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THE FIDUCIARY DUTY OF INSTITUTIONIAL INVESTORS ENGAGING IN SOCIALLY RESPONSIBLE INVESTING

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ABSTRACT

In an increasingly more conscious world, firms are feeling more pressure from consumers and shareholders to engage in corporate social responsibility and sustainability measures. This increased awareness in firms' activities has driven demand for sustainable investing, also known as socially responsible investing. Despite this increased demand, many institutional investors are not engaging in SRI for their clients. Part of this discrepancy stems from institutional investors' misperception of their fiduciary duty. This thesis will seek to clarify the duty institutional investors have for their clients while highlighting that socially responsible investing does not contradict their fiduciary duty as is commonly believed. Additionally, this thesis will review extensive studies on socially responsible investing performance to demonstrate that socially responsible investing does not have to mean accepting diminished financial performance. Finally, this thesis will make predictions for expanding socially responsible investing in the United States.

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Chapter 1

Introduction

This thesis examines the fiduciary duty of institutional investors in regards to socially responsible investing (SRI). A general overview of both the global and U.S. socially responsible investing universe is provided in order to show the scope and growth socially responsible investing has taken in recent years. The first part of this thesis explores the legality surrounding institutional investors' ability to engage in socially responsible investing. This section focuses on the question of whether or not institutional investors violate their fiduciary duty to their clients when they engage in SRI. A commonly held belief in the finance world is that profit maximization encapsulates the fiduciary duty and should be the only goal of institutional investors when making investment decisions for their clients. As a result, taking considerations like environmental, social, and governance (ESG) issues into account would then violate institutional investors' obligations to their beneficiaries. However, extensive legal reviews of multiple jurisdictions around the world found that taking environmental, social, and governance issues into consideration when making investment decisions is both allowed and a case can even be made that considering these issues is required.

The second part of this thesis is an extensive review of studies on socially responsible investing performance. After examining a large amount of studies examining the performance of SRI mutual funds versus traditional mutual funds, most studies found that the performance of these funds was not statistically different even on a risk-adjusted basis. These studies along with the legal review should encourage institutional investors to integrate ESG considerations into their investment decisions without fear of violating their fiduciary duty to their clients or of accepting inferior performance.

The final component of this thesis provides an estimate for how socially responsible investing could expand in the United States through the year 2020. This estimate is based on the current growth rate of SRI assets in the United States as well as law changes that will make it easier for more institutional investors to engage in socially responsible investing.

Chapter 2

Socially Responsible Investing

One of the major hindrances to socially responsible investing is confusion concerning what exactly constitutes socially responsible investing and unclear terminology. Socially responsible investing is also known as sustainable investing as well as ESG incorporation and the terms are used interchangeably. A good general definition for socially responsible investing provided by the Global Sustainable Alliance is “an investment approach that considers environmental, social and governance (ESG) factors in portfolio selection and management” (Global Sustainable Investment Alliance, 2014, p. 6.).

Within SRI, investors use a wide variety of investment strategies, including negative screening, positive screening, and ESG integration to construct their portfolios. Negative screening is an investment strategy where investors exclude certain firms from their portfolio that do not meet their required standard for ESG criteria (Global Sustainable Investment Alliance 2014). Criteria vary by investor but common screens exclude companies with a history of human rights violations, companies with military contracts, or firms involved in the tobacco industry. Another popular screening strategy, positive screening, also called best-in-class screening, selects industries and firms to include in the investment portfolio that have strong ESG performance relative to their peers. ESG integration is another popular method used by investors though it should not be confused with ESG incorporation. While ESG incorporation is a broad term covering all types of socially responsible investment, ESG integration is an SRI investment approach defined as, “the systematic and explicit inclusion by investment managers of environmental, social and governance factors into traditional financial analysis" (Global Sustainable Investment Alliance, 2014, p. 6.). All of these investment methods, negative screening, positive screening, and ESG integration, are methods of socially responsible investing or ESG incorporation. In this paper, SRI and ESG incorporation will be used interchangeably.

SRI – Global Landscape

Socially responsible investment has expanded tremendously in recent years. Globally, SRI assets increased to $21.4 trillion USD in 2014 from $13.3 trillion USD in 2012, an incredible 61 percent increase, faster than the increase in total professionally managed assets. As far as proportion of global SRI assets held in each region, Europe dominates, holding a 63.7 percent of global SRI assets. However, the United States' contribution has grown from 28.2 to 30.8 percent from 2012 to 2014. Canada holds the next largest amount of global SRI assets at 4.4 percent. These three regions represent the largest areas for SRI in terms of total SRI assets held and hold 99 percent of the total global SRI assets (Global Sustainable Investment Alliance, 2014).

Europe is not only more involved than the United States in socially responsible investing in terms of total SRI assets, but also in terms of the ratio of SRI assets relative to the total managed assets in that region. In Europe, SRI assets account for an incredible 58.8 percent of total managed assets, an increase from 49 percent in 2012. Canada follows Europe with SRI assets accounting for 31.3 percent of total managed assets from 20.2 percent in 2012. In a distant third is the United States where SRI assets only account for 17.9 percent of total managed assets though this is an increase from 11.2 percent in 2012 (Global Sustainable Investment Alliance, 2014).

