



# The price of ethics and stakeholder governance: The performance of socially responsible mutual funds<sup>☆</sup>

Luc Renneboog<sup>a,b</sup>, Jenke Ter Horst<sup>a</sup>, Chendi Zhang<sup>c,\*</sup>

<sup>a</sup> CentER, Tilburg University, P.O. Box 90153, 5000 LE Tilburg, The Netherlands

<sup>b</sup> European Corporate Governance Institute (ECGI), Brussels, Belgium

<sup>c</sup> Warwick Business School, University of Warwick, CV4 7AL Coventry, UK

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## ABSTRACT

Do investors pay a price for investing in socially responsible investments (SRI) funds, or do they obtain superior returns? This paper investigates these under- and overperformance hypotheses for all SRI funds across the world. Consistent with investors paying a price for ethics, SRI funds in the US, the UK, and in many continental European and Asia-Pacific countries underperform their domestic benchmarks by –2.2% to –6.5%. However, with the exception of some countries such as France, Japan and Sweden, the risk-adjusted returns of SRI funds are not statistically different from the performance of conventional funds. We also find that the underperformance of SRI funds is not driven by loadings on an ethics style factor. There is mixed evidence of a smart money effect: SRI investors are unable to identify the funds that will outperform in the future, whereas they show some fund-selection ability in identifying funds that will perform poorly. Finally, corporate governance and social screens yield lower risk-adjusted returns.

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## 1. Introduction

“The life of money-making is one undertaken under compulsion, and wealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else.”

Aristotle, written around 350 B.C.<sup>1</sup>

Although economics textbooks usually state that human behavior is driven by the maximization of self-interest, many people deviate from exclusively selfish behavior (Fehr and Gächter, 2000 and 2002). For example, recent experimental evidence indicates that altruism or selflessness is a powerful feature of human demeanor (Fehr and Fischbacher, 2003). An individual's utility partially depends on the utility of other members of the community, and ethical and social considerations are important determinants of economic behavior.<sup>2</sup> Economic theories of social norms (see Akerlof, 1980, and Romer, 1984) point out that, even when individuals

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\* Corresponding author.

E-mail addresses: [Luc.Renneboog@uvt.nl](mailto:Luc.Renneboog@uvt.nl) (L. Renneboog), [j.r.terhorst@uvt.nl](mailto:j.r.terhorst@uvt.nl) (J. Ter Horst), [chendi.zhang@wbs.ac.uk](mailto:chendi.zhang@wbs.ac.uk) (C. Zhang).

<sup>1</sup> The Nicomachean Ethics, Book I.5; in the translation by Ross (1980).

<sup>2</sup> In fact, economics was for a long time seen as a branch of ethics (see Sen, 1987). For example, Adam Smith was a Professor of Moral Philosophy.

maximize self-interest, social norms that are financially costly to the individual may nevertheless persist if individuals are sanctioned by loss of reputation when disobeying the norm.<sup>3</sup> Using a repeated game framework, Bovenberg (2002) formalizes various roles of social norms and values that facilitate economic cooperation. He argues that social considerations of corporate stakeholders (including consumers, employees and shareholders) may incite corporations to care for public goods such as the natural environment, even when such social considerations do not yield a direct benefit to the stakeholders.

This paper studies the impact of ethics and stakeholder governance on the risk-adjusted performance of the money-management industry. We define stakeholder governance as the amalgam of good corporate governance (protecting shareholders' interests), sound stakeholder relations (protecting the interests of other stakeholders, including those of employees and local communities), and environmental care (protecting the environment). Stakeholder governance (as defined by Tirole (2001:4)) takes thus a broader view: it is "the design of institutions that induce or force management to internalize the welfare of stakeholders". Over the past decade, ethical mutual funds, often also more broadly called socially responsible investment (SRI) funds<sup>4</sup> which screen their investment portfolio based on ethical, social, corporate governance or environmental criteria, have experienced an explosive growth around the world. The assets in the SRI portfolios reached \$2.3 trillion in 2005 or approximately 9.4% of the total universe of professionally managed assets in the US (Social Investment Forum, 2005). This type of funds provides an ideal setting for studying the economic effects of ethical/governance/social strategies for the following reason. Investors in SRI funds explicitly pursue two types of goals: the economic rational goal of wealth-maximization and social responsibility. SRI investors are socially conscious and derive non-financial utility by holding assets consistent with their ethical and social values. Still, by investing in mutual funds rather than giving money to charity, SRI investors desire to enhance their financial utility as they expect positive risk-adjusted returns on their investments.

