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Article

Do ethical and conventional mutual fund managers show different risk-taking behavior?

Isabel Marco, Fernando Muñoz*, María Vargas

Centro Universitario de la Defensa, Universidad de Zaragoza, Zaragoza, Spain

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ABSTRACT

This paper analyses the risk-taking behavior of a fund manager in response to prior performance by conducting a comparative analysis between ethical and conventional investment portfolios. We examine the influence on managerial risk taking of the compensation and employment incentives. Our analysis looks at the British and Italian markets. We find differences in behavior between the two groups, with ethical investment portfolios managers enjoying greater freedom for shifting the risk taken. We can also see a greater influence of employment incentives in risk decision taking with respect to the managers of conventional investment portfolios. The results we have obtained are very similar for both the British and Italian markets.

1. Introduction

The influence of prior mutual fund performance on mutual fund managers' attitude to risk is a matter of interest that has been broadly covered in finance literature. Brown et al. (1996) are the first to analyze in their seminal study the influence that the incentives arising from the asymmetrical structure of the relationship between performance and fund flow have on the fund managers' attitude to risk. Huang et al. (2007) and other authors, show that while the mutual funds with the best prior performance are those that attract the greatest amount of inflows, the funds with the worst prior performance did not suffer proportional outflows.

Bearing in mind that the managers' wages depend in part on the assets they manage (Khorana, 1996), a compensation incentive arises. Fund managers seek to hold themselves in the best possible place in the year-end performance-based rankings in order to attract the greatest amount of inflow and thereby maximize their salaries. Brown et al. (1996) show how this incentive creates tournament behavior among mutual fund managers, meaning that those who occupy the lowest positions in the ranking at the end of the first part of the year (interim losers) increase their level of risk to a greater extent than those fund managers in the best positions (interim winners), in an attempt to catch up with them.

There has been much research in this area, showing empirical evidence for or against the results from Brown et al. (1996). Among those reporting empirical evidence in favor are Goriaev et al. (2001) and Basak et al. (2008), among others. Empirical evidence against this hypothesis is shown by Qiu (2003) and Goriaev et al. (2005), among others.

Other authors associate the thesis proposed by Brown et al. (1996) with a number of determining factors. For example Busse (2001) considers that such behavior varies depending on modifications to the frequency of data, while Taylor (2003) shows the benchmark as being the triggering event of the strategic response of fund managers. The study from Hallahan et al. (2008) argues against Taylor's theory. Furthermore, Kempf and Ruenzi (2008) believe that the size of the fund management company also influences its behavior.

Others focus on the risk of termination or employment incentives – the possibility that the fund manager might lose his or her job – as being the main factor determining the behavior of the fund manager with respect to risk (e.g., Qiu, 2003). Kempf et al. (2009) argue that in a bearish market employment incentives dominate, while compensation incentives are more common in a bullish market. They can also see that when compensation incentives prevail, the lowest ranking fund managers over the first part of the year are those who increase risk-taking in the second part of the year to the greatest extent. When employment incentives are foremost, on the other hand, the opposite occurs.

In this study, we analyze whether or not the ranking obtained by a fund based on its performance over the first part of the year has an

* Corresponding author.
E-mail address: fmunoz@unizar.es (F. Muñoz).

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influence on behavior, compared to the risk taken by the fund manager in the second part of the year. We conduct this analysis from the perspective of a comparison between ethical and conventional mutual funds.

We also extend the analysis to examine whether or not there is a difference in behavior depending on whether compensation or employment incentives dominate and whether or not both types of incentives influence mutual fund managers in the same way, regardless of whether they manage ethical or conventional funds.

The most interesting point of this study is the comparative analysis of risk-taking behavior of conventional and ethical fund managers in response to prior performance, as to the best of our knowledge no prior research examines this matter in the case of socially responsible mutual funds. The boom in recent years of ethical mutual funds both in Europe and elsewhere highlights the importance of examining the behavior of fund managers and investors in mutual funds of this nature. Furthermore, bearing in mind that ethical funds not only pursue financial interests but also have more socially orientated objectives, it is reasonable to surmise that their behavior differs in certain aspects.

With respect to ethical mutual funds, the topic most frequently analyzed by researchers is a comparison of their financial performance with that of conventional investment funds. Certain authors have found evidence in favor of ethical funds (e.g., Derwall and Koedijk, 2009), while others have presented evidence to the contrary, (e.g., Renneboog et al., 2008). There is also research that argues that there are no significant differences in the levels of financial performance of both types of funds, as proposed by Cummings (2000); Kreandert et al. (2005); and Bauer et al. (2007).

Behavioral finance literature also examines socially responsible investment. Such is the case of research that examined the behavior of investors, as seen in Geczy et al. (2003), Renneboog et al. (forthcoming, 2007), and Bollen (2007).

Investor behavior is of particular interest in our paper, and it further justifies the comparative study of ethical and conventional fund managers. The fact that the ethical mutual fund investor shows himself as more sensitive to positive prior performance and less sensitive to negative prior performance suggests a structure that is even more asymmetrical, in the performance-fund flow relationship, and thus there are even greater incentives for fund managers to take on additional risk. In other words, ethical mutual fund managers enjoy greater flexibility to modify the risk taken.

The remainder of the paper is structured as follows. In the second section, we explain the growing importance of the ethical mutual fund industry, especially in the two countries we study. Section 3 describes the database used in our analysis. Section 4 presents our methodology. Section 5 provides empirical results. Section 6 contains a series of tests to confirm the robustness of the findings. Finally, Section 7 concludes.

2. British and Italian ethical mutual fund markets

An ethical mutual fund functions in exactly the same way as a conventional fund, with one fundamental difference. When selecting the investments that will make up the portfolio, managers not only consider criteria such as return and risk but also a range of ecological, social and ethical aspects. This type of mutual fund is aimed at investors who not only wish to ensure maximum returns with minimum risk but also seek a series of related social objectives, including, for example, the environment, the encouragement of human rights in certain areas and the promotion of good corporate governance practices.

Ethical mutual fund portfolios are comprised of carefully selected companies who have passed through a strict ethical screen. An Ethics Committee is responsible for analyzing negative screens

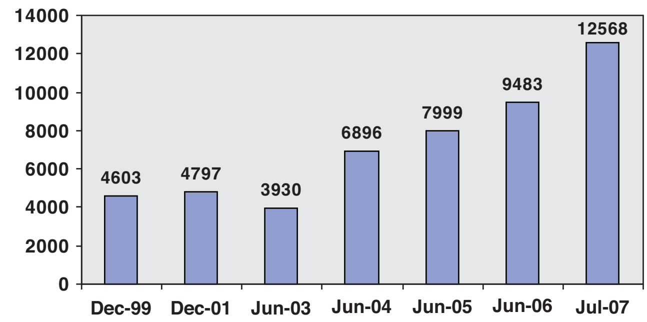

Fig. 1. Evolution of total assets managed by British ethical mutual funds (€ millions). Graph 1 shows the evolution of total assets managed by UK ethical mutual funds from December 1999 to July 2007. The data were obtained from reports drawn up by the SIRI (Sustainable Investment Research International) Group.

that will prevent the financing of pre-determined activities (e.g., companies that are in breach of certain ethical principles, such as human rights), as well as positive screens that seek to influence business attitudes by working towards more sustainable development therefore providing incentives in the form of investment for companies that act in a socially responsible manner.

Countries in which socially responsible investment is most common have seen a gradual growth in Social Investment Forums that aim to promote such activity by running informative campaigns, publicly advising as to good business practices and facilitating dialogue and the dissemination of information regarding the ethical investment industry. In North America, it is worth mentioning the US Social Investment Forum and the Social Investment Organization (SIO) in Canada. Seven similar institutions have already been set up in Europe (in the United Kingdom, the Netherlands, Germany, France, Italy, Switzerland and Belgium) with others planned (e.g., Spain, Norway, and Austria). In Asia, there is for example the Association for Sustainable & Responsible Investment in Hong Kong, as well as the Ethical Investment Association in Australia.

In 2001, the European Social Investment Forum (EUROSIF) was founded, a non-profit-making pan-European association set up to promote sustainability in financial markets, thanks to the efforts of five national social investment forums: France, Germany, Italy, the Netherlands and the UK, who together have basically established the direction the organization will take and the strategy it is to adopt. The importance of socially responsible investment, on both a European and global level, has continued to grow year after year. This has led to the appearance of financial instruments through which investors are able to channel their ethical investment.

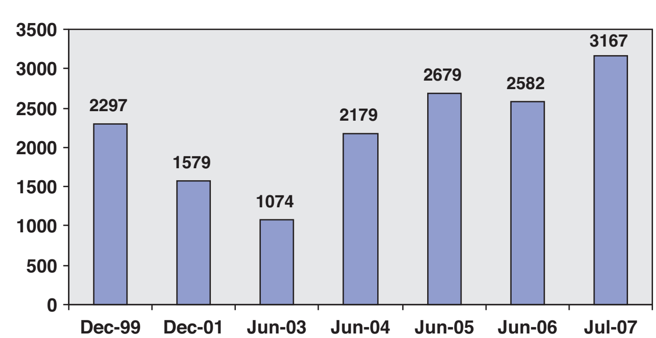

Fig. 2. Evolution of total assets managed by Italian ethical mutual funds (€ millions). Graph 2 shows the evolution of total assets managed by Italian ethical mutual funds from December 1999 to July 2007. The data were obtained from reports drawn up by the SIRI (Sustainable Investment Research International) Group.