Although the United States may lag behind Europe in socially responsible investing, SRI is growing fastest in the United States compared to any other region including Europe and Canada. In 2014, SRI investments in Europe accounted for $13.6 trillion USD, a 55 percent increase from 2012's $8.8 trillion USD. The United States holds the second largest amount of SRI assets by region with $6.57 trillion SRI assets representing a 76 percent growth from $3.74 trillion in 2012. Finally, Canada experienced a 60 percent growth in its SRI assets during this two year time period from $589 billion to $945 billion USD (Global Sustainable Investment Alliance, 2014).

The most common screening methods for socially responsible investing are negative screening which accounts for $14.4 trillion followed by ESG integration at $12.9 trillion. While negative screening is the most popular method in Europe, ESG integration is now the most commonly used method in the United States as well as Australia/ New Zealand and Asia. ESG integration is also one of the fastest growing socially responsible investing strategies growing from $5.94 trillion in 2012 to $12.85 trillion in 2014 or a 117 percent increase. Most of this growth occurred in the United States and Europe (Global Sustainable Investment Alliance, 2014).

ESG integration is likely to increase in Europe following the a April 15, 2014, vote by the European Parliament which overpoweringly voted to approve a Directive that requires certain large listed European companies to produce a disclosure of diversity and other ESG information. Once the Directive gains approval by the Council which represents the heads of state of EU member states and is then passed into the law, the law will be the first time that information relating to the environmental, social, governance as well as human rights, bribery, and corruption is explicitly required for companies to disclose in management reports (Global Sustainable Investment Alliance, 2014). The new directive appears to indicate to European investors that nontraditional indicators like environmental and governance concerns can have an impact of the performance.

ESG in the United States

The total US-domiciled assets under management using SRI strategies expanded from $3.74 trillion at the start of 2012 to $6.57 trillion at the start of 2014, an increase of 76 percent. These assets now account for more than one out of every six dollars under professional management in the United States (US SIF, 2014). The tremendous growth socially responsible investing has experienced in the past few years means that SRI assets now account for 17.9 percent of total managed assets in the United States. For around a decade, the ratio of SRI assets in the United States to total managed assets only ranged from around 10 to 12 percent which makes its leap to nearly 18 percent in 2014 that more promising for the future growth of socially responsible investing in the United States (Global Sustainable Investment Alliance, 2014).

In 2014, The US SIF: The Forum for Sustainable and Responsible Investment identified 880 community investing institutions and 308 money managers that incorporate ESG considerations when making investment decisions which accounted for $4.8 trillion assets under management over triple the 2012 figure of $1.41trillion assets under management (US SIF, 2014). Part of this dramatic upsurge in ESG incorporation is believed to be the result of increasing market penetration by SRI investment products and the expanding ESG criteria by asset managers to larger shares of their investment portfolios as well as more asset managers and institutional investors committing to the UN's Principles for Responsible Investment (US SIF, 2014).

A variety of SRI investment products is available for U.S. investors including SRI mutual funds and SRI or ESG exchange-traded funds. One such SRI mutual fund, the Walden Social Equity Fund, assesses companies based on their environmental impacts, corporate governance, community relations, and workplace conditions. The fund also excludes companies engaged in gambling, alcohol and tobacco as well as major military contractors. Additionally, fund managers generally evaluate companies' environmental performance on a case by case basis for inclusion into the fund portfolio (US News, 2010). ESG ETFs are another relatively new investment option for socially responsible investors. The iShares MSCI KLD 400 Social ETF provided by the investment management company Black Rock seeks to match the make-up and performance of the MSCI KLD 400 Social Index (Black Rock, 2016). Originally launched in 1990 as the Domini 400 Social Index, this index fund includes large, mid, and small cap companies and engages in both positive screening, including companies with excellent ESG characteristics, and negative screening, excluding companies with poor social and environmental impacts. The index fund also strives to maintain similar sector weights to the MSCI USA IMI Index (MSCI, 2016).

Investment funds, excluding separate account vehicles and community investing institutions, using ESG incorporation have increased dramatically in recent years. In 1995, only 55 funds incorporated ESG criteria representing $12 billion in assets. By 2007, these figures had risen to 260 funds accounting for $202 billion in assets. Since 2007, the number of funds incorporating ESG criteria has increased substantially. By 2014, 925 funds considered ESG criteria representing $4.31 trillion in assets, over four times the amount of assets using ESG criteria in 2012 of $1.01 trillion (US SIF, 2014). Driving the growth of SRI by money managers is unsurprisingly client demand. According the US SIF Foundation, 80 percent of the managers who responded to their information request identified client demand as their driver behind their incorporation of ESG issues into investment decisions (2014).

