



DOES SOCIALLY RESPONSIBLE INVESTING HURT INVESTMENT RETURNS?

A common concern about socially responsible investing (SRI) is that there is a premium to be paid for being socially responsible that necessarily diminishes investment returns. A comprehensive review of the empirical literature questions this premise. At RBC Global Asset Management, we monitor a broad range of financial trends and issues that may influence our clients' decision-making. Periodically, we produce research articles to help provide background for investment decisions on many different levels. This article, an update of an earlier research paper, challenges the myth of lower long-term returns for SRI investors and provides an overview of the current research on the subject.

Introduction

Socially responsible investing (SRI) has been practiced for more than a century. Almost from the beginning, practitioners, academics and the investing public have asked if the inclusion of social and environmental considerations in the investment decision-making process hurts investment returns.

The answer to this question is central to the future growth of SRI. If it is the case that SRI produces lower investment returns, then SRI will never be more than a niche market, appealing solely to those individuals with strong convictions about the types of companies they want to hold and who are prepared to accept less material wealth in order to satisfy these concerns. If, however, it can be shown that SRI produces superior investment returns, then SRI will move further into the mainstream and traditional investment managers increasingly will integrate SRI principles into their investment processes in order to boost returns. Finally, if research shows that there is no material difference between the investment performance of SRI funds and traditional investment funds, then SRI will establish itself as a legitimate investment alternative for those investors who believe companies should be held accountable for their social and environmental practices.

Opponents of SRI argue that the application of non-financial considerations, such as environmental, social, and governance (ESG) factors, to the investment process must result in lower investment returns because the number of investment opportunities is reduced. Relying on modern portfolio theory, this position, stated crudely, says that investment portfolios constructed from an investment universe of, say, 2,000 companies will be more efficient (i.e., they will have higher expected returns and/or lower expected volatility) than portfolios constructed from an investment universe



of, say, 1,500 companies. In other words, SRI works with a smaller investment universe and therefore will generate lower expected risk-adjusted returns¹.

Supporters of SRI readily admit that the application of ESG considerations will reduce investment opportunities – after all, the *raison d'être* of SRI is to exclude “irresponsible” companies from consideration – but argue that their integration into the investment process delivers benefits that more than offset the loss of portfolio efficiency caused by the more limited investment set. Socially responsible investors believe that integrating ESG factors into the investment process will eliminate companies that are expected to perform more poorly than their competitors. Excluded companies are engaged in unsustainable activities or practices that will make them less profitable over time². In other words, companies that embrace corporate social responsibility (CSR) will deliver better financial performance than competitors that do not, and market participants systematically overlook these positive factors. Therefore, SRI proponents argue that any loss of portfolio efficiency due to a smaller investment universe is more than offset by the more attractive investment characteristics of the remaining companies.

¹ A useful discussion and more formal treatment of this argument are found in Geczy et al. (2005).
² For example, companies, which are heavy polluters, have a greater chance of facing litigation over their emissions and will use more inputs in production.

There is a third view, which to date has not received as much attention. This view holds that, under normal conditions, there should be no meaningful difference between the long-term performance of a broad universe of SRI funds and a broad universe of traditional investment funds that are managed with comparable mandates. This view is based on three premises:

- The integration of ESG factors into the investment process, providing it employs a best-of-sector approach³, reduces the investment universe on a random basis;
- The number of securities eliminated through the integration of ESG considerations is not large; and
- The smaller investment universe does not produce a material loss of efficiency in portfolios constructed from that universe.

Proponents of this view have divorced themselves from the ideologically-laden debates about whether SRI funds should perform better or worse than traditional investment funds. Instead, they believe that there should be no expected difference in performance and that the merits of SRI rest entirely with the wishes of individual investors. According to this view, SRI does not involve a Faustian choice between following one's conscience and following one's pocketbook; instead, it is a legitimate investment approach that can be expected to provide investment performance on par with investment funds that do not formally apply socially responsible investment principles.

Given these competing theoretical views, the question of how SRI portfolios perform relative to traditional investment portfolios is, at the end of the day, an empirical one. Research into this question has been approached in four ways:

- Comparing the performance of SRI indices with traditional indices;
- Comparing the performance of SRI funds with traditional investment funds/indices;
- Creating hypothetical portfolios of companies ranked highly against ESG factors and comparing their performance with lower-ranked companies; and
- Comparing the financial performance of companies that score highly on measures of corporate social performance with those that do not.

The remainder of this report provides an overview of the key findings of the empirical research conducted in each of these areas. The main finding from this body of work is that socially responsible investing does not result in lower investment returns.

Index Comparisons

An index is a universe of securities constructed to represent a particular market or asset class. Examples include the S&P/TSX Composite Index, a grouping of about 250 companies representing the Canadian stock market, and the S&P 500 Index, a grouping of 500 companies representing the U.S. stock market. While construction rules differ among indices, two important features of most are that: (i) larger capitalization securities have a higher weight in the index than smaller capitalization securities and (ii) the composition of the index is adjusted regularly, either based on the decisions of an oversight committee and/or through a rules-based formulation.

Stock market indices have been around for more than a century. While they serve many purposes, one of the most important is to permit investment managers to compare their performance with that of the overall market. In the past 30 years, there has been a significant increase in the number of indices available to investors⁴.

In May 1990, the Domini 400 Social Index (now the FTSE KLD 400 Index) was created, the first index to measure the performance of a broad universe of socially responsible stocks in the United States. Since then, a number of other SRI indices have been created⁵, including the:

- KLD Global Sustainability Index (GSI) (2007);
- MCSI North American ESG Total Return (NNASIU) Index (2010);
- Dow Jones Sustainability North American Index (2001);
- Dow Jones Sustainability Group Index for global portfolios (1999);
- Jantzi Social Index (JSI) in Canada (2000);
- Calvert Social Index in the United States (2000);
- ECPI Index Family for European and global portfolios (2000);
- FTSE4Good Index for global portfolios (2001);
- ASPI Eurozone Index for European markets (2001);
- Johannesburg Stock Exchange SRI Index (2004);
- Ethibel Sustainability Index Global (2002).

One method to determine if SRI results in lower investment returns is to compare the performance of an SRI index with a comparable traditional index.

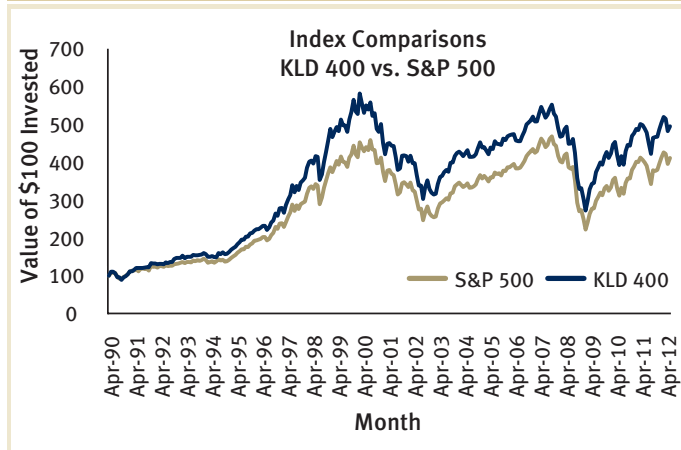
³ Rather than exclude all companies in a sector that is considered "bad," such as mining, the "best-of-sector" approach seeks to identify those companies with the best relative ESG performance within the sector peer group.

⁴ The five main global providers of stock market indices are: Standard & Poor's (S&P), Russell, FTSE, Morgan Stanley Capital International (MSCI) and Dow Jones.

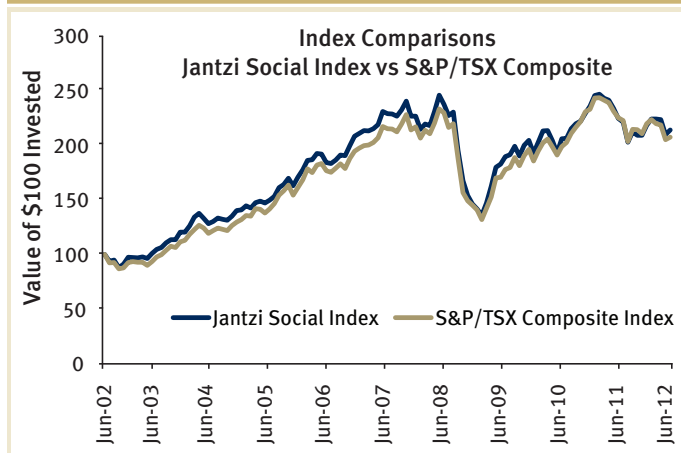
⁵ For a more comprehensive list, including definitions of indices, please refer to "Vice vs. Virtue Investing Around the World," Lobe and Walkshausl (2011)

This is shown in the charts below for the United States and Canada. In both cases the SRI index has slightly outperformed the traditional index, although the differences are small. However, there can be meaningful differences, both positive and negative, over shorter periods (e.g., differences of +/- 2% over a one year period are not uncommon, and they have been as large as 5%).

U.S. Index Comparison



Canadian Index Comparison



Looking at SRI indices has the advantage that it eliminates the effects of such factors as transaction costs, timing, and management skills; that a similar study of SRI mutual funds would need to address. However, a simple comparison of the performance of an SRI index with a comparable traditional investment index, while intuitively appealing, is not sufficient to determine if SRI performs better, the same, or worse than traditional investing. Differences in performance could, for instance, be due to style, industry, or size biases that have material impacts on performance during the comparison

period. For instance, SRI indices are widely acknowledged to have a growth bias relative to traditional indices and performance differences between these two indices over any given period could be caused by this factor. This has been illustrated in a study by Statman and Klimek (2005), who found that SRI indexes outperformed the S&P 500 Index in the late 1990's during the tech bubble, and subsequently lagged the S&P 500 Index in the early 2000's.

This has also been illustrated in an updated study by di Bartolomeo and Kurtz (2011). Performing a holdings-based attribution analysis using the Northfield U.S. Fundamental Equity Risk Model, they examined the risk and return characteristics of the S&P 500 Index and the KLD 400 Index for an 18-year period between January 1992 and June 2010. Within the total 18-year period, 2 sub-periods were also analyzed: January 1992-November 1999, and December 1999-June 2010. The KLD 400 outperformed the S&P 500 during January 1992-November 1999, but underperformed during the latter period. Di Bartolomeo and Kurtz concluded that the strong performance in the 1990s was entirely factor driven, during which time the KLD 400 Index had a higher market beta, bets on higher valuation, and an overweight position in the Information Technology sector (i.e., growth stocks). The underperformance following the 1999 peak was said to be due to an over reliance on the same factors. According to a CFA Digest summary of the study, conclusions were that “investors seeking superior investment performance have incurred no material benefit or cost from using (the KLD 400 Index) universe,” and that “predictions of negative alpha (for socially responsible stocks) are wrong.”

Other studies examining the relative performance of socially responsible indices have been conducted⁶. In their extensive review of relative performance in the U.S., UK, and Japan during the 2000's, Managi, Okimoto, and Matsuda (2012) concluded that conventional indices do not outperform SRI indexes, and that “investors can take ESG criteria into consideration without sacrificing risk or return.”⁷ However, while Schroder (2005) also confirmed this, he found that 20 of the 29 international SRI indices he looked at had higher risk (volatility) than their benchmarks. This suggests that on a risk-adjusted basis, SRI indices may underperform conventional indices.

As the number of SRI indices grows, and the length of their performance history increases, we expect to see more empirical research in this area. For the moment the evidence is mixed, but generally indicates that there is little or no difference in long-term performance.

⁶ See Luck (1998) and Dhrymes (1998).

⁷ See Managi, Okimoto and Matsuda (2012).

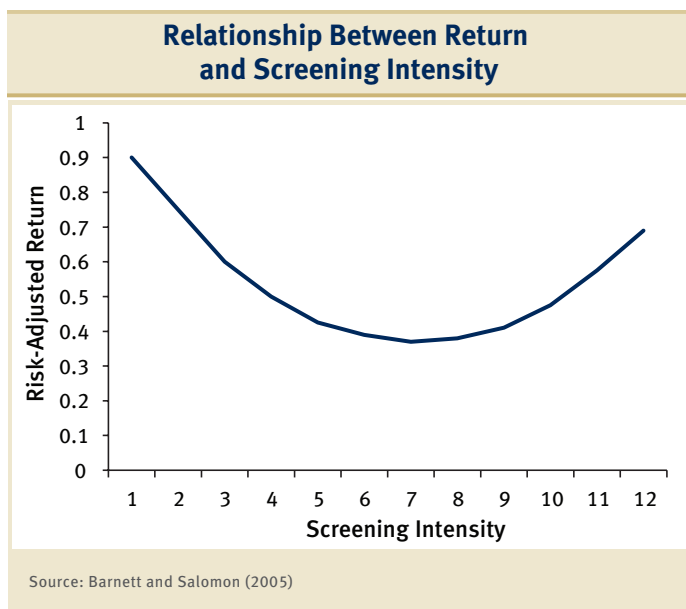
Mutual Fund Comparisons

A second body of work has attempted to determine if SRI results in lower investment returns by comparing the performance of SRI mutual funds with traditional mutual funds and/or traditional market indices. This research is difficult because the sample size of SRI mutual funds is small and few have performance histories exceeding 10 years. A third challenge is constructing an appropriate control group of traditional mutual funds. Notwithstanding these methodological issues, several studies have been conducted. The key findings of a selection of these studies are reported in Table 1.

The findings to date from these (and other) empirical studies are contradictory, although, with a small number of exceptions, in all cases where differences were found (higher or lower), the authors concluded that the differences were small and/or statistically insignificant.

Three interesting pieces of research have given some insights as to why the empirical evidence thus far has been contradictory. One study found that while SRI funds perform similar to conventional funds, conventional funds with a slightly higher SRI tilt tend to perform better than funds with fewer socially responsible companies⁸.

The second study⁹ found that there was a curvilinear relationship between the number of screens used by a fund and the financial performance of the fund. In plain English, this means that as the number of screens increases the returns of the funds at first decline and then begins to increase again. See the following graph as an illustration of this effect.



The explanation put forward by the researchers is that when you use only a small number of screens you eliminate fewer companies from your portfolio and consequently performance will not be greatly impacted. As the number of screens increases, more companies are eliminated from the portfolio, the portfolio is therefore less diversified and performance suffers. However, once a certain number of screens are reached the companies that remain in the portfolio are of a higher quality and lower inherent risk, and as such the performance then begins to improve. Blancard and Monjon (2010) further tested this relationship, and produced similar results.

Moreover, Cortez, Silva, and Areal (2009) found that SRI mutual funds have shown superior performance in Europe as opposed to the United States. This may be attributed, according to the authors, to differences in SRI investment style. The European SRI approach generally used positive criteria (security selections based on the most socially responsible companies), whereas the American approach was more oriented towards negative screening (security selection based on excluding the least socially responsible companies). These results imply further support for the curvilinear relationship.

This research seems to reconcile the current conflicting evidence, and is intuitively appealing. However, more corroborating research would need to be performed before we can reach any conclusions. Therefore, the evidence to suggest that SRI funds systematically underperform traditional mutual funds is limited, as is the evidence to suggest that SRI funds outperform traditional funds.

In separate reviews of this literature, two investment banks reached strikingly similar conclusions:

“Contrary to theory, most academic studies show that incorporating social screening into a portfolio does not necessarily have detrimental effects on performance. Studies suggested that SRI portfolios have about the same risk-adjusted returns as their normal counterparts.” (UBS Warburg, 2001, p. 14)

“...the balance of the empirical evidence supports the view that an SRI approach will in general not lead to long run risk-adjusted under-performance compared with a conventional approach.” (ABM-AMRO, 2001, p. 93)

⁸ See Plantinga and Scholtens (2001)

⁹ See Barnett and Saloman (2005)

Table 1: Summary of SRI Fund Studies

Study	Country	Data	Time Period	Findings for SRI Funds
Amene, Sourd (2008)	France	62 mutual funds compared to conventional indices	January 2002 to December 2007	<ul style="list-style-type: none"> No significant performance differences
Areal, Cortez, Silva (2010)	United States	38 SRI funds compared to the Vice fund and S&P 500 benchmark	October 1993 to September 2009	<ul style="list-style-type: none"> SRI funds performed better during a crisis Evidence of both higher and lower returns
Asmundson & Foerster (2001)	Canada	2 SRI Funds (over 10 year period) vs. TSE 300 Index	January 1990 to December 1999	<ul style="list-style-type: none"> Evidence of both higher and lower returns Lower risk
Bauer et al. (2002)	Germany, UK, & U.S.	103 SRI Funds and 4,384 traditional mutual funds	January 1990 to March 2001	<ul style="list-style-type: none"> Evidence of both higher and lower returns Differences are not statistically different
Bauer et al. (2006)	Canada	8 ethical, 267 conventional mutual funds	January 1994 to January 2003	<ul style="list-style-type: none"> No significant performance differences between funds
Bello (2005)	United States	42 SRI funds, 84 conventional funds	January 1994 to March 2001	<ul style="list-style-type: none"> Risk adjusted returns of SRI funds indistinguishable from returns of conventional funds Fund characteristics did not differ between the two groups
Cortez, Silva, Areal (2009)	United States, Austria, Belgium, France, Germany, Italy, Netherlands, UK	39 European market mutual funds and 7 US mutual funds compared to conventional and socially responsible indexes	August 1996 to August 2008	<ul style="list-style-type: none"> No significant performance differences for European funds Significant underperformance for US and Austrian funds
Derwell & Koedijk (2005)	United States	8 SRI bond funds	1987 - 2003	<ul style="list-style-type: none"> SRI bond funds provided returns similar to or superior to conventional bond funds Found to perform in-line during an economic expansion, and significantly outperform during an economic contraction
Derwall and Koedijk (2008)	United States	15 SRI mutual bond funds and 9 balanced mutual funds vs. their conventional counterparts	1987 to 2003 (months not specified)	<ul style="list-style-type: none"> Higher returns No results statistically significant Expenses for SRI funds did not cause underperformance
Geczy et al. (2003)	United States	35 no-load SRI funds and 859 no-load traditional mutual funds	July 1963 to December 2001	<ul style="list-style-type: none"> Lower returns Difference is significant under certain conditions
Gil-Bazo, Ruiz-Verdu, Santos (2008)	United States	86 SRI mutual funds compared to 1,761 conventional funds	1997-2005 (months not specified)	<ul style="list-style-type: none"> Higher risk adjusted performance before and after fees
Kreander et al. (2005)	Europe	30 SRI funds matched with 30 similar non-SRI funds	January 1995 to December 2001	<ul style="list-style-type: none"> No difference in performance on a risk adjusted basis
Magnier, Luchet, Schaff (2008)	Europe, North America, Australia, Asia	171 SRI mutual funds compared to non-SRI indexes and non-SRI funds	October 2006 to October 2008	<ul style="list-style-type: none"> No significant performance differences Best-in-class funds that did not use exclusion criteria performed better than those that did
Scholtens (2005)	Netherlands	12 SRI funds compared to SRI and non-SRI indexes	November 2001 to April 2003	<ul style="list-style-type: none"> Slight outperformance of SRI funds vs. the index Slight underperformance of SRI funds vs. non-SRI funds Neither result was statistically significant
Schroeder (2003)	Germany, U.S.A., UK	30 U.S. funds, 16 German and Swiss funds, and 10 SRI indices	Minimum of 30 months of data before 2002	<ul style="list-style-type: none"> No significant performance differences Some SRI funds exhibited insignificantly higher returns
Sourd (2012)	France	87 SRI funds compared to both cap-weighted and efficient benchmarks	January 2008 to December 2011	<ul style="list-style-type: none"> Most results insignificant Significant values were negative Efficient benchmarks were beat less often

* As reported in ABN-AMRO (2001).

Comparing Performance of High-Ranked Socially Responsible Companies vs. Low-Ranked Socially Responsible Companies

A third area of SRI research has been focused on creating hypothetical portfolios of socially responsible companies, using data primarily provided by Innovest Strategic Value Advisors¹⁰. For the most part, these studies have used a company's environmental rating as the key independent variable.

This area of research has evolved over the last ten years, and can be illustrated by looking at two studies. The first of these studies by Blank & Daniel (2002) took a portfolio made up of equally weighted positions of top-rated eco-efficient companies, and made three distinct performance comparisons,

1. to an equally weighted universe of all Innovest rated companies,
2. to an equally weighted portfolio of low-rated eco-efficient companies, and
3. to the S&P 500 (a comparison of risk adjusted returns using the Sharpe Ratio was used).

What the researchers observed is that, for all three comparisons, there was clear and significant out performance by the portfolio made up of top-rated eco-efficient companies for the observed period (1997 – 2001). The authors then went on to adjust these raw results for any kind of style bias, and found that there was still significant out performance for the “eco-efficient” portfolio. This observation was significant; as such a strong link between an SRI approach and excess returns had rarely been so clearly demonstrated in the past.

The second study in this area took the Blank & Daniel research a step further by taking a closer look at this “eco-efficiency premium puzzle” (Derwell et al. 2005)¹¹. This study took a more in-depth look at the out performance of the eco-efficient portfolio, and in particular at how this anomaly could be explained. The authors found that a portfolio made up of high ranked eco-efficient companies out performed a portfolio made up of low-ranked companies, and that it could not be explained by adjusting for market risk, investment style, and industry effects. The authors then went on to demonstrate how to build an eco-efficient portfolio that would outperform, even when transaction costs were considered. The authors conclude by observing that the superior performance of a portfolio constructed using environmental considerations as a key factor, could be an example of the market mispricing information on the ecological performance of companies.

More recent research has also provided some additional general insight¹². It has been observed that the eco-efficiency premium initially did not exist, but has developed and increased strongly over time. This indicates that environmental factors are having an increasingly significant effect on firm performance, and that the proportion of total risk that environmental risk represents is increasing.

In addition there is research that extends this effect to other socially responsible criteria. A study by Statman and Glushkov (2008) found that a portfolio of stocks with high ratings of a broad range of social responsibility characteristics outperformed those with low ratings. The factors that had the strongest correlation with performance were community, employee relations, and environment. Another study by Edmans (2007) found that there may also be an employee satisfaction premium. The researcher's findings imply that “the stock market does not fully value intangibles, even when independently verified by a highly public survey,” (e.g., “100 best companies to work for in America” by Fortune magazine), and “SRI screens based on employee welfare may improve investment performance.”

While this area of research has provided some interesting results, more empirical testing would add to our understanding of the factors that drive the eco-efficiency premium and how it has changed through time. In particular, results based on additional data sets and the performance of actual portfolios would be useful extensions to this line of research. Regardless, this will continue to be a fertile and interesting area of SRI research in the coming years.

Corporate Social Performance

The fourth approach to determine if SRI impacts investment returns has been to examine the financial performance of companies that score highly on one or more measures of good corporate social responsibility (CSR) versus those that do not. Proponents of SRI argue that companies embracing corporate social responsibility should deliver superior financial performance. Some of the benefits CSR is purported to deliver include¹³:

- An improved ability to attract and retain better employees;
- Competitive advantages in production technology designed to eliminate waste;

¹⁰ Innovest is an investment research and advisory firm that specializes in analyzing companies' performance on environmental issues, on a best-in-class approach, termed “Eco-Efficiency”.

