING ON MUTUAL FUND PERFORMANCE

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Abstract. In the presented paper there is analyzed the essence and development of socially reponsible investing, also there is made a review of socially responsible market worldwide and finally is presented results of a comparative analysis of socially responsible mutual funds and benchmarks, like S&P 500 TR and with Index Morningstar Moderate Target Risk. Presented results of comparison of SRI funds with selected benchmarks show that investing in socially responsible mutual funds for the potential investor could be effetive.

Keywords: socially responsible investing, mutual funds, effectiveness of investments, benchmarks, socially responsible market.

Jel classification: J11, M14

1. Introduction

Recently investment funds have gained a significat impact on World economy. Solid attention to the investment funds industry is common not only in the USA or EU, but also in separate developed coutries.

According to Bivainis and Volodzkiene (2008) economies and social sectors of the 21st century are not invisible without investment funds. The extent of investments, the variety of funds as well as the opportunities for investment are constantly increasing.

The challenges of the globalization process, such as climate change, waste of mother nature resources, social – demographic and ecological problems – all these issues promote people and business to be more conscious. As a result, in the past few decades growing concerns over environmental and social issues made socially responsible investing to take an outstanding place in the financial markets (Kempf, Osthoff 2008; Plakys 2011, Northcott 2009).

Socially responsible investing (SRI) is an investment strategy which align values with financial benefits through the incorporation of environmental, social and corporate governance (ESG) factors into the investment process. Until now, it can be still called as a niche market, because it is well developed in a few countries (Andritoiu 2010; Bello 2005; Kinder 2005).

The origins of socially responsible investing started hundreds of years ago – in the biblical times when Jewish law laid down directions how to invest ethically. The modern roots of socially responsible investing dated from the 1960s with different social movements such as civil-rights, feminism, environmentalism and protest against the Vietnam War (Ferruz *et al.* 2007).

The number of socially concerned investors grew dramatically through the 1980s when millions of people, institutions and even states focused investment strategies on pressuring the white minority government of South Africa to destroy the racist system of apartheid. Issues of environment, human rights and healthy working conditions in the factories in all over the world producing goods for the U.S. consumption became the forefront for lots of investors (Schueth 2003).

So the rise of SR funds is partly attributed to the rise of social responsible investment activities across the world, increasing concern about global warming, and political decisions on renewable energy and alternative energy sources.

According G. Pivo (2005) socially responsible investing is mainly pointed to three activities: financial profitability of investments, social performance of enterprises, and ecological integrity. Socially-responsible funds are also referred to as ethical funds. They focus on socially responsible companies. In other words such funds never invest in tobacco, nuclear power, weapons or alcoholic beverages producing companies. So socially responsible investing could be expressed as socially – conscious or ethical investing, which describes an investment strategy that seeks to maximize both financial return and social good (Bauer *et al.* 2005; Plakys 2009; Purlys 2010).

According to K. L. Benson ir J. E. Humphrey (2008) managers of SRI funds aim to offer products that reflect investors' values and provide investment returns to satisfy their financial goals. SRI investors gain both financial and non-financial utility from their investment choice.

Theoretically socially responsible investing is described as the practice of incorporating environmental, social and governance (ESG) factors into decision making (Umlas 2008).

SRI investors believe that by combining certain social criteria with rigorous investment standards, they can identify securities that will earn competitive returns and help build a better world.

So SRI has a strong idea of making a world better – "the bottom line, though, is that SRI not only allows you to make money for a secure retirement, it empowers you to make a difference with your money" (Kridel 2005).

Generally, socially responsible investors favour corporate practises that promote corporate governance and ethics workplace practices, environmental concerns, product safety and impact, human rights, community relations indigenous peoples' rights (Carter 2007).

It should be noted that socially responsible investing is essentially interested in promoting the adherence to the positive aspects of these areas with publicly held companies. But SRI also gets a lot of attention for industries and companies that act as "bad" for society. These industries and companies that include businesses involved in gambling, tobacco, weapons and alcohol, so caller „sinful" investment categories are often eliminated through SRI screening (Carter 2007; Kinnel 2009).

Socially responsible investors include individuals and also institutions, such as corporations, universities, hospitals, foundations, insurance companies, public and private pension funds, nonprofit organizations, and religious institutions.

