Morphic
Perspectives Series

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CAN SOCIALLY RESPONSIBLE INVESTING AND GOOD RETURNS COEXIST?

Spoiler alert: the answer is yes.

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Asset Management

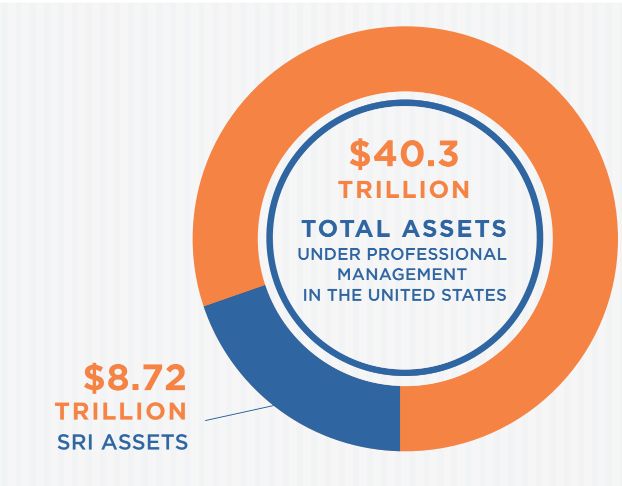
Do the right thing. It will gratify some people and astonish the rest.

Mark Twain

INTRODUCTION

Over the last few years, there has been a significant increase in the interest in environmental, social and governance (ESG) investing. According to a paper released recently, over $8trn of the $40trn of money managed in the USA is now under some form of Sustainable and Responsible Investing (SRI) or ESG, up 33% since 2014 and up fivefold from $1.4trn in 2012 for money run by fund managers.

Figure 1 - Sustainable and impact investing in the United States



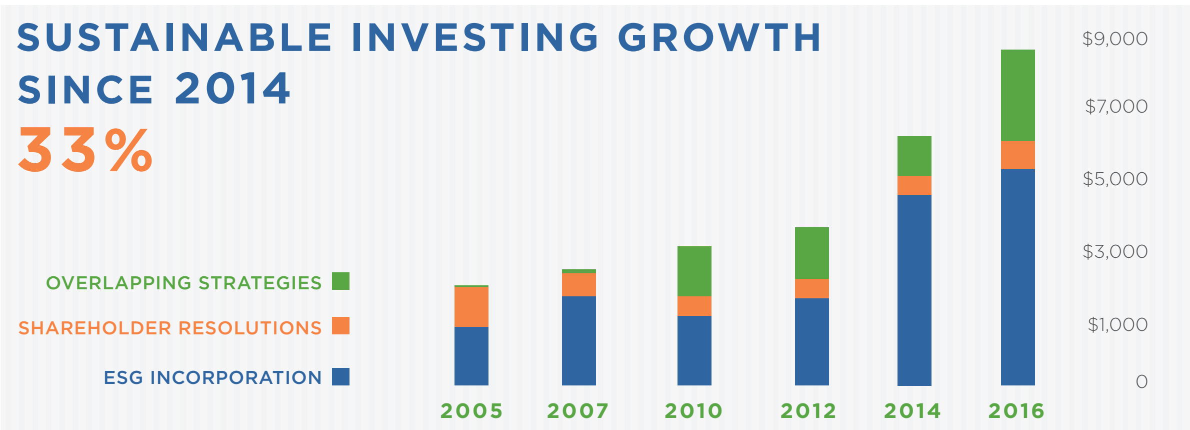
Source:US SIF Foundation

In many respects Australian fund managers have been caught unready for this change. If we look at the Mercer survey data for January 2017, the Global Equities strategy section contains 127 global funds that are sold in Australia. Of this, only 5 are classed as SRI funds. It is somewhat better for Australian equities with 157 funds in the survey, of which 13 are SRI. If we were to use the ratio of assets in the USA, the number of SRI funds should be 27 and 34 respectively.

One reason could be that there is a view amongst many people (and particularly fund managers) that "you can't have your cake and eat it too": that SRI results in lower returns for investors and the investors have to pay a price to be responsible.

In some ways this misconception, of accepting lower returns for being ethical, goes against another tenant of conventional investing wisdom: buy good businesses. The grandfather of long term investing, Warren Buffett, discusses a lot in his letters to shareholders the importance of ethics and the quality of the character of the people running the businesses he owns.

Figure 2 - Sustainable investing growth in the United States (Billions) between 2005 and 2016



Source:US SIF Foundation

Implicitly he is saying that businesses that have an ethos and focus on 'doing the right thing' by staff and customers, should generate higher returns. Now admittedly he is discussing the character of the people rather than the nature of the business, and some people would find owning Coca Cola unethical.

And it is this differentiation between good people and bad unethical businesses that opens an interesting next line of inquiry.

WHAT DO THE STATISTICS SAY?

UBS recently published an excellent summary of recent academic literature[1] looking at this question of whether SRI negatively affects investor returns. **The conclusion was that it did not.**

Verheyden, Eccles & Feiner (2016)[2] wanted to look at whether a portfolio manager would be put at a disadvantage in terms of performance, risk and diversification if he/she were to start from a screen based on ESG criteria. The empirical evidence shows that all ESG-screened portfolios have performed very similarly to their respective underlying benchmarks, if not slightly outperforming them. Put differently, the findings of the paper show that – at the very least – there is no performance penalty from screening out low ESG-scoring firms of each industry.

This is consistent with our own experience as portfolio managers at Hunter Hall, where we were able to outperform against an all-inclusive benchmark, despite having a restricted ownership list.

Taking another tack, Nagy, Kassam & Lee (2016)[3] wanted to see if not only do highly rated ESG outperform, but do companies get rewarded for improving (going from OK to good)? The answer was yes and unequivocally yes. