



## SOCIALLY RESPONSIBLE MUTUAL FUNDS - A PROFITABLE WAY OF INVESTING

**Indre SLAPIKAITE**

Faculty of Business Management  
Vilnius Gediminas Technical University  
Vilnius, Lithuania  
*indre.slapikaite@gmail.com*

**Rima TAMOSIUNIENE**

Faculty of Business Management  
Vilnius Gediminas Technical University  
Vilnius, Lithuania  
*rima.tamosiuniene@vgtu.lt*

### Abstract

*In the presented paper there is analyzed the idea, essence and strategies of socially responsible investing, there is also made a review of socially responsible mutual fund market worldwide and in the Baltics, and made a research on the relation between financial and social performance of mutual funds. Finally, there are presented results of a comparative analysis of S&P 500 TR and Index Morningstar Moderate Target Risk to their benchmarks. The presented results show the trends of socially responsible market and the effectiveness of socially responsible mutual funds comparing to their benchmarks. The specifics of socially responsible mutual market in the Baltics and research of the link between financial and social performances of mutual funds may lead to the further scientific researches.*

**Keywords:** socially responsible investing, socially responsible mutual funds, ESG criteria, benchmarks, socially responsible mutual fund market.

**JEL classification:** G15, G20, J11

### 1. INTRODUCTION

During the last few decades investment funds have taken a significant part in most of the developed countries' financial systems. The variety of funds and opportunities for the investors are increasing constantly together with the extent of the investments. Therefore, the economies and social sectors of the 21<sup>st</sup> century simply seem to be not invisible without the investment funds (Bivainis and Volodzkienė, 2008, p.150).

Together with the growth in the mutual fund industry and concern over environmental and social issues problems some new investment typologies have been created. Socially Responsible Investment (SRI) – the type of investment that was first created in the USA in

the beginning of the Seventies, nowadays developed into a dynamic and promising market (Kempf and Osthoff, 2008, p.1; Plakys, 2011, p.56; Barreda-Tarrazona et al., 2011, p.305).

Barreda-Tarrazona et al. (2011, p.306) assesses the interrelation between social responsibility and investment decisions as a promising research field. The related literature and studies can be divided into: analysis from a sociological, psychological and even philosophical perspective of investors' explanations regarding SRI; and studies of the potential opportunity costs of SRI comparing to other investments, by means of performance measures. The academic community has displayed considerable interest in the analysis of SRI investment performance but there have no existing relationship indicated between individual dimensions of SRI and returns (Climent and Soriano, 2011, p.275).

Socially responsible investing (SRI) is sometimes called as a niche investment strategy or a global phenomenon that is based on aligning financial benefits with values incorporating environmental, social and corporate governance (ESG) factors into the investment process. In other words, it can be described as investment strategy that seeks to maximize both financial return and social good (Bello, 2005, p.42). According to Pivo (2005, p.16), socially responsible investing can also be pointed to three main activities: financial profitability of investments, social performance of enterprises, and ecological integrity.

The origins of socially responsible investing started back in the biblical times when Jewish law laid down directions how to invest ethically (Schueth, 2003, p.189). Modern roots of SRI is dated from the 1960s together with the social movements such as civil rights, feminism, environmentalism and protest against the Vietnam War (Ferruz et al. 2007). Two decades later, back in the 1980s, the number of socially concerned investors dramatically grew when millions of people, institutions and even states focused investment strategies on worldwide problems: Chernobyl's accident, Bhopal (gas disaster in India), the racist system of apartheid in South Africa (Schueth, 2003, p.190; Howell, 2008, p.245). Today the climate change is widely recognized as the most significant environmental issue facing the global economy. Therefore, the investor demand is mainly focused on investment opportunities in clean and green technology, alternative and renewable energy, responsible property and business development and environmentally driven businesses (Climent and Soriano, 2011, p.275).

This investment strategy is essentially interested in promoting the adherence to the positive aspects of areas such as corporate governance and ethics, workplace practices environmental concerns, product safety and impact, human right, community relations and indigenous people's right. Also it takes a lot of attention for industries and companies that act as a "bad" for society – businesses involved in gambling, tobacco, weapons and alcohol. All of them are often eliminated through SRI screening (Kinnel, 2009, p.10).