Institutional investors have also greatly contributed to the surge in socially responsible investing in the United States. In 2014, $4.04 trillion assets under institutional investor management considered ESG issues, a 77 increase from 2012. The most prevalent ESG considerations included restrictions on investing with companies engaged in business in Sudan and other repressive regimes, tobacco restrictions, and governance considerations (US SIF, 2014).

Chapter 3

Fiduciary Duty

The fiduciary duty refers to the legal relationship between the fiduciary who acts on behalf of another, the beneficiary. The fiduciary is obliged to work in the best interests of the beneficiary, not his or her own. Institutional investors such as pension and mutual fund managers are bound by this fiduciary duty when investing for their clients. According to the report *Fiduciary Duty in the 21st Century,* the two most important fiduciary duties are the duty of loyalty and the duty of prudence. The duty of loyalty ensures that fiduciaries serve the best interests of their beneficiaries, not act to serve their own interests or the interests of a third party. The duty of prudence requires fiduciaries to use "due care, skill and diligence, investing as an 'ordinary prudent person' would do" (Sullivan, 2015, p. 11).

Fiduciary duties are the main way in which common law countries restrict the power of fiduciaries when making investment decisions. These fiduciary duties are the result of both statues and case law. In civil law countries, on the other hand, statutory provisions establish the fiduciary duty and control the behavior of institutional investors. Though statues differ by jurisdiction, common regulations include duty to act in the interests of beneficiaries, duty to seek profitability, and use of a modern portfolio theory approach to investing.

A common interruption of this fiduciary duty concerning institutional investors is that serving their client's best interest involves solely seeking profit maximization and that taking other considerations such as environmental, social, and governance issues violate institutional investors' fiduciary duty to their clients (Freshfields Bruckhaus Deringer, 2005.) Conducted in 2005 by the law firm Freshfields Bruckhaus Deringer for the Asset Managing Working Group of the UNEP Finance Imitative, the Freshfields Report examined the fiduciary duty of institutional investors in the US, UK, Australia, Canada, France, Italy, Germany, Spain, and Japan to determine whether ESG considerations violated the fiduciary duties that institutional investors have to their clients in these jurisdictions. The overall conclusion of the report found that using ESG criteria when making investing decisions "is clearly permissible and is arguably required in all jurisdictions" (Freshfields Bruckhaus Deringer, 2005, p. 13). An update to the 2005 Freshfields Report produced in 2015 by the Principles for Responsible Investment and UNEP FI called *Fiduciary Duty in the 21st Century* expanded on the work of the Freshfields Report and furthermore, finds that "failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty" (Sullivan, 2015, p. 9).

The report also investigated reasons why institutional investors are not factoring ESG issues into their financial decisions. These reasons include outdated beliefs about fiduciary duty, the need for clarification concerning what ESG incorporation constitutes and how to put it in practice, limited awareness of the evidence supporting socially responsible investing, inconsistent reporting on ESG issues by companies and failure to adequately analyze the financial significance of ESG issues, and poor oversight in legislation and industry codes concerning socially responsible investment (Sullivan, 2015).

The type of retirement plan, whether defined-benefit or defined-contribution, also affects the fiduciary duty. In his 2007 paper examining how the fiduciary duty of pension fund managers impacts socially responsible investing, Richardson argues that managers in charge of defined-contribution plans have an even greater imperative to give their clients SRI options. Richardson explains that with defined-benefit plans, the employer bears the primary risk that employees receive their pension income upon retirement. However, with defined-contribution plans, although the employer contributes a certain amount during employment, the primary risk of meeting retirement income needs shifts from the employer to the employees. Therefore, Richardson argues that employees under defined-contribution plans should have even more control over where they invest their money and should be presented with investments that include SRI options (Richardson, 2007).

Richardson also addresses how many countries are trying to encourage institutional investors to incorporate ESG issues into their investing decisions. In his paper, Richardson discusses two common approaches that countries have used in order to try to encourage socially responsible investing by pension funds, a disclosure approach and a compulsory approach. The disclosure approach involves a country passing legislation requiring funds to disclose their SRI policy, if any exists, to their beneficiaries (Richardson, 2007).

The first country to begin to use disclosure reporting was the United Kingdom. In July 1999, the Pensions Act of 1995 was amended so that occupation pension fund trustees must disclose their policies, if any, on social responsible investing and their exercise of shareholder rights, including voting right as a part of their Statement of Investment Principles (OECD, 2007). A similar requirement was made for local government pension funds as well. This change in law appears to have been implemented effectively in the United Kingdom. According to the Ethical Investment Research Service's 2003 study, 90 percent of UK pension funds included social, environmental, and ethical policies in their Statement of Investment Principles. Additionally, a 2004 study found a sharp increase in ethical investing conducted by UK pension funds, though the authors do not claim that this stemmed from the 1999 law change (OECD, 2007). Many European countries followed the UK's lead and implemented similar disclosure reporting regulation including Austria, Belgium, France, Germany, Italy, Sweden, and Spain (OECD, 2007).