According to the European SRI study (2008) about 94 % of investments in the SRI market in Europe are investing institutional investors, expecially public pension funds and money market funds (24 %), non-profit organizations (23 %), religious and charity institutions (32 %) (Plakys 2011). According to the European SRI study (2010) the SRI market in Europe remains lagely driven by institutional investors representing about 92 % of the total assets under management (AuM).

So the phenomenon of socially responsible investing has became more widespread. But still there are countries and investors that are lagging behind significantly about the conscious investing.

The purpose of the presented paper is to give the answer to such question, as:

Why do investors should choose socially responsible mutual funds that combine financial and non – financial criterias instead of choosing conventional funds?

How positive or negative is the effect of socially responsible investing on a mutual fund performance?

2. Review of socially responsible investing market

From year 2007 to the year 2009–2010, SRI market had grown from 4.963 billion euro to 7.594 billion euro. This rapidly growing market (35 percent) shows that more than a half of the global SRI market is in Europe. At the end of the year 2007 SRI European market took 53.7 % in total world market and in year 2009 it was even more – approximately 66 %. The smallest parts of Global SRI market belongs to Japan (Table 1).

Table 1. Global SRI market, year - end 2007 and 2009 - 2010 (Source: European SRI study 2008, European SRI study 2010)

	Total SRI (€ bn), year 2007	Part in the global SRI market (%)	Total SRI (€ bn), year 2009-2010	Part in the global SRI market (%)
United States	1.917 (year 2007)	38.7 %	2.141 (year 2010)	28.2 %
Canada	334 (2006)	6.7 %	405 (2008)*	5.3 %
Australia/NZ	41 (2007)	0.8 %	58 (2010)	0.8 %
Japan	6 (2007)	0.1 %	4 (2009)	0.05 %
Europe	2.665 (2007)	53.7 %	4.986 (2009)	65.65 %
Total World	€ 4.963	100 %	€ 7.594	100 %

* The year of the available data differs. The last data by SIO (Canada) is published in 2008.

During the last two years (period 2008–2010) after the world financial crisis, the number of socially responsible mutual funds was still growing in Europe. Between 2008 and 2009 the growth was from 537 to 683 funds (+21 %), between year 2009 and 2010–from 683 to 879 funds (+22 %). The amount of SR fund in Europe is presented in the Figure 1 below.

The biggest increase in the number of SRI funds belongs to Belgium, France, U.K. and Switzerland. These for countries account for 72 % of total SRI funds in Europe (Green, Social and Ethical Funds in Europe 2010).

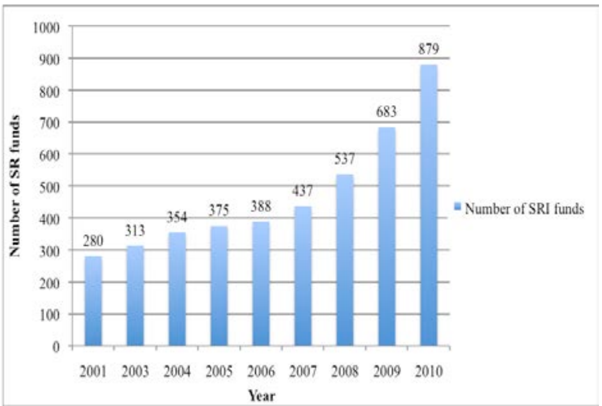

Fig.1. Number of SR funds in Europe, period 2001–Jun 2010 (Source: Green, Social and Ethical Funds in Europe 2010)

The most rapid growth of SR funds was from the year 2009 to 2010–29 % (Figure 2). Like according to the number of SR funds, the biggest part of the total European asset belongs as well to four largest markets – France, U.K., Switzerland and Belgium. These markets take approximately 76 % of all assets under SRI management in Europe (Green, Social and Ethical Funds in Europe 2010).

From the year 2007 and 2008 there might be seen a negative change – (-0.03 %). The most important reason for this is the world financial crisis. But the amount of assets didn't change considerably and on June 2009 the total assets reached 53.276 mln. Euro (+0.8 %).

As it was mentioned in the European SRI study 2010, bonds are now the favoured asset class among SRI investors, representing 53 % of total SRI assets, while equities have dropped down to 33 %.

