The Performance of Socially Responsible Investment
A review of scholarly studies published 2008-2010

A report by AP7
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Foreword

As the interest in responsible investment has increased, the question if corporate social responsibility affects shareholder returns has received more attention. For a long time the main concern was that corporate responsibility may have a negative impact on the diversification of risk and entail costs that could ultimately reduce yield. In recent years the opposite relationship has been increasingly argued, namely that social responsibility can enhance shareholder returns, for example by reducing reputational risk and increase profitability.

A situation in which different experts give diametrically opposite answers about the consequences of environmental and ethical considerations in asset management is obviously unsatisfactory, particularly for those working with these issues professionally.

In the year 2007 UNEPFI presented the report Demystifying Responsible Investment Performance, a compilation of the results from some twenty academic studies with the aim to shed light on the profitability issue. The report had a positive perspective on responsible investment, but found no strong correlations and requested more data to draw firm conclusions.

The present report analyzes an additional 21 academic studies published after UNEPFI’s report. The approach is the same, that is, a review and compilation of results in a number of original studies. However this report focuses only on the first two areas of ESG (Environment, Social) and thus omits pure “Governance” studies.

Some responsible investment enthusiasts may become disappointed, but overall the results actually reinforce the image that already existed before: there is nothing to suggest that responsibility for environmental and ethical issues in asset management in general either raises or lowers returns.

On the contrary, two thirds of the studies in this report state that there is no obvious connection. And in the last third, five studies suggest a positive correlation while three points to a negative correlation – in other words the group also confirms the overall conclusion, albeit with a slight predominance of increased yields.
These types of analyses based on a large number of studies are especially useful in asset management. There general conclusions from individual studies are less applicable since small changes in the conditions of time, asset classes and geographic market can have large effects on performance figures.

Johan Florén, Head of Communications AP7
Christian Ragnartz, Chief Investment Officer AP7
1. Introduction

Socially responsible investment (SRI) is a growing phenomenon in the global financial market today. SRI combines investors’ financial objectives with concerns about social, environmental and corporate governance issues, also known as ESG factors. This is typically accomplished by including the best-performing corporations from an ESG view-point and/or by excluding corporations or entire sectors that are deemed incompliant with ESG criteria. This is done in addition to using conventional financial screening criteria.

The purpose of this report is to explore if SRI generates higher or lower (or similar) financial return compared with “conventional” investing. Many scholars have sought to answer this question over the years, with varying results. Financial theory would suggest that if SRI implies a restricted investment universe, SRI portfolios cannot effectively diversify and consequently should underperform the market. In addition, it could be argued that screening and monitoring of ESG performance will imply extra costs and may cause fund performance to deteriorate. On the other hand, some argue that firms with stronger social performance have a higher quality of corporate management and will offer superior economic performance in the long run.

This report provides an overview of the results from more than twenty studies that were recently published, in order to shed light on this pertinent matter.
2. About the studies

The report covers 21 peer-reviewed academic studies on the topic of the investment performance of SRI products. The studies were published during 2008-2010. While we may have missed studies that were either not available through the databases we consulted or that did not match our search terms, this should cover the bulk of available studies on this topic that were published during the specific time period.

In this report, we are interested in the risk-adjusted return (where applicable). This means that the investment’s return is adjusted in relation to how risky it is (an asset with a superior risk-adjusted return has higher return for a given level of risk). This is done in order to avoid that a difference in return between an SRI fund and its “conventional” peer is simply due to different levels of risk.

In the studies, SRI may be defined differently depending on which database is used to construct a sample. Scholars have for example included products that are classified as SRI by the organization Social Investment Forum, by Morningstar, or by different market index providers. The common denominator is however that the products are including a social and/or environmental dimension.

One category of SRI is faith-based investment. In Europe and North America, this is often translated to screening criteria based on Christian values, which may imply exclusion of sectors such as weapons, alcohol and gambling. This report also includes studies on Islamic investments, also known as Shariah-compliant investments. These funds are prohibited from making investments in industries such as gambling, alcohol, pork, and companies providing financial services on interest (including conventional banking). Malaysia has

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1 Peer reviewed means that the journal’s editor sends the article to other scholars in the same field to get their opinion on the quality of the study, its relevance to the field, et cetera, prior to publishing. This process is used in order to ensure that the articles represent the best scholarship currently available.

2 Search terms: ethical/SRI/socially responsible/ESG/sustainable/green/environmental/faith-based/Islamic/shariah + fund/index + investment/financial + performance/return
proportionally many Shariah-compliant funds\(^3\) and it is therefore natural that many of the studies on Shariah-compliant investments that are included in this report have used samples from the Malaysian market.

While some studies use samples from entire continents or the world, some are specifically focusing investment products in one country. Country-specific studies that are included in this report have looked at SRI in Australia, Malaysia, South Africa, Spain and USA.

The studies in this report focus on a number of different types of products, including equity funds, fixed-income funds, unit trust funds, sovereign bonds, and stock indices. While most samples are based on real products, some studies use synthetic portfolios.

To some extent, this report continues the work that was published by UNEP-FI and Mercer in the report *Demystifying Responsible Investment Performance*\(^4\) in 2007. The Mercer report covers 20 academic studies on the topic of ESG and investment performance published 1996-2007. This is why we have chosen to study the subsequent period of 2008-2010. A notable difference is however that our scope is narrower; while the Mercer report has the broad objective of examining “the link between ESG factors and investment performance”, and includes academic studies on for example the effects of shareholder activism on stock performance, we are focusing on comparisons of portfolio performance between SRI and non-SRI only. In addition, while the Mercer report includes studies on environmental, social and governance factors respectively (i.e. some studies focus on governance alone), we exclude studies that solely look at the governance aspect (and not environment and/or social aspects), since we find that governance is not always directly related to social responsibility *per se*.

The next section presents our results.


3. Results

This overview finds that the results from the studies point in different directions.

Of twenty-one studies, seven conclude that SRI investment products have similar performance relative to their conventional peers. Five studies report that SRI outperforms conventional investment. Three studies find that SRI generates inferior performance relative to its conventional peers. Finally, six studies report mixed results – for example, the performance of SRI may vary with e.g. fund category (for example bond funds vs. balanced funds), the number of screens employed, and time period. In the “mixed” category, a majority of studies find a positive performance as part of their results, in combination with a neutral or negative performance for other parts of their results.

Given the variety of results from the reported studies in this review, we argue that it would be unwise to base a categorical statement about the investment return from SRI products on only one or a few studies (as some scholars and practitioners would). Depending on parameters such as product category, time period, geographical market, benchmark and performance measure, studies may conclude different results about SRI. In addition, SRI is not a standard concept. A Spanish SRI fund may be defined different to an Australian SRI fund, a Shariah fund may include different investment criteria than an environmental fund, and so on. Consequently, we cannot necessarily extend the result from one study to the entire SRI market.

While our main finding is that studies come to a variety of conclusions about the performance of SRI, we can also establish that there is a slight tilt towards a positive performance of SRI compared with conventional investment. We base this on the fact that of the eight studies that point to a solely positive or solely negative result for SRI, five show a positive result. This is however such a small tilt that we cannot assign any real significance to it. Furthermore, the fact that studies with a negative result for SRI is in minority does not disqualify their results.
We find that some of the most interesting results can be found if we look beyond the mere under-/outperformance dichotomy, and instead seek to understand what it is that affects performance. For example, studies in this review find that:

- ...SRI performs better when managed by specialists (as opposed to generalists) or by in-house teams
- ...SRI may impact stock returns by lowering the book-to-market ratio
- ...Islamic funds, which are naturally relatively delinked from the sub-prime market, have remained rather insulated from the recent financial crisis
- ...management fees are not higher for SRI funds than conventional funds (in the market under study, the US in this case), and hence the costs associated with screening does not cause SRI funds to underperform

The studies are summarized in sections 3.1-3.4.
### 3.1 Neutral performance

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<tr>
<td>1. The Performance of European Socially Responsible Funds</td>
<td>88 socially responsible mutual funds from seven European countries, investing globally and/or in the European market</td>
<td>1996-2007</td>
<td>SRI fund performance is neutral both in relation to conventional and socially responsible benchmarks.</td>
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<td>2. Exploring the Cost of Investing in Socially Responsible Mutual Funds: An Empirical Study</td>
<td>134 actively managed funds and 12 exchange-traded funds (ETFs) classified as Socially Conscious by Morningstar</td>
<td>1990-2008</td>
<td>SRI funds outperformed their non-SRI peers by a slim margin in the aggregate. The result is neither statistically or economically significant.</td>
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<td>5. Is Faith-Based Investing Rewarding? The case for Malaysian Unit Trust Funds</td>
<td>30 Islamic Malaysian unit trust funds 50 non-Islamic Malaysian unit trust funds</td>
<td>1996-2005</td>
<td>The difference in performance between Islamic and non-Islamic Malaysian unit trust funds is negligible.</td>
</tr>
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</table>
| 6. Is There a Cost to Faith-Based Investing: Evidence from FTSE Islamic Indices | FTSE Islamic Global Index  
FTSE Islamic Asia Pacific Index  
FTSE Islamic Americas Index  
FTSE Islamic Europe Index  
FTSE Islamic South Africa Index | 1999-2006 | The difference in return between Islamic and conventional indices is not significant.  
Islamic indices have a higher proportion of growth stock, which may in part be due to the exclusion of value sectors with higher environmental risks, e.g. chemical, energy, and basic industries. |
|---|---|---|---|
| 7. Sovereign Bonds and Socially Responsible Investment | Sovereign bonds from 20 developed countries | 1995-2008 | It is possible to build sovereign bond portfolios with a higher than average sustainability country rating (in this case Vigeo’s rating, based on international codes and norms) without significantly harming the risk/return relationship.  
The results differ somewhat with the ESG criteria favoured by the investor: requiring better than average ratings costs more in terms of diversification for e.g. civil rights and democratic institutions (“institutional responsibility”) than for environmental, social and solidarity ratings. |
### 3.2 Positive performance

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<tr>
<td>1. Global Standards and Ethical Stock Indexes: The Case of the Dow Jones Sustainability Stoxx Index</td>
<td>Dow Jones Sustainability Stoxx Index (DJSSI)</td>
<td>2001-2006</td>
<td>The DJSSI slightly outperforms the benchmark index (base universe ex DJSSI components). The authors also study the announcement effect of inclusion/deletion: Inclusion generates positive cumulated abnormal returns, while there is a negative market reaction to deletion from the index.</td>
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<tr>
<td>2. The Performance of Socially Responsible Mutual Funds: The Role of Fees and Management Companies</td>
<td>86 actively managed, retail, domestic, US equity mutual SRI funds</td>
<td>1997-2005</td>
<td>The average before- and after-fee performance of SRI funds is higher than that of conventional funds with similar characteristics. SRI funds that are run by management companies specializing in SRI significantly outperform similar conventional funds, while funds run by generalist companies underperform their matched conventional funds. There are no significant differences in management fees between SRI and conventional funds, except that SRI funds tend to be cheaper than conventional funds when they are offered by the same management company.</td>
</tr>
<tr>
<td>3. Performance of Ethical Mutual Funds in Spain: Sacrifice or Premium?</td>
<td>13 Spanish retail SRI funds</td>
<td>1998-2001</td>
<td>The performance of SRI funds is superior or similar to that achieved by the rest of the Spanish fund market.</td>
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<td>4. The Impact of Faith-Based Screens on Investment Performance</td>
<td>36 faith-based funds</td>
<td>2001-2008</td>
<td>Faith-based funds mostly outperform the overall market (S&amp;P 500) as well as SRI funds in general (Domini 400 Social Index).</td>
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</table>
5. Shariah-Compliant Equities: Empirical Evaluation of Performance in the European Market During Credit Crunch

| S&P Europe 350 Shariah Index | 2006-2009 | The authors investigate if Shariah-based financial products, which are by nature relatively de-linked from the sub-prime market, have remained insulated from the financial crisis. Shariah-compliant equities significantly outperformed the benchmark market index (S&P Europe 350), as well as the market index excluding financial firms (which were worse affected in this period of general economic downfall). The authors therefore suggest that Islamic equity can provide a hedge against downward movement of the market. |
### 3.3 Negative performance