Besides disclosure reporting, a compulsory approach has been successfully used, especially for national pensions. For instance, the Norwegian Government Public Pension Fund was established in January 2006 by government regulation to have an SRI mandate in its "Ethical Guidelines." According to these Guidelines, the fund "should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages (Richardson, 2007, p. 52)." The Ethical Guidelines specify that negative screening will be used to exclude firms that do not meet its SRI criteria. The fund excludes Walmart from its portfolio due to its "allegedly harsh labor practices" (Richardson, 2007, p. 197). In addition, Norwegian Government Pension Fund has also excluded since 2005, weapon producers like Lockheed Martin, Boeing, and Honeywell International. Freeport, one of the world's largest mining companies, is also excluded by the fund for Freeport's "extensive and serious damage to the environment" (OECD, 2007, p. 11). Similar to Norway, French national pension schemes also require fund managers to make SRI considerations. The French Retirement Reserve Fund, Fonds de Réserve Pour Les Retraites, requires that managers' investment decisions take into account social and environmental issues. In addition, the French Pension Reserve Fund maintains a policy of devoting at least €600 million for SRI-related investment (OECD, 2007).

An important milestone in the growth of socially responsible investing was the launch of the Principles for Responsible Investment in 2006 by then UN Secretary-General Kofi Annan with 550 institutional investor signatories representing USD $18 trillion in assets under management (Linder & Trunow, 2015). The UN's Principles for Responsible Investment now include 1,380 signatories including asset owners, investment managers, and service providers that represents USD $59 trillion in assets under management (Principles for Responsible Investment, 2015). Partnered with the UNEP Finance Initiative and UN Global Compact, the Principles for Responsible Investment established a framework for investors to incorporate environmental, social, and governance issues into their investment decisions and ownership practices.

Fiduciary Duty in the United States

In the United States, fiduciaries must "exercise reasonable care, skill, and caution in pursuing an overall investment strategy that incorporates risk and return objectives reasonably suitable to the trust" (Freshfields Bruckhaus Deringer, 2005, p. 8). In the United States, institutional investors are primarily expected to follow the modern prudent investor rule. The modern prudent investor rule uses modern portfolio theory to justify investment decisions not in isolation but in the context of the entire investment portfolio. This rule gives institutional investors significant freedom to make a wide range of investment decisions as long as these choices are prudent and defensible at the time that the investment is made. Based on this rule, institutional investors should be able to pursue an investment strategy that considers ESG considerations though investors must ensure that they adhere to their duty of loyalty, which means that decisions should still serve the best interests of their clients. Overall, the Freshfields Report, finds no reasons why ESG incorporation cannot be integrated into the investment strategy of a pension or mutual fund as long as this strategy does not go against the beneficiary's interest or the purpose of the fund.

Despite the findings of the Freshfields Report in 2005, many institutional investors in the United States have been slow to adopt ESG considerations due to a 2008 bulletin from the Department of Labor. The bulletin made it difficult to consider nonfinancial concerns for investments that fall under ERISA, which covers nearly all private sector pension plan and retirement funds in the United States. However, in October 2015, the Department of Labor rescinded this 2008 bulletin greatly expanding the potential for socially responsible investing by pension funds in the United States (Brown, 2015). The old 2008 bulletin had said that considerations other than risk and return, like ESG considerations, should be rare which likely prevented many funds that fell under the Employee Retirement Income Security Act of 1974 from engaging in socially responsible investment. In fact, according to Vanguard Group only nine percent of the defined-contribution plans that they keep records for held a socially responsible domestic equity fund in 2014 (Iacurci, 2015). The new guidance, Interpretive Bulletin 2015-01, states, "Fiduciaries need not treat commercially reasonable investments as inherently suspect or in need of special scrutiny merely because they take into consideration environmental, social or other such factors" (Medland, 2015, p. 1). The new rule essentially means that while private industry pension fund managers cannot accept lower returns or take on greater risk in order to integrate ESG considerations, ESG considerations may be used as "tiebreaker" between investments. This ruling is significant in that pension plans and other investors that fall under ERISA, a total of around $8.4 trillion, will now be able to use ESG factors without concern about conflicting with ERISA (Brown, 2015).

Although the 2008 bulletin may have prevented until very recently asset managers from incorporating ESG factors, state and local pension and retirement funds do not fall under ERISA, and many have taken this opportunity to develop a SRI policy. For example, the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), the New York City Employees Retirement System and the New York State Teachers' Retirement System have all joined the UN's Principles for Responsible Investment (OECD, 2007). These pension funds represent an enormous amount of capital. As of February 2016, CalPERS Fund market value was $279.2 billion (CalPERS, 2016) and CalSTRS, the largest educators-only pension fund in the world, represented assets worth $178.7 billion (CalSTRS, 2016).