The SRI market in the Baltic states of Estonia, Latvia and Lithuania is still quite small. The first SRI fund, called New Europe Socially Responsible Fund at Limestone Funds, was launched in Estonia in 2008. Another fund – SEB Ethical Europe fund is offered by local asset manager SEB Asset Management and this fund is managed externally. Generally, financial market structure in the Baltic countries is special, because the main players in the market are local branches of large Scandinavian banks.

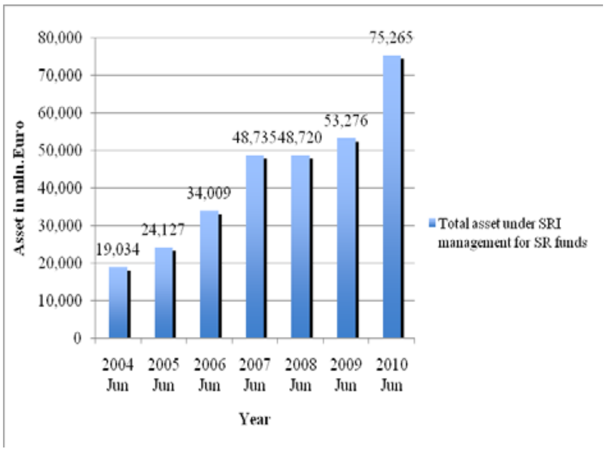

Fig.2. Total asset under management for SR funds domiciled in Europe (end of Jun 2010, mln. Euro) (Source: Green, Social and Ethical Funds in Europe 2010)

The total amount of assets currently in Baltic pension funds is 1.648 billion Euro (in Estonia – 1.07 billion Euro, in Latvia – 257 million Euro, in Lithuania - 321 million Euro) (European SRI study 2010).

According to Plakys and Ambrusevic (2009) Baltic Coutries showed the really law correlation beween assets in the investment and pension funds, it means, that the market should use the capital for creation and development of modern technologies. The higher technologies are used in the industry (expecially energy), the better environmental conditions are kept.

With increasing popularity of socially responsible living more possibilities come to establish funds which follow the socially responsible investing ideas and rules. Even if there is no such fund sold/established yet in Lithuania, such type of fund with a proper marketing would gain lots of people confidence and capital.

3. Investment strategies and environmental, social and governance criteria analysis

Socially responsible investors apply three primary strategies: screens to select investments; shareholder advocacy to influence companies; and community investment for needy areas.

– Screening – socially responsible mutual funds subject stocks to a set of "screens", or criteria. The criteria could be, for example – if the company pollutes the environment. Many socially responsible investment funds avoid companies that produce nuclear power, tobacco, alcohol and firearms. The screening process generates SRI buy lists that may include those companies that have environmentally friendly products/practices, etc. The screening process rejects the stock of companies that do not meet certain SRI frames (Andritoiu 2010; Kinnel, 2009).

Shareholder advocacy – is another powerful SRI strategy, where shareholders have pressured major corporations such as McDonald's and JC Penney to be more socially responsible through shareholder resolutions and divestment campaigns (Cortez *et al.* 2009). According to this SRI strategy, the investor acquires shares in companies that would be rejected by the first strategy (social screening). The goal of such strategy is to make an impact on the company's policies. The tool of this pressure on the company's management is through a dialogue or filling shareholder resolutions to amend any social, environmental or labor issue. The biggest advantage of this strategy is that investors are allowed to benefit from the company's stock price appreciation and dividends together with changing with company's policies. But the minus is that generally it requires a large commitment of time and capital (Andritoiu 2010).

– Community investing – it is a third strategy that encourages people to invest in valuable local projects that might not qualify for funding (Statman 2008). With this strategy, the investor directs capital to communities around the world that have limited access to traditional financial services institutions (Andritoiu 2010). A common misconception is that these investments are donations. Many community investments are put toward community development banks in developing countries or in lower-income areas in the U. S. for affordable housing and venture capital. Generally, you can lend your money and get paid interest and get paid back and help the world (Carter 2007).

Mutual funds choose firms with good long - term performance based on factors like environmental policies, community involvement and fair employee practices. Yet, mutual funds are also concerned with diversifying. If a fund has strict social performance criteria – it may exclude some companies and it leads to less diversified portfolio and greater risk on returns.

Key findings of Barnett M.L. and Salomon R.S. (2006):

– Financial return declines when the number of social screens increases. SRI funds that are using few screens improve financial performance by diversifying portfolio.