From the point of investor, socially responsible investing has a strong idea of making a world better – it does not only allows the investor to make money for a secure retirement, it also empowers to make a difference with the money (Kridel, 2005, p.72). Moreover – the vision has turned into a philosophy, since more and more people are becoming increasingly aware that the future is uncertain, unless the businesses take into account environmental, social and ethical issues into corporate decision making (Radu and Funaru, 2010, p.158).

Socially responsible investors include individuals and also institutions, such as corporations, universities, hospitals, foundations, insurance companies, public and private pension funds, non-profit organizations, and religious institutions.

The aim of the presented paper is to find the answers to the questions stated below:

How positive or negative is the effect of social – ethical criterias in the mutual fund performance comparing to benchmarks?

Does the link between social and financial performance of a socially responsible mutual fund exists?

## 2. ESG CRITERIA ANALYSIS AND INVESTMENT STRATEGIES

SRI mutual funds seek to invest in companies with sustainable business models. ESG criteria that incorporate environmental, social and corporate governance factors into the investment process helps identify better managed companies and construct portfolios with better long term investment prospects.

The impact of ESG criteria on financial performance of the companies is attained through the following business areas:

The effect of ethical behaviour of the mutual fund performance can be evaluated mainly in the two ways: at the company level and at the ethical portfolio level.

Socially responsible investors apply three main strategies: screens to select investments, shareholder advocacy to influence companies and community investment for needy areas.

*Screening strategy* – socially responsible mutual funds subject stocks to a set of “screens”, or criteria. There are two main ways of applying screens: negative screen – whereby certain businesses are avoided (alcohol, tobacco, nuclear power, gambling, etc.), positive sreen to firms – those identified as engaging in socially responsible practices are seen as more attractive for investments (Andritoiu, 2010; Kinnel, 2009, p.10; Barreda-Tarrazona et al., 2011, p.306).

*Shareholder advocacy strategy* – where the investor acquires shares in companies that would be rejected by the first strategy (social screening). The goal of such strategy is to make an impact on the company’s policies – to be more socially responsible through shareholders resolutions and divestment campaigns. The tool of this pressure on the company’s management is through a dialogue or filling shareholder resolutions to amend any social, environmental or labor issue. The biggest advantage of this strategy is that investors are allowed to benefit from the company’s stock price appreciation and dividends together with changing with company’s policies. But the minus is that generally it requires a large commitment of time and capital (Cortez et al., 2009, p.574; Andritoiu, 2010).

*Community investing strategy* – with this strategy, the investor directs capital to communities around the world that have limited access to traditional financial services institutions or funding. A common misconception is that these investments are donations. Many community investments are put toward community development banks in developing countries or in lower-income areas in the U. S. for affordable housing and venture capital. Generally, you can lend your money and get paid interest and get paid back and help the world (Carter, 2007; Andritoiu, 2010).

Table no. 1 ESG criteria effect on financial performance of the companies

	<b>Environmental</b>	<b>Social</b>	<b>Governance</b>
<b>Criteria</b>	<ul style="list-style-type: none"> <li>- Resource management and pollution prevention</li> <li>- Reduced emissions and climate impact</li> <li>- Environmental reporting</li> </ul>	Workplace: <ul style="list-style-type: none"> <li>-Diversity</li> <li>-Health and safety</li> <li>-Labor – management relations</li> <li>-Human rights</li> </ul> Product integrity: <ul style="list-style-type: none"> <li>-Safety</li> <li>-Quality</li> </ul> Community impact: <ul style="list-style-type: none"> <li>-Community relations</li> <li>-Responsible lending</li> <li>-Corporate philanthropy</li> </ul>	<ul style="list-style-type: none"> <li>- Executive compensation</li> <li>- Broad accountability</li> <li>- Shareholder rights</li> <li>- Reporting and disclosure</li> </ul>
<b>Impact on company's performance</b>	<ul style="list-style-type: none"> <li>- Avoid or minimize the effect on the environment</li> <li>- Lower costs / increase profitability through efficiencies (i.e. energy)</li> <li>- Reduce regulatory, litigation and reputational risk</li> <li>- An indication of well – governed company</li> </ul>	Workplace: <ul style="list-style-type: none"> <li>- Improved productivity</li> <li>- Reduced turnover and absenteeism</li> <li>- Openness to new ideas and innovation</li> <li>- Reduce potential for litigation and reputational risk</li> </ul> Product Integrity: <ul style="list-style-type: none"> <li>- Create brand loyalty</li> <li>- Increased sales based on product safety and excellence</li> <li>- Reduce reputational risk and potential for litigation</li> </ul> Community impact: <ul style="list-style-type: none"> <li>- Improve brand loyalty</li> <li>- Protect license to operate</li> </ul>	<ul style="list-style-type: none"> <li>- Align interests of shareowners and management</li> <li>- Avoid unpleasant financial surprises of “blow-ups”</li> <li>- Reduce reputational risk</li> </ul>

Source: [The Benefits of ESG]

Key findings by Barnett and Salomon (2006, p.1114-1116):

- Financial return declines when the number of social screens increases. SRI funds that are using few screens improve financial performance by diversifying portfolio;
- SRI funds that use many social screens (like 7-12 screens) may benefit by eliminating underperforming companies;

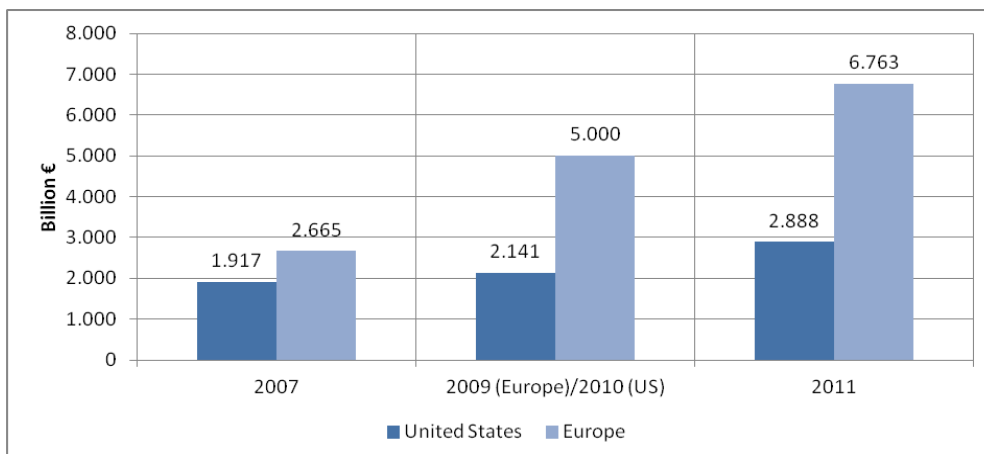
- Community relations screening increases better performance of SRI funds. Companies operating costs reduce because of fewer local restrictions, better access to skilled employees and less criticism from activists.

According to the Report on Socially Responsible Investing Trends in the United States (2012, online) ESG criteria incorporation is also stated as the socially responsible strategy. While comparing it to the above mentioned strategies, it takes an outstanding place worldwide – more than 50 percent in total SRI mutual fund assets. Also it is a rather usual practise for two of the investment strategies to be combined (mostly shareholder resolutions with ESG incorporation), therefore, there should be eliminated double-counting for assets in both strategies of the funds.

### 3. REVIEW OF SOCIALLY RESPONSIBLE INVESTING MARKET

#### 3.1. United States versus Europe

Investing in socially responsible mutual funds has been a booming market in the United States and Europe during the past few years. From year 2007 to the year 2009 – 2010, SRI market in US has grown from 1.917 billion euro to 2.141 billion euro in 2010 (+12%). While during the shortest period SRI market in Europe has grown almost twice (+88%) – from 2.665 billion euro in 2007 up to 5 billion euro in 2009. Moreover, European SRI market took more than a half of total world's market in 2007 and approximately 66% in year 2009.



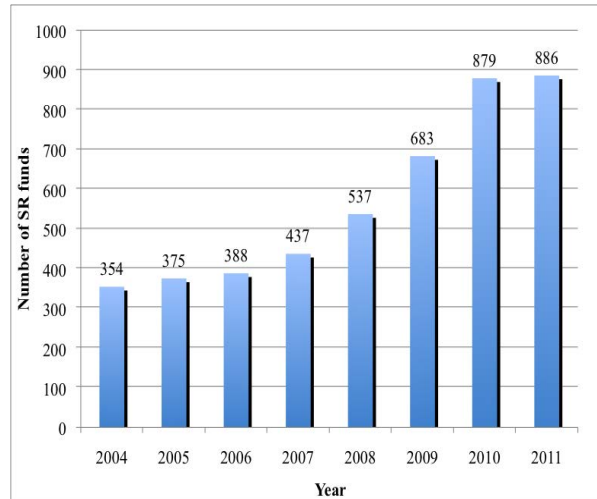
Source: [European SRI study 2010, European SRI study 2011, Report on Sustainable and Responsible Investing Trends in the United States 2012]

**Figure no. 1 SRI market in United States and Europe, from the year end 2007 to 2011**

According to the latest data provided (Source: European SRI study 2010, European SRI study 2011, Report on Sustainable and Responsible Investing Trends in the United States 2012), for the end of the year 2011 European SRI market was more than two times bigger comparing to the SRI market in USA.

Despite the world financial crisis, the number of socially responsible mutual funds kept on growing rapidly. Between 2008 and 2009 the growth was from 537 to 683 funds (+21%),

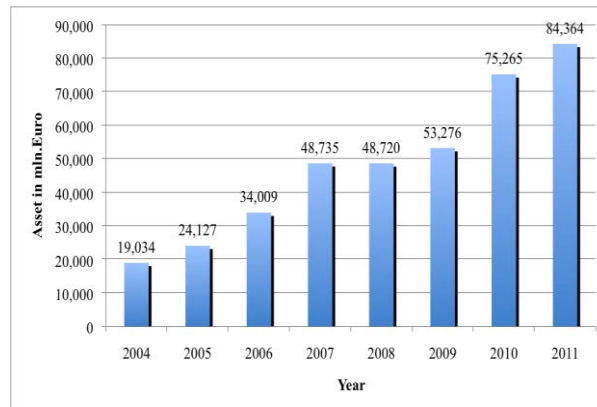
between year 2009 and 2010 – from 683 to 879 funds (+22%). The amount of SRI funds in Europe is presented in the Figure 2 below. The biggest increase in the number of SRI funds belongs to Belgium, France, U.K. and Switzerland. These for countries account for 72% of total SRI funds in Europe (Green, Social and Ethical Funds in Europe 2011).



Source: [Green, Social and Ethical Funds in Europe 2011; European Responsible Investing Fund Survey 2012]

**Figure no. 2 Number of SRI funds in Europe, period 2004 – 2011**

The most rapid growth of SRI funds was from the year 2009 to 2010 – 29% (Figure 3). In number of mutual funds and SRI assets the biggest part comparing to the rest of the Europe belongs to four countries - France, U.K., Switzerland and Belgium. These markets take approximately 76 % of all assets under SRI management in Europe (Green, Social and Ethical Funds in Europe 2011).



Source: [Green, Social and Ethical Funds in Europe 2011]

**Figure no. 3 Total asset under management for SR funds domiciled in Europe**

The allocation of SRI assets has not changed significantly during the recent few years – equities representing 33% of total SRI assets and bonds decreasing from 53% to 51% (European SRI study 2010, European SRI study 2010). In 2007 equities represented 50% of total SRI assets, while bonds 39% (according to European SRI study 2008).

### *3.2. Baltic States market*

The SRI market in the Baltic States of Estonia, Latvia and Lithuania is insignificant comparing to the other countries in Europe. The first SRI fund, called New Europe Socially Responsible Fund at Limestone Funds, was launched in Estonia in 2008 with assets under management in amount of 650 million Euro by the end of year 2011 (Limestone New Europe Fund 2012).

Another fund – SEB Ethical Europe fund is offered by local asset manager SEB Asset Management and this fund is managed externally. Generally, financial market structure in the Baltic countries is called as special, because of the Scandinavian banks that are the main players in the market of the Baltic countries (European SRI study 2010).

With increasing popularity of socially responsible living more possibilities come to establish funds that follow the socially responsible investing ideas and rules. Even if there are not such funds sold/established yet in Lithuania, such type of fund with a proper marketing would gain lots of people confidence and capital. On the other hand, even if the popularity is increasing, the Baltic States market does not seem to be expanding in number of funds significantly because of to the banks of Scandinavian capital.

## **4. RELATION BETWEEN FINANCIAL AND SUSTAINABILITY RATINGS**

Many studies and literature have shown the link between good environmental performance and high corporate profitability, but this case still remains as an interesting topic for the debates. Especially when evaluating the economic activity that can be achievable through the correlation between environmental and financial performance (Radu and Funaru, 2011, p.158).

Most of the financial ratings does not include sustainability factors when evaluating fund's performance. In order to find out if there exists any relation between financial and sustainability ratings, the correlation analysis between Morningstar Rating (or Star Rating) and NIS Rating (or Heart Rating) has been made. Morningstar rating is about the fund's past performance which is measured in the scale from one to five star, with one designating a fund with a worst performance in the group and five given for a fund that has good past performance. NIS rating evaluates how mutual fund actually verifies the stated screens – either informally or via written policy (Morningstar Sector Methodology 2008; Benz, 2011). 57 SRI funds were selected that have both ratings in the scale from 1 to 5.

In this case, correlation coefficient measures the degree to which two different types of ratings are associated. The correlation coefficient varies from -1 to +1. A -1 indicates perfect negative correlation, and +1 indicates perfect positive correlation. In order to count the correlation coefficient, there was calculated mean, variance and standard deviation at first. The mean of NIS Rating is much higher (4.25) comparing to Morningstar Rating (2.95) and it means that, more funds of all selected 57 SRI funds are evaluated as highly sustainable. And the standard deviation is a little bit lower compared to the Morningstar Rating – it means that the values vary less wide from the mean.

Table no. 2 Descriptive statistics of NIS and Morningstar ratings

	<b>NIS Rating (Hearts)</b>	<b>Morningstar Rating (Stars)</b>
<b>Mean</b>	4.25	2.95
<b>Variance</b>	1.22	1.30
<b>Standard Deviation</b>	1.11	1.14

Source: [created by authors]

After counting the covariance which is a measure of the degree to which variables move in tandem (positive covariance means that numbers move together, a negative covariance means inversely movement), the correlation scope of the ratings was evaluated – it equals to 0.14.

The correlation between NIS and Morningstar ratings is positive – it means that it moves in the same direction. If one variable increases, other also increases and if one variable decreases, other also decreases as well. The correlation coefficient is 0.14 and this means a weak (low) or not significant correlation – ratings are not closely related to each other. Morningstar Rating evaluates only the fund's past performance and NIS Rating analyzes the screens stated in funds prospectus and verified with the funds managers how they apply the screens, either informally or via written policy.

## **5. COMPARATIVE ANALYSIS OF SRI FUNDS AND BENCHMARK PERFORMANCE**

Superior performance of SRI funds is mostly linked to the management companies that specialises in SRI. It can be described that more ethical management companies could be less prone to act against investors' interests, which may give an effect of a better fund performance. Also, they could be more inclined to manage SRI funds. Therefore, SRI funds operated by these companies could, thus, outperform conventional funds (Gil-Bazo et al., 2010, p.246).

In order to find out if a certain investment gains better performance comparing to another type of investment, the analysis of SRI funds comparing to the appropriate benchmark was executed. The choice of the benchmark must be well weighed and motivated. Chegut et al. (2011, p.80) suggests utilizing multiple benchmarks to evaluate the performance of SRI and also emphasizes that ranking an SRI fund against socially responsible and conventional indexes gives more insight about the fund.