Chapter 4

Pension Funds and SRI

Pension funds offer a huge opportunity for socially responsible investing, but barriers including pension fund managers' perception of their fiduciary duty may impede the growth of SRI in pension funds. Worldwide, pension funds represent one of the major sources of capital for investing, representing 26.7 percent of total assets held by institutional investors (OECD, 2014). According to the Organisation for Economic Co-operation and Development, pension fund assets represented over $25 trillion USD (2015). By far the largest holder of pension fund assets of any country, the United States holds pension fund assets totaling over $14.7 trillion USD (OECD, 2015). The next largest countries in the OECD area are the United Kingdom, Australia, Canada, and the Netherlands. All together, these four countries and the Unites States' pension funds' assets represent $21.7 trillion USD or 85% of OECD pension funds' assets (OECD, 2015).

While the United States has the most pension fund assets of any country, in terms of pension fund assets compared to the relevant size of the economy, pension funds are even more prevalent in several European countries like the Netherlands, United Kingdom, and Switzerland. When comparing pension funds' assets to GDP, the OECD countries with the highest asset to GDP ratios are the Netherlands (161%), Iceland (146%), Switzerland (126%), Australia (113%), and the United Kingdom (96%). For the United States, the pension funds' asset to GDP ratio was only 85% (OECD, 2015). Relative to GDP, pension fund assets are not as significant in the United States as in many countries especially European countries, even though the total amount of pension funds' assets held in the United States is still very substantial.

Fiduciary Duty of Pension Fund Managers

In most common law countries, pension fund managers are fiduciaries with the duty to invest prudently in the best interests of their beneficiaries. A 2007 study reviewed whether the fiduciary duties of pension fund managers deter them from investing in SRI. According to this study, most common law countries define the best interests of beneficiaries to mean financial returns, which may mean that considering nonfinancial criteria when evaluating investments constitute a breach of the pension fund manager's fiduciary duty (Richardson, 2007). However, as many of the financial studies later discussed in this paper show, socially responsible investing does not necessarily decrease financial performance. Most of the studies cited in this paper found no significant difference in performance between SRI and traditional investing meaning that pension fund managers do not breach their fiduciary duty by considering ESG factors when making financial decisions.

Many pension funds, especially European funds, already actively engage in socially responsible investing. A comprehensive study of European corporate pension funds conducted by Eurosif in 2011 found that 94 of the 169 pension funds reviewed or 56 percent of pension funds reviewed responded that they have a responsible investment policy with an additional, 15 funds indicating that they plan to implement to a SRI policy in the near future. Similarly, 102 of these pension funds indicated that they believe that ESG factors contribute to the long-term performance of investments (Eurosif, 2011). Governance, followed by social and environmental criteria was cited as the most important ESG factors by the pension funds. An additional, 66 percent or 111 of the pension funds believe that SRI policy represents a part of their fiduciary duty (Eurosif, 2011).

Based on the current scholarship on the financial performance of socially responsible investing, institutional investors do not need to accept lower financial performance. Despite comparable financial performance, many institutional investors are not incorporating ESG issues into their financial decisions. The 2015 report investigating the fiduciary duty of institutional investors found that reasons for this discrepancy include outdated beliefs about fiduciary duty, the need for clarification concerning what ESG incorporation constitutes and how to put in practice, limited awareness of the evidence supporting socially responsible investing, inconsistent reporting on ESG issues by companies and failure to adequately analyze the financial significance of ESG issues, and poor oversight in legislation and industry codes concerning socially responsible investment (Sullivan, 2015). Additionally, a 2009 report conducted as a follow up to the Freshfield's Report recommended that ESG criteria be included in the legal contract between the beneficiaries and the fiduciaries (Asset Management Working Group of the UNEP Finance Initiative).

The 2015 report called *Fiduciary Duty in* the 21st Century addressed specific recommendations in order to encourage socially responsible investing, specifically in the United States. The report recommends that the Department of Labor specify that the fiduciary duty requires fiduciaries to use a long-term, risk-adjusted approach for managing pension assets. Additionally, the Department of Labor should require asset owners to disclose how they incorporate ESG issues in their investment decision-making. Finally, the report recommends, the New York Stock Exchange and NASDAQ strengthen their disclosure requirements as they regard to ESG issues for companies listed by these exchanges (Sullivan, 2015).

Chapter 5

Literature Review of Financial Studies

According to traditional portfolio theory, an investor maximizes their utility by creating a mean variant efficient portfolio that is formed through sufficient asset diversification. By nature, socially responsible investing limits the investment universe by imposing nonfinancial screening criteria for assets to be included. Much of the prior research on socially responsible investing has examined how screening may affect an investor's ability to adequately diversify their portfolio. According to the underperformance hypothesis, SRI's risk-adjusted returns are lower than conventional investor return's due to the inability to adequately diversify the portfolio. On the other side of the underperformance hypothesis, the overperformance hypothesis theorizes that the screening process weeds out firms with poor characteristics (like weak social governance or firms engaged in environmentally irresponsible practices) leaving behind a superior portfolio of firms that will outperform the market and conventional investing strategies. A third popular hypothesis is that these effects largely cancel each other out and the risk-adjusted performance for socially responsible and conventional investors is not significantly different.