– SRI funds that use mane social screens (like 7-12 screens) may benefit by eliminating under-performing companies.

– Community relations screening increases better performance of SRI funds. Companies operating costs reduce because of fewer local restrictions, better assess to skilled employees and less criticism from activists.

In year 2006 there was launched Principles for Responsible Investment by United Nations Environment Programme. The principles provide a framework for the investors to help them incorporate environmental, social and governance (ESG) criteria into their investment process (The Benefits of ESG…online 2011).

SRI mutual funds seek to invest in companies with sustainable business models. To better identify those companies, their financial analysis should be combined with ESG analysis. ESG criteria include environmental, social and governance factors.

Environmental factors are:

– Resource management and pollution prevention;

– Reduced emissions and climate impact;

– Environmental reporting.

Social factors are:

– Workplace (diversity, health and safety, labor-management relations, human rights);

– Product integrity (safety, quality, emerging technology issues);

– Community impact (community relations, responsible lending, corporate philanthropy).

Governance factors are:

– Executive compensation;

– Broad accountability;

– Shareholder rights;

– Reporting and disclosure (The Benefits of ESG…online 2011; Kempf, Osthoff 2008).

The most popular SRI strategy is ESG incorporation (positive and negative screenings). The dynamics on assets of strategies in USA (period 1999–2010) according to the year can be evaluated in the Table 2.

Table 2. Socially Responsible Investing in US, period 1999 - 2010 (In Billion Dollars) Source: Report on socially responsible investing trends in the United States 2010 online.

	1999	**2001**	**2003**	**2005**	**2007**	**2010**
ESG Incorporation	1.497	2.010	2.143	1.685	2.098	2.512
Shareholder Advocacy	922	897	448	703	739	1.497
Community Investing	5	8	14	20	26	38
Overlapping Strategies	(265)	(592)	(441)	(117)	(151)	(981)
Total	**2.159**	**2.323**	**2.164**	**2.290**	**2.712**	**3.069**

4. Comparison of effectiveness of SRI funds and benchmark performance

When evaluating the performance of any investment, it's important to compare it against an appropriate benchmark. To analyze similarities between SRI mutual funds and their benchmarks, funds are compared to their benchmark indexes.

SRI mutual funds used in the research are selected from the Natural Investments Social (NIS) Rating Database (Natural investment social rating…online 2011) according to the Morningstar Rating (Kramer 2007, A Guide to Mutual Fund Ratings…online 2012). Quarterly performance data (period 2001–2010 Q3) of 45 socially responsible mutual funds were used from Yahoo Finance database. All the sample size that was analyzed (45 SRI funds), funds are grouped according to the benchmarks. Number of SRI funds according to the S&P 500 TR benchmark is 35 mutual funds, according to the Morningstar Moderate Target Risk benchmark is 10 mutual funds.

Moreover, there are selected these mutual funds which have both ratings – financial (Morningstar) and sustainability (NIS) ratings. Morningstar rating is about the fund's past performance which is measured in the scale from one to five star, with one designating a fund with a worst performance in the group and five given for a fund that has good past performance. NIS rating evaluates how mutual fund actually verifies the stated screens – either informally or via written policy (Moningstar Sector Methodology 2008; Benz 2011).

For comparison of effectiveness of SRI funds was chosen S&P 500 TR Index and Morningstar Moderate Target Risk Index.

S&P 500 TR Index* includes 500 large – cap common stocks that are actively traded in the United States. The index focus is U.S. based companies although there are a few legacy companies with headquarters in other countries.

Many mutual funds, exchange-traded funds and other funds like pension funds are designed to track the performance of the S&P 500 index. The stocks that are included in the S&P 500 TR Index are those of large publicly held companies that trade on either of the two largest American stock market exchanges – the NASDAQ and the New York Stock Exchange (S&P 500 Sector Breakdown…online 2011).

In the figure 3 there is presented quarterly returns of 35 SRI funds that are being compared to S&P 500 TR Index. Upward development is from 2003 Q1 to 2007 Q3. During this period SRI fund performed better then the S&P 500 TR Index. Downward movement started from 2007 Q3 to 2009 Q1 – benchmark's quarterly returns are lower compared to the mean of SRI funds. Thus, the graphs shows a higher financial return of SRI funds that are compared to the certain index. Also, it is important to mention that the SRI funds recovered faster and more significantly after the world financial crisis (period 2009 Q2 – 2010 Q3).