Data used the research:

a. SRI mutual funds used in the research are those who are rated according to Natural Investments Social (NIS) Rating (Natural investment social rating...online 2011) and according to the Morningstar Rating (Kramer, 2007; A Guide to Mutual Fund Ratings...online 2012);

b. Quarterly performance data for the period 2001-2012 Q4 of 40 socially responsible mutual funds were used from Yahoo Finance database;

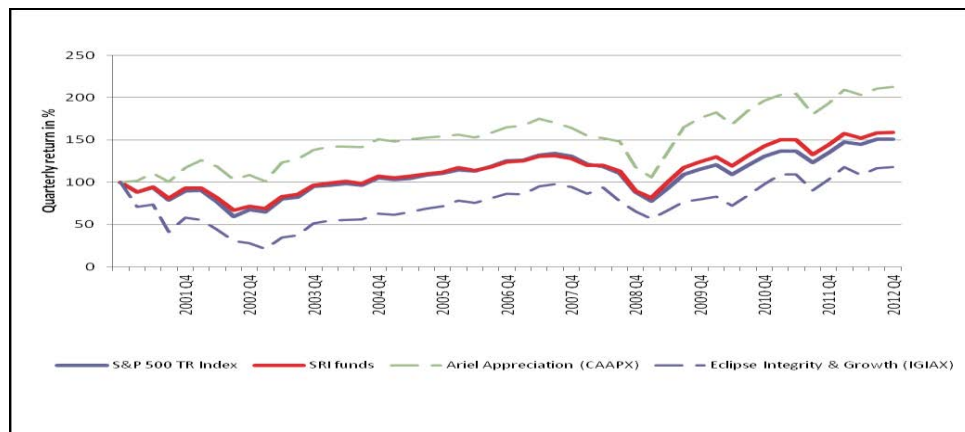
Funds from the whole sample used in the research were grouped according to the benchmark that is practically applicable: 29 mutual funds were compared to S&P 500 TR benchmark and 11 mutual funds Morningstar Moderate Target Risk benchmark.



### 5.1. SRI funds to S&P 500 TR\* Index

S&P 500 TR\* Index includes 500 large – cap common stocks that are actively traded in the United States. The index focus is U.S. based companies although there are a few legacy companies with headquarters in other countries. Many mutual funds, exchange-traded funds and other funds like pension funds are designed to track the performance of the S&P 500 index. The stocks that are included in the S&P 500 TR Index are those of large publicly held companies that trade on either of the two largest American stock market exchanges – the NASDAQ and the New York Stock Exchange (S&P 500 Sector Breakdown...online 2012).

In the figure 4 there is presented quarterly returns of 29 SRI funds that are being compared to S&P 500 TR Index. Upward development is from 2003 Q1 to 2007 Q3. During this period SRI fund performed better than the S&P 500 TR Index. Downward movement started from 2007 Q3 to 2009 Q1 – benchmark's quarterly returns are lower compared to the mean of SRI funds. Thus, the graphs shows a higher financial return of SRI funds that are compared to the certain index. Also, it is important to mention that the SRI funds recovered faster and more significantly after the world financial crisis (period 2009 Q2 – 2012 Q4).



Source: [created by authors]

**Figure no. 4 Quarterly returns of SRI funds and of S&P 500 TR Index in period 2001-2012 Q4**

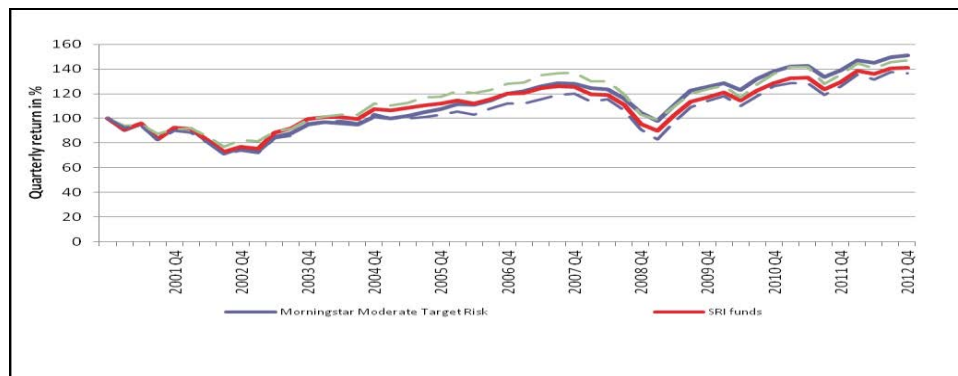
There are also analyzed the best (CAAPX) and the worst (IGIAX) performed SRI fund in the period 2001 – 2012 Q4. According to the figure 4, these socially responsible mutual funds are moved away from the benchmark nearly the same distance.