Traditional SRI research has focused on exploring the possible benefits and tradeoffs for individuals who engage in socially responsible investing using three popular methodologies. These methodologies include examining the performance of socially responsible indexes against traditional indexes, evaluating the performance of SRI mutual funds against conventional funds, and finally, comparing a portfolio of stocks known for social responsibility against a portfolio consisting of stocks of firms with poor social responsibility performance.

Socially Responsible Indexes

Some study authors favor the methodology of tracking the performance of socially responsible indexes against the performance of traditional indexes over examining mutual fund performance since index studies eliminate variables such as the skill of the mutual fund manager as well as transaction costs when tracking performance. In their article, “The Long-Term Performance of a Social Investment Universe,” by Kurtz and diBartolomeo, the authors conducted an 18 year holdings based attribution analysis of the performance of the KLD 400 Social Index Fund against the S&P 500 and found that any difference in returns could be explained by fundamental factors and beta, and that any unexplained factors were not statistically different from zero (2011). Another study which examined the performance of SRI Indexes in the United States, United Kingdom, and Japan compared to conventional stock indexes using Markov Switching model, found that there was no statistical difference in means and volatilities between the two types of indexes in any of the regions and additionally, found that there was significant comovement between the two indexes (Managi, Okimoto, & Matsuda, 2012). The studies of SRI Indexes appear to support that SRI performance does not adversely hinder or improve financial performance.

Socially Responsible Investing Mutual Funds

A significant amount of the prior research of SRI investing has focused on SRI mutual fund performance. Based on most of the past studies, no significant difference in risk-adjusted returns appears to exist between SRI funds and conventional mutual funds. For instance, a 2005 study by Bauer, Koedijk, and Otten which investigated the returns of 103 US, UK, and German SRI funds from 1990-2001 against their conventional mutual funds found that SRI funds experienced a "catching up" phase underperforming conventional funds, but by 1998-2001 they experienced comparable risk-adjusted returns to conventional funds (2005). Another study conducted by Renneboog, Ter Horst, and Zhang, found similar results in their study of SRI funds in 17 countries. The authors found that SRI funds' risk-adjusted returns consistently underperformed domestic benchmarks, but found that most countries' risk-adjusted returns were not statistically different from conventional funds. Only a few countries like Japan, France, and Sweden's SRI funds underperformed their conventional mutual fund benchmarks. SRI mutual funds' lack of underperformance was also found by another study by Gregory and Whittaker that examined 32 UK SRI funds from 1989 to 2002. The authors' results showed that although the SRI funds exhibited lower absolute returns than conventional funds, they did not underperform on a risk-adjusted basis.

SRI Fund Screening Intensity and Criteria

Research has also been conducted on how the screening criteria of SRI funds affect risk-adjusted returns. One of the first studies to examine screening criteria found a curvelinear relationship between financial performance of socially responsible mutual funds and screening intensity (Barnett & Salomon, 2006). In this study of 61 SRI funds from 1972-2000, the authors found that initially adding social screen criteria to funds caused the financial returns of the mutual fund to decline, but as the number of social screens increased, financial returns actually began to increase. The findings of this study seem to lend support to both the under and overperformance hypotheses. Initially, the underperformance hypothesis dominates and returns decline, but as more and more social screens are added, the overperformance hypothesis dominates and returns increase. Additionally, the authors of this study found that the performance depends upon the type of screen used. For example, environmental and labor relations screening decreased performance, but community relations screening increased financial performance.

Recent research in SRI mutual funds has looked more into how intensity and different methods of screening, positive or negative, affect financial performance. Positive screening uses a “best of sector” approach including only firms meeting the highest socially responsible standards in their respective industries. Negative screening eliminates firms from the portfolio that engage in practices not considered socially responsible by the mutual fund like alcohol and firearms. A 2014 study of French SRI funds by Capelle-Blancard and Monjon compared the performance of French SRI mutual funds based on their level of screening intensity and type of screens used. Based on this study, greater screening intensity or using more screens, reduced financial performance initially, but as the screening intensity continued to increase, enhanced financial performance. These results appear to support the findings of Barnett and Salomon. Furthermore, only negative screens decreased financial performance while positive screens had no impact (2014). Similarly, a 2011 study of Australian SRI mutual funds also looked into how screening methods affect financial performance. In addition to finding no significant difference in returns between the performances of conventional funds versus SRI mutual funds, the study showed that the type of screen did not affect total return, but found weak evidence that firms with more total screens performed better on a risk-adjusted basis supporting the findings of Barnett and Salomon as well as Capelle-Blancard and Monjon. Additionally, positive screening significantly reduced risk while negative screening increased risk and reduced the fund's ability to hold a diversified portfolio (Humphrey & Lee, 2011). According to this study's findings, positive screening appears to support the overperformance hypothesis while negative screening appears to support the underperformance hypothesis.