There are also analyzed the best (CAAPX) and the worst (IGIAX) performed SRI fund in the period 2001 – 2010 Q3. According to the figure 3, these socially responsible mutual funds are moved away from the benchmark nearly the same distance.

Below in the table 3 there is calculated Tracking error which is a tool that measures the performance of a mutual fund scheme against its benchmark index. It refers how close the weightages of the stock in the portfolio are to the weightages of the stocks in the index. Closer the weightage of the portfolio to the Index, lower will be the Tracking Error. If the portfolio exactly tracked the benchmark, then this measure would be pretty close to 0.

Comparing SRI funds to the benchmark, the tracking error is 2.18 % – it means that mostly SRI funds replicate the results very similarly to the benchmark results. Those 2.18 % can be explained as fund's management taxes, which are included in net asset value. The benchmark index of course doesn't have these taxes. The best and the worst performed mutual funds Tracking error (8.01 % and 9.05 %) are not very high as well, they don't trend far away from the benchmark.

The Morningstar Asset Allocation Index family includes two index series designed to benchmark target – date and target – risk investment products. The Morningstar Lifetime Allocation Index series consists of 13 indexes available in three risk profiles: aggressive, moderate, and conservative. The *Morningstar Moderate Target Risk Index* represents a portfolio of global equities, bonds, and traditional inflation hedges, such as commodities and TIPS. This portfolio is held in a static allocation of 60 % equities and 40 % fixed income, which is appropriate for U.S. investors who seek average exposure to equity market risk and returns (Morningstar Moderate Target Risk Index…online 2011).

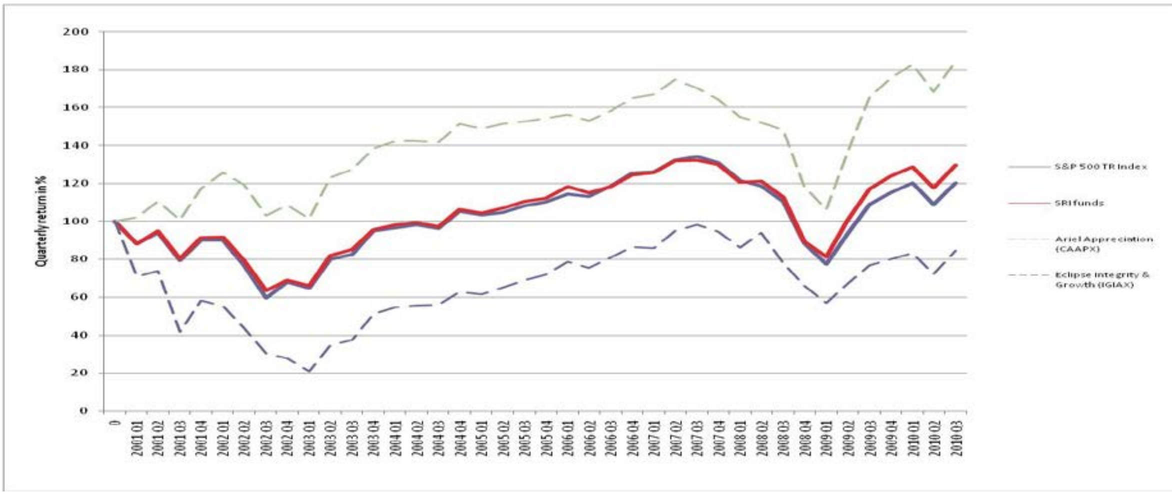

Fig.3. Quarterly returns of SRI funds and of S&P 500 TR Index in period 2001–2010 Q3 (created by authors)

Table 3. Tracking Error of SRI funds compared to S&P 500 TR Index (created by authors)

	SRI funds – Benchmark	CAAPX – Benchmark	IGIAX – Benchmark
Tracking Error	2.18	8.01	9.05

In the figure 4 there is presented quarterly returns of 10 SRI funds that are being compared to Morningstar Moderate Target Risk Index. Upward development is from 2003 Q1 to 2007 Q3. SRI funds almost all the time through upward trend outperform the benchmark index, except the period from 2006 Q4 to 2007 Q2. Downward movement (from 2007 Q3 to 2009 Q1) – benchmark's quarterly returns are higher compared to the mean of SRI funds. Thus, the graphs shows a higher financial return of SRI funds that are compared to the certain index. After the world financial crisis, SRI funds quarterly performance results are lower compared to the benchmark but it doesn't say anything about the volatility (risk) which will be measured later in the further research.