¹¹ Derwell, Guenster, Bauer, & Koedijk (2005)

¹² Guenster, Derwall, Bauer, & Koedijk (2005)

¹³ These and other benefits of CSR are put forward by various non-governmental organizations promoting corporate social responsibility.

- More productive workforces;
- Higher sales and more loyal customers;
- Lower litigation costs;
- Lower environmental costs;
- Enhanced brand value and reputation;
- Better risk and crisis management; and
- Good relations with government and communities.

Supporters of SRI argue that these benefits will translate into improved financial performance.

Opponents of SRI are skeptical that CSR confers meaningful benefits on companies and, even if such benefits can be shown to be present, they do not translate into better financial performance. At best, according to opponents, there are no financial advantages to corporate social responsibility. Some opponents of SRI would go one step further: companies pursuing CSR will actually perform worse because such efforts will distract management from their key focus – to maximize profits¹⁴.

Needless to say, this question has been fertile ground for academic research and more than 100 empirical studies¹⁵ can be identified that have attempted to determine if a relationship between corporate social performance and financial performance exists. This research can be divided into two main segments¹⁶:

- **Event studies** – measuring the impact of a major CSR event on the subsequent financial performance of a company. A “CSR event” can be positive (e.g., receiving an award for good environmental management) or negative (e.g., a pollution spill or product recall).
- **Cross-sectional regression analysis** – examining the relationship between one or more CSR indicators and one or more measures of financial performance.

There has also been a number of what can best be described as “anecdotal” studies, which have used selective case studies to illustrate the benefits to companies of corporate social responsibility. For the most part, this “research” has been sponsored or prepared by non-governmental organizations dedicated to promoting the wide-spread adoption of CSR and, consequently, is of limited empirical value.

While the majority of these studies have found some evidence of a positive linkage between corporate social performance and financial performance¹⁷, these studies suffer many methodological failings that make it difficult to draw any strong conclusions. Three of the more serious methodological problems are:

- **Definition of the independent variable(s)**

Researchers are attempting to determine if CSR produces better financial performance. Three approaches have been used to specify the independent variable: (i) using one CSR attribute – such as good environmental stewardship or good corporate governance – as a proxy for CSR; (ii) using multiple CSR attributes as separate independent variables; and (iii) converting multiple CSR variables into a single CSR “index”, which is then used as the independent variable. Further, many CSR variables have a strong qualitative element and this makes it difficult to convert them into numerical values, which is necessary to perform statistical analysis. These definitional issues mean that CSR studies are often not directly comparable and this undermines the ability to reach strong general conclusions from this body of research.

- **Improper model specification/omitted variables**

Most often these studies have used relatively simple linear regression models to determine if a statistical relationship exists between CSR and financial performance. Until recently, these studies have often omitted other variables that could affect financial performance. Some of the better work more recently has integrated CSR variables into a more general asset-pricing model.

- **Correlation does not mean causation**

Establishing a positive linkage between CSR and financial performance does not mean that CSR caused this to happen. In fact, the opposite could be true. Perhaps CSR is a “luxury good” that is pursued by companies that are already highly profitable? According to this view, companies with weak financial performance cannot afford to be “socially responsible” but are instead focused on core production activities designed to improve short-term financial performance.

While it is hard to draw conclusions from the research thus far, one group¹⁸ has attempted to overcome these and other methodological issues by conducting a “meta-analysis” comprised of large amounts of data from many independent studies. This technique has allowed them to perform a holistic analysis of the CSR and corporate financial performance (CFP) relationship rather than looking at each facet of CSR independently and has also helped to eliminate inherent biases found in previous studies. The meta-analysis study was able to make the following conclusions:

¹⁴For one expression of this view, see Friedman (1970).

¹⁵We have not provided citations for these studies in this paper. Good bibliographies are available from Eccles, Ioannou, and Serateim (2012), Ghoul et al. (2011) and ABM-AMRO (2001).

¹⁶ABM-AMRO (2001), pp. 27-28.

¹⁷See Griffin and Mahon (1997) and ABM-AMRO (2001) for reviews of these studies.

¹⁸Orlitzky, M., Schmidt, F., Rynes, S. (2003)

- There is generally a positive, bidirectional causal association between good CSR and CFP across all industries;
- Counter-intuitively, corporate environmental performance has a smaller effect on CFP than other CSR measures (i.e., managerial principles, corporate reputations for minority hiring, etc.); and
- Good CSR is more highly reflected in accounting-based financial performance than market-based financial performance, possibly because the market views over-emphasis of CSR as a deliberate attempt of the company to manage external impressions.

Baron, Harjoto, and Jo (2009) further analyzed the relationship between CSR and CSP on a holistic scale by determining relationships between company Corporate Social Performance (CSP) and social pressure, Corporate Financial Performance (CFP) and social pressure, and CSP and CFP. There was a significant positive relationship between CSP and social pressure, a significant negative relationship between CFP and social pressure, but no significant relationship between CFP and CSP. However, it was found that CSP was greater and social pressure less in more competitive industries, suggesting that CSP may be strategic rather than mandated.

Three recent studies have also given some interesting insight into CSR by looking at slightly different aspects of the topic. The first study¹⁹, from Harvard Business School, looked at the impact of a “sustainability corporate culture” on financial performance. High Sustainability companies (that long ago adopted policies guiding their impact on society and the environment) outperformed Low Sustainability companies (those that had not adopted those policies) in both stock market and accounting measures over an 18-year period, despite the market not expecting that performance. Another noteworthy finding of the study was that firms with a focus on sustainability have benefitted most in advertising intensive (consumer oriented) industries, and industries where firms’ products depend on the extracting of natural resources. The second study²⁰ provides further support for this conclusion, showing that bondholders should expect a higher default risk for borrowers with poor environmental practices.

The third study²¹ looked at CSR as it relates to the cost of equity capital. The researchers found that companies with a significant focus on ESG practices typically enjoy cheaper equity financing than companies with less focus on ESG practices. A possible explanation is that companies with low ESG scores experience a reduced investor base and are perceived as riskier investments.

There seems to be an interesting body of research emerging that indicates that CSR factors are beginning to be incorporated into the markets overall perception of risk. What is relevant to potential investors in SRI funds is that this literature does not provide any compelling evidence that companies pursuing CSR worsen their financial performance. This finding is consistent with research from the other three areas of inquiry that found SRI does not hurt investment returns.

Summary and Conclusion

This report has provided a review of empirical literature related to the question: Does socially responsible investing produce lower investment returns? Four distinct bodies of research have addressed this question. The first looked at the performance of SRI indices relative to traditional market indices. The second examined the performance of SRI mutual funds relative to traditional mutual funds and/or market indices. The third compared the relative financial performance of hypothetical SRI stock portfolios against conventional portfolios and indices, and the fourth has tried to determine if there is a linkage between corporate social responsibility and improved financial performance. The chief finding of this research is that socially responsible investing does not result in lower investment returns. This is an important finding because it provides support to individual investors and trustees of institutional funds that they can pursue a program of socially responsible investing with the expectation that investment returns will be similar to traditional investment options.

Finally, it is important to note that the question of whether or not SRI reduces investment returns will never be laid completely to rest. One reason is that this is a difficult empirical question and there will always be legitimate disputes over the quality of the data and the most appropriate methodology to use. Perhaps more importantly, this question will never be answered to everyone’s satisfaction because many of the people engaged in this debate carry with them strong ideological baggage. Opponents of SRI are opposed to the notion of anything other than financial factors affecting the value of a security that, in their view, “hell will freeze over” before they accept that this is not the case. Likewise, some proponents of SRI are so steeped in their own moral superiority that they cannot fathom the possibility that the integration of ESG factors does not have a beneficial effect on investment returns. The challenge for the rest of us is to ignore the rhetorical noise emanating from these extreme views and focus on the facts.

¹⁹ Eccles, Ioannou, Serateim (2012)

²⁰ Bauer and Hann (2010)

²¹ Ghoul, Guedhami, Kwok, Mishra (2011)

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