Academic interest has followed the rapid growth of the SRI industry. Most studies focus on SRI fund performance in individual countries (mainly, the US and the UK). Hamilton et al. (1993), Goldreyer and Diltz (1999), Statman (2000), and Bello (2005) show that the performance of SRI funds in the US is not significantly different from that of non-SRI funds. In contrast, Geczy et al. (2003) show that the financial costs of SRI screens on mean-variance optimizing investors can be substantial. Specifically, the SRI constraints impose a cost of more than 1.5% per month on investors believing in asset selection skills, i.e. investors who rely heavily on individual funds' historical risk-adjusted returns to predict future performance.<sup>5</sup> The UK evidence (Luther et al. 1992; Mallin et al., 1995 and Gregory et al., 1997) concludes that the difference in performance between SRI and non-SRI funds is not statistically different from zero. A similar conclusion is drawn by Bauer, Otten and Tourani Rad (2006) and Bauer, Derwall and Otten (2006) for Australian and Canadian SRI funds, respectively. Multi-country studies are undertaken by Schroder (2004) for US, German and Swiss SRI funds; by Bauer et al. (2005) for US, UK and German funds; and by Kreander et al. (2005) for SRI funds in a few European countries. A detailed review of this SRI literature can be found in Renneboog, Ter Horst and Zhang (in press). Still, it is rather difficult to draw definitive conclusions on SRI performance as some of the performance evaluation methods used in the above papers are deficient. For example, some studies use the CAPM model to evaluate fund performance without controlling for other risk factors such as size, book-to-market value, and momentum. In addition, given that the above studies are not only based on different methodologies but also on fairly small samples, different sample periods and benchmarks, international comparisons of SRI performance are difficult to make.

This paper makes the following four contributions to the literature. First, we relate the SRI fund performance to the performance of conventional funds in each country. This setup allows us to examine whether SRI fund investors pay a price for the ethical, corporate governance, social and environmental policies that firms have adopted across different institutional settings and in different phases of the economic cycles. In order to pursue social objectives, SRI funds employ a set of investment screens that restrict their investment opportunities. On the one hand, the exclusion of companies based on SRI screens may *constrain the risk-return optimization* and negatively influence fund performance. For instance, SRI funds typically do not invest in 'sin' stocks, i.e. publicly traded companies involved in producing alcohol or tobacco and in gambling, although these stocks have historically outperformed the market (see Hong and Kacperczyk, 2005). SRI investors who derive non-financial utility from investing in companies meeting high ethical/social standards may be content with a lower rate of return. Therefore, we expect SRI funds to do worse than their benchmarks and than conventional mutual funds (the *underperformance hypothesis*). On the other hand, the labor-intensive screening process applied by SRI funds may generate value-relevant information and yield superior fund performance (the *overperformance hypothesis*). Under this hypothesis, the SRI screens are usually also used as filters to identify managerial competence and superior corporate governance, or to avoid the potential costs of corporate social crises and environmental disasters.

Second, the paper investigates whether or not ethical investors are able to select the SRI funds that will generate superior performance in subsequent periods (*a smart money effect*). Geczy et al. (2003) show that the fund selection process of SRI investors

<sup>3</sup> Elster (1989) provides a review of the literature on social norms and economic theory, and argues that self-interest does not provide a full explanation for adherence to social norms. Following Akerlof (1980), social norms are defined as acts whose utility to the agent depends on the beliefs or actions of other members of the community. Social values are preferences that value particular social norms (Bovenberg, 2002).

<sup>4</sup> In the fund industry and in some academic papers, SRI funds are often called 'ethical' funds. In this paper, we also use these terms interchangeably (e.g. an 'ethical' investor is an SRI investor). It should be noted that the screens that SRI funds apply are unambiguously labeled: ethical screens are based on the ethical standards of a religion or ideology; social screens are based on the social policies adopted by firms (e.g. no child labor); corporate governance screens are based on corporate governance regulation; environmental screens are based on policies geared at protecting the environment or limiting environmental damage (see Renneboog, Ter Horst and Zhang (in press), Table 3 for an overview of SRI screens).

<sup>5</sup> To an investor who strongly believes in the CAPM and rules out stock selection skills, i.e. a market index investor, the financial costs of SRI constraints are merely 5 basis points per month.

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