Not all studies agree that additional screening will increase financial performance. A different study of Australian SRI funds that looked into the effect screening intensity has on risk found that while screening intensity had no effect on raw returns or idiosyncratic risk, each additional screen added translated into a significant 70 basis point reduction in fund performance per screen using the Carhart model. Additionally, the study's authors also found that increased number of screens result in lower systematic risk, which they propose, is the result of SRI fund managers selecting lower beta stocks to minimize total risk (Lee, Humphrey, Benson, & Ahn, 2010).

SRI Meta-analyses

Discrepancies between the findings of different SRI fund studies have led some researchers to conduct meta-analyses studies. One such study conducted by Rathner in 2013 investigated 25 prior studies on SRI fund performance to determine why so many of these studies have found contradictory results. Based on the findings of this paper, accounting for survivorship bias in a study increases the probability that SRI funds will significantly outperform their conventional counterparts and decreases the probability of underperformance. Furthermore, studies consisting of only United States SRI funds also increase the probability of outperformance while decreasing the probability of underperformance. Finally, studies that match SRI funds to conventional funds with similar attributes also increase the probability of SRI funds outperforming conventional funds and decrease the probability of underperformance.

SRI Portfolio Studies

The final popular methodology for investigating the returns of social responsible investing examines the returns of a portfolio of stocks known for social responsibility against a portfolio consisting of stocks of firms with poor social responsibility performance. In a study by Statman and Glushkov that examined the stock returns of firms rated by their social responsibility from 1992-2002, the authors found a positive advantage for investors who tilted their portfolios towards stocks rated highly in social responsibility. However, they also found that shunning “sin stocks” or firms associated with tobacco, alcohol, gambling, firearms, and military or nuclear operations, negatively affected portfolio performance. Overall, they discovered that the positive effect from tilting the portfolio towards highly socially responsible firms largely offset the negative effects caused by excluding the sin stocks (2009). These findings seem to support the study of Australian SRI mutual funds conducted by Humphrey and Lee concerning the role of positive and negative screening as well as support the Barnett and Salomon study that found a curvelinear relationship between financial and social performance.

Another portfolio-based study examined a portfolio of highly ranked eco-efficient firms against a portfolio of low ranked eco-efficient firms and found that the highly eco-efficient portfolio outperformed the low-efficient firms. The authors defined eco-efficiency as the economic value created by a company compared to the waste it generates to produce that value and ranked companies based on Innovest Strategic Value Advisors' corporate eco-efficiency scores (Derwall, Guenster, Bauer, & Koedijk., 2005). During the 1995 to 2003 period of the study, the portfolio of the highly ranked firms achieved significantly higher average returns. The authors also found that this difference in returns could not be explained by differences in market sensitivity, industry factors, transaction costs, or differences in investment style.

Large Data Set Analyses

Recent studies that examined very large data sets have also showed that sustainable or socially responsible investing does not produce lower returns than traditional methods. One of these studies published by Morgan Stanley’s Institute for Sustainable Investing found that sustainable investing performed as well or better than traditional investing strategies (2015). They found that this remained true on a risk-adjusted basis and across time and asset classes. This study looked into the performance of 10,228 open-end mutual funds and 2,874 Separately Managed Accounts (SMAs). Of the 10,228 funds, 118 equity and 31 fixed income funds were deemed by Morningstar as using a “Socially Conscious” active investment strategy. The sustainable funds’ performance was tracked against peers in the same asset class according to Morningstar’s classification. The study found that the sustainably managed equity funds produced equal or higher median returns and equal or lower volatility over 64 percent of the period studied (2007-2014). Additionally, the study also examined the performance of the SMAs from Informa PSA. Of the 2,874 SMAs, 102 were deemed sustainable by the study because they had either “Important” or “Very Important” mandate for socially responsible investments. These sustainable funds were compared to peers in the same asset class according to Informa. The study found that sustainable SMAs performed very similarly to conventional SMAs even on a risk-adjusted basis. Additionally, a 2014 Oxford University meta-study found that 80 percent of the firms reviewed demonstrated a positive relationship between stock performance and sustainability measures. Of the 39 studies reviewed, 31 of them or 80 percent demonstrated a positive correlation between good sustainability and producing financial market performance (Arabesque Partners and University of Oxford, 2014).

SRI ETFs

Limited research has been conducted on the socially responsible investment opportunities of exchange-traded funds. This is probably because SRI ETFs or ESG (Energy, Social, Governance) ETFs, named because of their incorporation of energy, social, and governance factors in investment decisions, are a relatively new socially responsible investing tool and not much data exists on them. However, Deutsche Bank did conduct a market research study on the performance of 16 ESG-related ETFs in 2013. The study found that the US ESG indexes performed as well as or better than the traditional market cap weighted index during most of the period studied, and the international ESG index performed similarly to the traditional index during the period studied. Additionally, US ESG ETFs did not exhibit significant differences in their exposure profiles for sector or country allocations compared to traditional ETFs but do tilt towards ESG-friendly sectors like Information Technology and away from unfriendly sectors like Energy. Like US ESG ETFs, international ESG ETFs do not exhibit significant differences in their general allocation profiles compared to traditional ETFs (Deutsche Bank, 2013).

Conclusion

Based on the current academic research of socially responsible investing, investors do not need to sacrifice financial performance in order to invest responsibly. While some studies find conflicting results, the vast majority of the academic studies reviewed do not find a significant, risk-adjusted performance difference between SRI and traditional investors. These findings coupled with the legal analyses of fiduciary duty should encourage institutional investors to engage in socially responsible investing since it neither violates their fiduciary duty nor causes decreased performance for their clients.

Chapter 6

Expanding SRI in the US

Socially responsible investing has experienced tremendous growth and this growth is likely to continue in the coming years. The following estimates the growth of SRI in the United States through the year 2020.

Methodology

The Global Sustainable Investment Alliance's 2014 Global Sustainable Investment Review provided the data for the United States, Europe, and global statistics on the amount of SRI assets in each region for 2012 and 2014. From these statistics, an overall percent increase and a CAGR were calculated.

Table 1

	2012	2014	Percent Change	CAGR
United States	$3.740	$6.572	75.72%	32.56%
Europe	$8.758	$13.608	55.38%	24.65%
Canada	$0.589	$0.945	69.44%	26.67%
Global	$13.261	$21.358	61.06%	26.91%
*Global (minus)	$0.174	$0.233	33.91%	15.72%

All numbers in trillions USD, taken from beginning of year

*Global (minus) does not include US, Europe, and Canada

From this data, five cases were made to estimate SRI growth in the United States. In the first case, the CAGR calculated for the United States is used as the growth rate through the year 2020.

In the second case, the United States' CAGR is used through the year 2016, but then Europe's CAGR is used for years 2017 through 2020 in order to simulate that as the United States' SRI market expands, it would behave more similarly to the European SRI market which is more mature and has a slower growth rate.

The third case resembles the first case except that it also accounts for the $8.4 trillion that falls under ERISA and that thanks to the rescinding of the 2008 bulletin by the Department of Labor is now free to be used for socially responsible investing. The $8.4 trillion is assumed to grow by two percent from 2015 to 2016 to $8.568 trillion, which reflects an estimation of the real GDP growth rate of the United States. Beginning in the year 2017, ten percent of this $8.568 trillion is assumed to be invested in socially responsible projects. From the year 2017 onwards, this amount grows at the United States' CAGR through 2020.

The fourth case follows the third except like the second case, the United States' CAGR is only used as the growth rate through 2016. The growth rate changes to Europe's CAGR through 2020.

The fifth case resembles the third case except that amount of SRI investing stemming from ERISA pension funds is assumed to only grow by ten percent each year instead of the United States' CAGR.

Empirical Findings

Table 2

	2014	2015	2016	2017	2018	2019	2020	% Change
Case 1	$6.572	$8.712	$11.548	$15.309	$20.293	$26.901	$35.660	443%
Case 2	$6.572	$8.712	$11.548	$14.395	$17.944	$22.367	$27.881	324%
Case 3	$6.572	$8.712	$11.548	$16.165	$21.429	$28.406	$37.655	473%
Case 4	$6.572	$8.712	$11.548	$15.252	$19.012	$23.698	$29.540	349%
Case 5	$6.572	$8.712	$11.548	$16.165	$21.236	$27.937	$36.800	460%

All numbers in trillion USD

The five different cases range substantially in their estimates for the rate of growth for socially responsible investing from 2014 to 2020. However, all cases predict dramatic growth. The most conservative case still predicting 324 percent for the period and the most generous case predicted an incredible 473 percent growth. The socially responsible investing that is possible because of the new regulations concerning funds that fall under ERISA would greatly impact growth of SRI. If only ten percent of the ERISA is initially invested in socially responsible projects and this amount grows at a conservative ten percent a year, the percent change of SRI assets from 2014 to 2020 increases by 17 percent. If this amount grows by the United States' CAGR, this amount increases to 30 percent.

Chapter 7

Conclusions

Based on the legal reviews of the fiduciary duty in various jurisdictions around the world and the extensive review of financial studies on socially responsible investing performance, institutional investors should consider ESG considerations when making financial decisions. Their fiduciary duty does not hinder them and socially responsible investing produces comparable performance. A major hindrance to increasing SRI amongst institutional investors seems to be investors' confusion about their fiduciary duty and false beliefs that incorporating ESG issues means accepting reduced performance. Increasing awareness about the lack of downsides from SRI will help it grow in the future. However, for SRI to grow successfully in the future, governments should clarify the fiduciary duty to investors and increase disclosure reporting for ESG issues. Clients of institutional investors should also express their interest in socially responsible investing to the managers that control their investment decisions and hold institutional investors responsible for reporting on how they are using ESG considerations when making investing decisions.

For those interested in socially responsible investing, many investment opportunities already exist, but the SRI investment universe, driven by investor demand, continues to expand at an increasing rate around the globe. The research compiled in this paper on the fiduciary duty and the financial performance of socially responsible investing support this upwards trend in SRI continuing in the coming years. Overall, the future looks bright for socially responsible investing in the United States and around the world.

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