The best (PAXWX) and the worst (SSIAX) performed socially responsible funds from the sample size goes closely to the benchmark index during all the analyzed period 2001–2010 Q3.

Table 4. Tracking Error of SRI funds compared to Morningstar Moderate Target Risk Index (created by authors)

	SRI funds – Benchmark	PAXWX – Benchmark	SSIAX – Benchmark
Tracking Error	**1.61**	**3.86**	**2.85**

The lowest Tracking error is of SRI funds that are compared to Morningstar Moderate Target Risk Index. The average of SRI funds (sample size) Tracking error is 1.61 %. It means that the funds replicate the benchmark realy closely. The best (PAXWX) and the worst (SSIAX) mutual funds Trakcing errors are also very low – the funds are replicating benchmark results very similarly. It is obvious when looking at the Figure 4 as well.

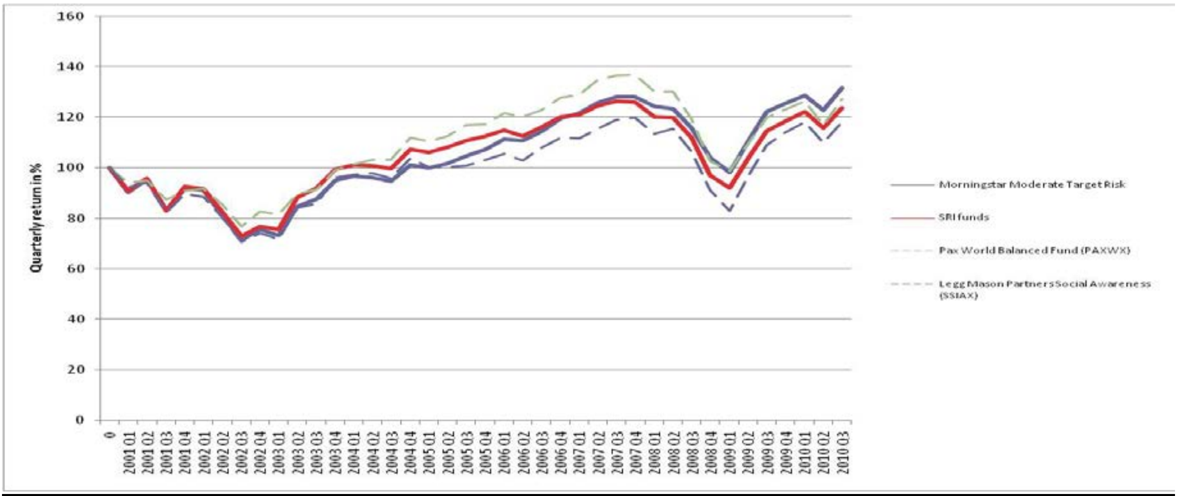

Fig.4. Quarterly returns of SRI funds and Morningstar Moderate Target Risk Index in period 2001–2010 Q3 (created by authors)

5. Conclusions

The review of SRI market shows that investing with conscience is growing and spreading all over the world rapidly in size and interest. According to the past few years, Europe takes the biggest part in the world (65 %) of total assets in SRI market which is inspired by growing number of SRI funds.

The biggest increase in the number of SRI funds belongs to Belgium, France, U.K. and Switzerland. These for countries account for 72 % of total SRI funds in Europe

The Baltic States market is still lagging behind significantly – the first socially responsible mutual fund was launched in Estonia in 2008. Another fund – SEB Ethical Europe fund is offered by local asset manager SEB Asset Management and this fund is managed externally.

Comparing the average quarterly returns of SRI fund sample sizes to S&P 500 TR* Index and to Morningstar Moderate Target Risk Index as a benchmark, the financial return do not differ significantly in the period 2001–2010 Q3. The calculated Tracking Error shows that SRI funds replicate the benchmark quite closesly. This results show that investing in socially responsible mutual funds for the potential investor could be effetive.

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