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Cherry Picking or Depth-oriented Strategic Investing? Evidence from SRI Activity

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Agenda

- Today, socially responsible investing (SRI) represents the youngest financial-services industry that investors can exploit to implement their investment strategies. Additional research is needed to disentangle the factors affecting the performance of SRI funds
- We investigate **the influence that a deeper investment strategy by SRI funds may have on the investment performance**
  - **larger SRI funds have a stronger capacity** to address their investment choices
  - Sample of 149 USA SRI funds referring to the Social Investment Forum (SIF) Foundation in the period 2009-2010
- Deepness of a sustainability investment strategy decreases the capacity of large SRI funds to reach positive financial returns if a broad sustainability investment strategy is pursued
- SRI funds able to focus the attention on specific environmental, social, governance, or product criteria do increase their capacity to reach positive financial performance.

Literature review: from CS….

- Investments in sustainability are **not just wasted costs** for a company (Lo and Sheu, 2007)
- Sustainability is **no longer** viewed as belonging at the **bottom of pyramid**. Rather, it is increasingly viewed as a **crucial asset** for companies wishing to be competitive on the market (Roberts and Dowling, 2002)
- Firms are increasing their investments in sustainable projects in order to **bolster their reputations**, thereby protecting their social **licenses to operate** (Russo and Tencati, 2009)
- Those firms that were the early leaders in the sustainability arena are experiencing a kind of **"Red Queen" effect**, as they need to continually **find ways to differentiate themselves** (Robinson et al., 2011)

The above context represent the conventional competitive arena in which SRI funds do pursue their investment activity, adopting a specific selection and investment process

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Literature review: … intangible assets…

- The CS-performance relationship is controversial
- The costs associated with acquiring **a good reputation on the CS side are offset by reductions in other costs**. According to this perspective, committing resources to socially responsible actions can have a positive impact on firm results
- Favourable reputations can generate excess returns by permitting firms to charge premium prices, hire the best people, and attract SRI funds (Fombrum and Shanley, 1990)
- **Lower costs** can result, for instance, from a reduction in the **expected volatility of cash flows**. In contrast, being socially or environmentally irresponsible might create problems for a firm in the medium- to long-term, diverting the interests of potential SRI funds
- The benefits of a good reputation have contributed to the development of **a new business sector that reviews the sustainability activities of companies and issues relevant reports** (Fowler and Hope, 2007)

Literature review: … to SRI

- Thus far, little research has attempted to address which are the factors affecting SRI performance; additional work is required to address **which factors are leading to SRI fund well known higher performances** (Cowton, 2004)
- Previous literature suggests the perceptions of **a tension** between the **implementation of an ethical policy and the achievement of good financial performance** (Cowton, 2004)
  - Investors having a more restricted scope in selecting their investment alternatives experience a lower performance, due to the lower level of risk diversification
- **SRI funds typically act as "stock pickers"**, therefore having a stronger capacity to identify best performer investments, basically due to the **more restricted investment universe** in which they operate, which in turn allows them to developed **detailed competences in the investment process** (Benson et al, 2006)

Hypotheses

- Larger SRI funds should have a stronger capacity to address their investment choices, leading to a higher performance for their assets under management
- ***Hypothesis 1***
  A positive relationship does exist between the size of assets under management and the SRI performance

- A deeper investment strategy by SRI funds might contribute to highest performances
- ***Hypothesis 2***
  The relationship between the size of assets under management and the SRI performance is moderated by the depth of the investment strategy. Specifically, as depth of the investment strategy increases, SRI funds with a larger amount of assets under management show higher financial performance.

Hypotheses

- We refer to the environmental, social, governance, and product characteristics of a sustainable investment strategy as those factors that might influence the performance of SRI funds

- ***Hypothesis 3***
  The relationship between the size of assets under management and the SRI performance is moderated by the depth of the investment strategy which focuses on:
  - *(3a) environmental characteristics of the portfolio under management,*
  - *(3b) social characteristics of the portfolio under management,*
  - *(3c) governance characteristics of the portfolio under management, and*
  - *(3d) product characteristics of the portfolio under management.*

- *Specifically, as depth of the investment strategy increases which focuses on environmental, product, social, and governance characteristics, SRI funds with a larger amount of assets under management show higher financial performance.*

Methodology

Sample

- 149 U.S. SRI funds referring to the Social Investment Forum (SIF) Foundation in the period 2009-2010
- USA is clearly the most developed market for this type of investments (Cortez et al., 2012)
- In the USA, as of 2012 the assets engaged in SRI practice represent 11.3 percent of the $33.3 trillion in total assets under management; in the period 1995-2012, the SRI universe has increased 486 percent, while the broader universe of assets under professional management in the USA has grown 376 percent (SIF, 2012)

Dependent variable

- Financial performance of SRI funds measured through the average return gained by each fund in a given time *t*: t+1 and t+5 (Cortez et al., 2012; Yu, 2014)

Methodology

Predictor

- To measure size of assets under management we referred to total **amount of assets held by each SRI fund** in the sample. Assets under management are typically used as a measure of size of SRI (and traditional) investments (Benijts, 2010). Assets under management in our sample ranged from 1.7 to 2,884 million dollar

Moderating effects

- 14 different criteria through which SRI funds assess their **ESG and Product** investment have been considered; Each has been ranked with a score ranging from 0 to 3
  - 0 if the specific criterion has not been considered
  - 1 if the criteria are partially considered identifying a so called “restricted investment”
  - 2 if a negative screening has been applied based on a specific criterion
  - and 3 if the criteria have been fully used to identify an ethical investment based on the highest degree of deepness of the investment strategy
- **4 different categorical variable, one for each of the 4 classes of investment strategy: environment depth, social depth, governance depth, and product depth**

Methodology

Control variables

- *time-period effect*: age
- *expense ratio:* representing the ratio (expressed in percentage) of the total annual cost by the fund's total assets averaged over that year
- *management fees:* representing the fees paid to the fund managers as part of the total cost for the investors participating the specific SRI fund
- *minimum account:* representing the minimum ticket required to invest in a specific SRI fund
- *typology of SRI fund*: Balanced (BL), Bond (BD), Equity Large Cap (EL), Equity Mid-Small Cap (EM), Equity Specialty (ES), and International/Global (IG)

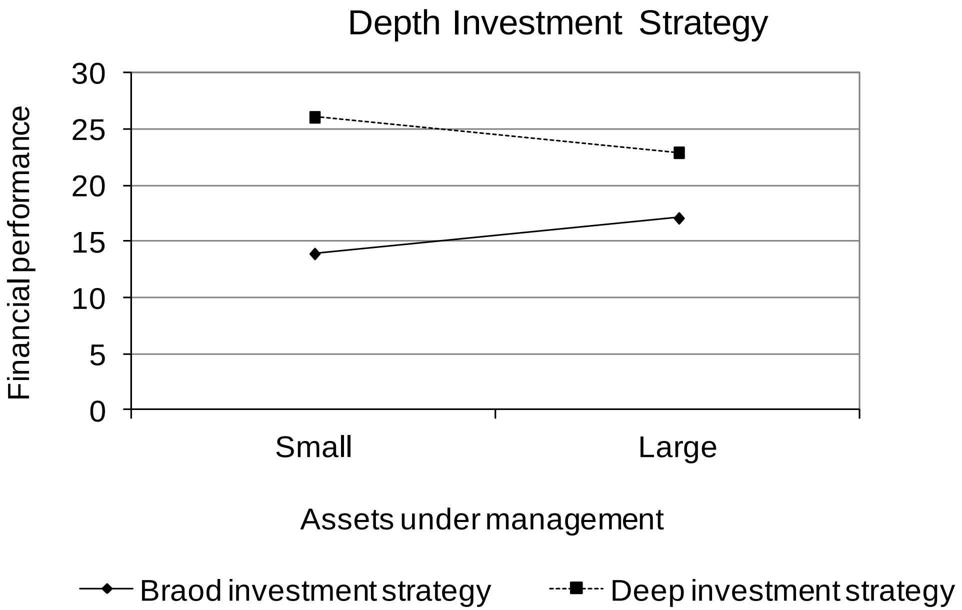
Results

- **Hypothesis 1 is supported (over the long-run)**

  Hypothesis 1 predicted a positive relationship between financial performance of SRI funds and size of assets under management. Results show a positive (r = 0.0011) and strong statistically significant (p<0.01) relationship if a long-term perspective is considered

- **Hypothesis 2 is not supported**

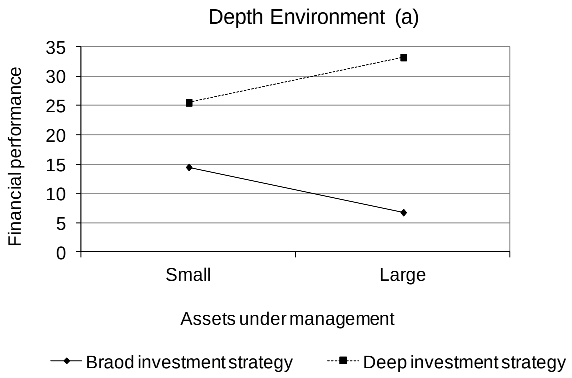
  Hypothesis 2 investigated the moderating effect that depth of an investment strategy can have on the above presented positive relationship between SRI financial performance and size of assets under management. Results reveal a negative (r = -1,5773) and statistically significant (p<0.01) moderating effect on the relationship between short-term SRI financial performance and assets under management, whereas it is worth note that the direct effect has not been supported in the previous hypothesis. A statistically non-significant effect has been found in the long-term run

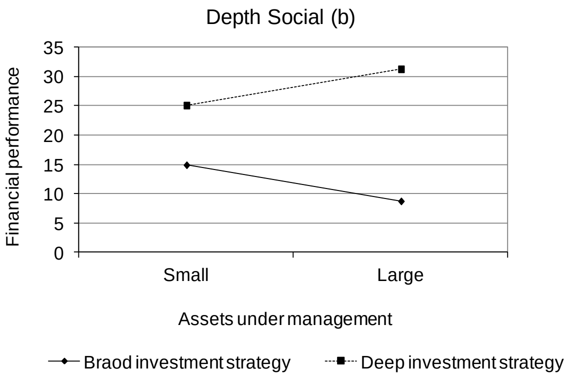


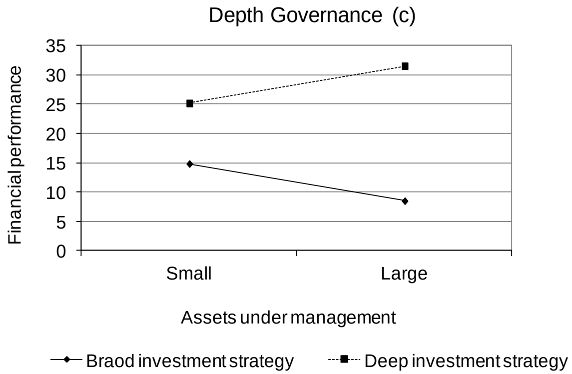
Results

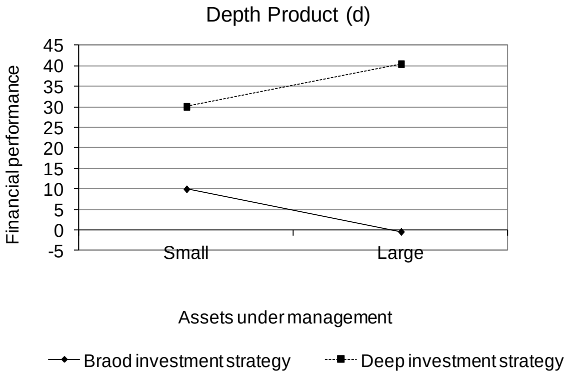
- **Hypothesis 3 is supported (over the short-run)**

  Hypothesis 3 predicted the moderating effect that a deep **ESG and Product** investment strategy has on the positive relationship between size of assets under management and SRI fund performance. Results provide evidence of a positive (r = 3.8601; r = 3.0904; r = 3.1675; r = 5.1868) and statistically significant ($p<0.01$; $p<0.05$; $p<0.01$; $p<0.01$) relationship when considering a short-term perspective. Surprisingly, non-significant results emerged with regard to a long-term perspective.









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Conclusions

- SRI fund **size** expressed as the total amount of assets under management **can influence the SRI fund capacity to gain higher positive financial returns**

- Moreover, the results offer empirical evidence of the **critical attention** required by SRI funds to the **deepness of their sustainability investment strategies** while searching for positive financial performance

- Surprisingly, we found that **deepness** of s sustainability investment strategy **decreases the capacity of large SRI funds** to reach positive financial returns if a broad sustainability investment strategy is pursued

- On the other hand, **SRI funds able to focus the attention on specific ESG or product criteria do increase their capacity to reach positive financial performance**

(Ethical) Implications

Hyp 1

- Target companies benefit from the resources that typically characterize the investment by institutional investors: **the larger the investment capacity, the stronger the diffusion of ethical practices the target companies are supposed to emphasize, the lower the probability of what can be defined as an ethical default**

Hyp 2

- A lower degree of focalization that a broad sustainability-oriented investment strategy implies for institutional investors does not pay
- Although large SRI funds are supposed to provide the investors with a higher degree of trustworthiness, the latter does not necessarily find a counterpart in a positive financial return. This result is interesting itself if we assume that investors participating SRI funds are able to give higher priority to ethical returns instead of financial returns
- **It is not about how much SRI funds earn in terms of financial returns, but it is much about how returns are gained and sustained in the short-term through a specific sustainability investment strategy**

(Ethical) Implications

Hyp 3

- Large SRI funds do hold the resources and competences to **deeply select the target investments** based on specific sustainability criterion. Therefore, a focused sustainability investment strategy **minimize the riskiness of the selection process** that in turn reveals higher financial returns (**in the short-run**)
- Additional factors might therefore influence the financial returns in the long-term, which might depend on exogenous features
- Adopting a selection process perspective, this result highlight a **higher capacity to identify the best ethical and organizational fit** between target projects and SRI sustainability investment strategy by large SRI funds

Limits

- Different sample: cultural clashes
- Performance: broader perspective beyond financial performance

Thanks!!!

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