### 5.2. SRI funds to Morningstar Asset Allocation Index

The Morningstar Asset Allocation Index family includes two index series designed to benchmark target – date and target – risk investment products. The Morningstar Lifetime Allocation Index series consists of 13 indexes available in three risk profiles: aggressive, moderate, and conservative. The *Morningstar Moderate Target Risk Index* represents a portfolio of global equities, bonds, and traditional inflation hedges, such as commodities and TIPS. This portfolio is held in a static allocation of 60% equities and 40% fixed income,

which is appropriate for U.S. investors who seek average exposure to equity market risk and returns (Morningstar Moderate Target Risk Index...online 2012).

In the figure 4 there is presented quarterly returns of 10 SRI funds that are being compared to Morningstar Moderate Target Risk Index. Upward development is from 2003 Q1 to 2007 Q3. SRI funds almost all the time through upward trend outperform the benchmark index, except the period from 2006 Q4 to 2007 Q2. Downward movement (from 2007 Q3 to 2009 Q1) – benchmark's quarterly returns are higher compared to the mean of SRI funds. Thus, the graphs shows a higher financial return of SRI funds that are compared to the certain index. After the world financial crisis, SRI funds quarterly performance results are lower compared to the benchmark but it doesn't say anything about the volatility (risk) which was should be measured as well.



Source: [created by authors]

**Figure no. 5 Quarterly returns of SRI funds and Morningstar Moderate Target Risk Index in period 2001 – 2012 Q4**

The best (PAXWX) and the worst (SSIAX) performed socially responsible funds from the sample size goes closely to the benchmark index during all the analyzed period 2001 – 2012 Q4.

## 6. CONCLUSIONS

1. SRI market is growing rapidly in size and interest. Europe take the outstanding place worldwide – more than 60% of the market share. The most significant increase belongs in the number of SRI funds belongs to Belgium, France, U.K. and Switzerland - these for countries account for 72% of total SRI funds in Europe.

2. SRI market in the Baltic States is insignificant comparing to the other countries in Europe. The first SRI fund, called New Europe Socially Responsible Fund at Limestone Funds, was launched in Estonia in 2008. Another fund – SEB Ethical Europe fund is offered by local asset manager SEB Asset Management and this fund is managed externally. Situation in the Baltic States is different due to financial market structure in the Baltic countries is called as special, because of the Scandinavian banks that are the main players in the market of the Baltic countries. The specifics and further development of SRI market in the Baltics may be also analysed in the further researches.

3. The correlation between NIS and Morningstar ratings is positive – the data are moving in the direction, nevertheless, the correlation coefficient of 0.14 means a weak

correlation – ratings are not closely related to each other. Therefore, it could be suggested to create a universal rating model or scale that would evaluate both financial and sustainability performances of the certain mutual fund at once. Also, as the close relation between financial performance and sustainability performance evaluation of mutual funds is rather weak, the analysis according to the same principles may be proceeded in the level of the companies in which the investments are made.

4. While comparing the average quarterly returns of SRI fund sample size to S&P 500 TR\* Index and Morningstar Asset Allocation Index for the period 2009 Q2 – 2012 Q4, generally, the results show higher financial return of SRI funds that are compared to the certain index. Also, SRI funds recovered faster and more significantly after the world financial crisis – especially comparing to S&P 500 TR\* Index. SRI funds compared to Morningstar Asset Allocation Index shows slightly lower results, but it may be characterized by the lower risk as well.

5. As the findings show generally positive results of socially responsible mutual funds' performance comparing to the benchmarks, therefore, this type of investing should be encouraged more by the fund managers and the government of developing countries should assess this as the opportunity to improve economy and social welfare of the country.

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