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<tr>
<td>1. The Investment Performance of Socially Responsible Investment Funds in Australia</td>
<td>89 SRI funds in Australia (retail and wholesale)</td>
<td>1986-2005</td>
<td>SRI funds significantly underperform the market in Australia. One possible contributor is that many Australian SRI funds have significant under-exposure to the resources and energy sectors, both of which have by far been Australia’s highest return sectors.</td>
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<tr>
<td>2. The Price of Ethics: Evidence from Socially Responsible Mutual Funds</td>
<td>463 (live and dead) socially responsible equity mutual funds domiciled in 23 countries and offshore jurisdictions.</td>
<td>1991-2003</td>
<td>The average SRI fund in most European and Asia-Pacific countries strongly underperform their benchmark portfolios. The strongest underperformance is found in Belgium, France, Ireland, Japan, Norway, Singapore and Sweden. The UK and the US are exceptions: the risk-adjusted returns of SRI funds are not significantly different from conventional funds. The performance of SRI funds increases with the number of SRI screens employed to model their investment universe. The performance of SRI funds is better when funds have an in-house SRI research team to screen their portfolios.</td>
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<tr>
<td>3. The Cost of Socially Responsible Investing</td>
<td>The study uses a simulation technique (Monte Carlo), and is not based on practical portfolios. Socially responsible investing is defined as avoiding “bad” companies. The cost of socially responsible investing is measured by the difference in return of portfolios selected from an unrestricted universe and a restricted universe.</td>
<td></td>
<td>There is a cost associated with excluding socially irresponsible corporations from funds. This cost increases with the investor’s skill, cross-sectional dispersion of the universe, fraction of the universe that is restricted, and number of securities in the portfolio.</td>
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### 3.4. Mixed results

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<td>1. Does Social Investing General Higher Returns?</td>
<td>Stocks included in KLD Research &amp; Analytics’ database of socially rated corporations (i.e. not a practical portfolio)</td>
<td>1992-2007</td>
<td>Portfolios with a tilt toward stocks of companies with high best-in-class scores outperform conventional portfolios. This advantage is however largely offset by a disadvantage from negative screening.</td>
</tr>
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</table>
| 2. Socially Responsible Fixed-Income Funds                           | 15 US SRI bond funds  
9 US SRI balanced funds                                                          | 1987-2003  | SRI bond funds perform similar to conventional bond funds.  
SRI balanced funds outperform its conventional peers.  
The expenses charged by SRI funds match those of conventional funds: the costs associated with screening do not cause SRI funds to underperform. |
| 3. Performance Evaluation of U.S. Socially Responsible Mutual Funds: Revisiting Doing Good and Doing Well | 184 socially responsible funds in the US mutual fund industry in four categories:  
- domestic (US) stock funds  
- international stock funds  
- balanced funds  
- fixed-income funds                                                                 | 1994-2008  | SRI funds in all categories except fixed-income funds have inferior reward-to-risk performance compared with the average of all mutual funds in the US fund industry (per category) over the five- and ten-year periods.  
On a three-year basis, however, SRI funds in all categories except domestic funds outperform the average fund.  
Fixed-income funds outperform the average fund over the three-, five- and ten-year periods. |
| 4. The Risk-Adjusted Performance of Responsible Investment Funds in South Africa | 24 SRI funds in South Africa                                                                 | 1992-2006  | SRI funds underperformed relative to their respective benchmark indices during 1992-2002. This represents a period when SRI was still relatively new in South Africa (the first fund was launched in 1992), and when there was a general market downturn.  
SRI funds significantly outperformed their benchmark indices during 2002-2006, a period when a number new SRI funds were launched in South Africa, |
and capital and property markets showed renewed and consistent growth. The authors suggest that the improved performance over time may be due to a learning effect, as fund managers have familiarized themselves better with socially responsible investment within the South African context.

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<tr>
<th>5. Socially Responsible Investment Fund Performance: The Impact of Screening Intensity</th>
<th>61 equity funds in the US</th>
<th>1989-2006</th>
<th>Highly screened funds suffer in terms of risk-adjusted performance. For SRI funds with 10 or more screens, on average approximately 7 percent of the annual return is sacrificed due to screening intensity alone. SRI managers are therefore advised to consider funds that do not screen too intensely. The authors do not find evidence of specific screens systematically impacting the performance of SRI funds.</th>
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<tr>
<td>6. The Stocks at Stake: Return and Risk in Socially Responsible Investment</td>
<td>6 “strength” portfolios based on KLD:s social scores (portfolios are not practical)</td>
<td>1992-2006 Book-to-m: 1991-2004</td>
<td>The six “strength” portfolios are compared with six “concern” portfolios, all based on KLD:s social scores. The risk-adjusted performance of SRI portfolios is not significantly different from zero. The authors go further, however, and find that firms with equal risk levels but different levels of socially responsibility have different book-to-market(^5) ratios due to an excess demand for socially responsible stocks. In particular, diversity and environment have a negative relationship with the book-to-market value, whereas governance has a positive relationship.</td>
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\(^5\) Book-to-market: The book-to-market ratio compares the book value of a firm (from its balance sheet) to its market value. The book-to-market ratio attempts to identify undervalued or overvalued securities.
Reference list

Neutral performance:


Positive performance:


Negative performance:


Mixed results: