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Does socially responsible investment equity indexes in emerging markets pay off? Evidence from Brazil

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ABSTRACT

This paper explores the financial performance of a mainstream socially responsible investment equity index in emerging markets: the Brazilian Corporate Sustainability Index. The results indicate that investors in emerging markets could accommodate their ethical values while at the same time not scarifying their overall portfolio performance in bullish market periods. However, the financial crisis led ethical investors to take a riskier and less profitable portfolio. These results seem to be due to socially responsible investment in Brazil that, as with other emerging markets, is highly influenced by social and institutional factors.

1. Introduction

Demand for integrating social and environmental concerns in financial markets was supplied by the introduction of different mechanisms for socially responsible investment (SRI). This approach, also known as ethical investment or sustainable investment (Renneboog et al., 2008), considers factors related to the environment, society, and human rights, in addition to traditional financial issues, thus allowing investors to match their investment strategy with their ethical values (Domini, 2001). Although SRI emerged in the middle of the last century, it has come into prominence largely within the past two decades (Fowler and Hope, 2007). During this period, SRI has ceased to be a niche activity and has become a core factor for mainstream investors in developed countries (Statman, 2006).

As a report from EUROSIF (2010a) emphasizes, “Total SRI Assets under Management (AuM) in Europe have reached €5 trillion, as of December 31, 2009, whereas they represented close to €2.7 trillion in 2005.” In the United States, SRI has increased in terms of dollars invested by 1200% between 1995 and 2009,

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resulting in a current share of about 10% of the SRI assets in the AuM on that market (EUROSIF, 2010a). The great development of this non-conventional investment approach was mainly originated by demand from institutional investors, through the mainstreaming of environmental, social, and governance principles in financial services, and by external pressures from the major nongovernment organizations (NGOs) worldwide (EUROSIF, 2010a).

This steep growth in SRI worldwide has stimulated the interest of academics and practitioners in conducting research on SRI performance (Fowler and Hope, 2007). Previous studies have mainly focused on measuring the risk-adjusted returns of several SRI assets, investment or pension funds, or SRI equity indexes in developed countries (Fowler and Hope, 2007). Although emerging markets have been a mainstream research area in the management and business agenda, thus far there has been little interest in SRI performance research in emerging countries. This lack is even more remarkable when considering that, according to the International Finance Corporation's[1] (IFC) claims, investor interest in SRI in emerging markets has gained momentum over the past decade (IFC, 2011).

A global overview indicates that SRI has gradually evolved in emerging markets to represent over €200 billion[2] (MERCER and IFC, 2009). This increase could be explained by the integration of corporate social responsibility (CSR) principles into financial markets, which is relevant to social and economic progress in emerging countries. More importantly, another relevant factor is the development of SRI equity indexes, which are non-conventional stock indexes of great relevance in this process because they have contributed to increased awareness and growing acceptance of the core concepts of sustainable investing among both companies and investors in these countries (IFC, 2011).

The most notable example of this process is the creation and development of the Brazilian Corporate Sustainability Index (BCSI) in Brazil in 2005. As an illustration, the amount of Brazilian retail SRI AuM grew from about €42 million in 2005 to over €700 million in 2009 (MERCER and IFC, 2009). This phenomenon has been similar to what occurred in the U.S. and Europe as a consequence of the appearance of the Dow Jones Sustainability Indexes (DJSI) and the FTSE4Good Indexes. However, although the U.S. and Europe SRI equity indexes' "revolution" has been widely studied (Schröder, 2007), similar studies have not been done in emerging markets.

To address this issue, this research explores, following traditional research on corporate social performance (CSP), the financial performance of the BCSI, thus contributing to the recent claims of the IFC and the World Bank that state that more research is required to further document the possible relationship between a company's sustainability performance and financial outcomes in emerging markets (IFC, 2011). Because the companies included in the BCSI are associated with higher levels of sustainability (see Appendix 3 for further details), this research should bring new insights about how companies' sustainability policies and strategies influence their financial performance. The analysis of BCSI performance could allow for the evaluation of how Brazilian companies manage risk and avoid costs (i.e., downside risks) and take advantage of sustainability-driven innovations in products, services, brands, and other intangibles (i.e., upside opportunities) (IFC, 2011).

Although there are SRI equity indexes in other emerging countries (see Appendix 1 for a complete list of the current SRI indexes in emerging markets), the BCSI was the second launched at the global level and the first of its kind in Latin America.[3] Moreover, the amount of SRI AuM in Brazil, where SRI has great institutional backing, is higher than in other emerging countries like India, where retail investors dominate. This is of special importance because institutional investors, such as pension funds, insurance companies, bank trusts, and other diversified financial forms, have become increasingly influential with their cross-border portfolios in the global financial markets in the past 20 years (Wen, 2009). Institutional investors' activism on SRI should subsequently promote global sustainability.

This study of SRI in Brazil is also relevant because that market, as with other emerging economies, presents some factors that differ from established markets and that could have a significant impact on SRI performance. Examples, among others, are the rapid population growth, the potential of companies in

[1] The IFC is the entity belonging to the World Bank Group that promotes sustainable development in the private sector of emerging markets. Further information can be found at: http://www.ifc.org/.

[2] This amount is mainly distributed among the Brazilian, Indian, and Chinese markets.

[3] In September 2010, the Mexican Stock Exchange announced an SRI equity index; however, at time of this writing, there was not enough market data to analyze this index. The publication of the index is scheduled for late 2012.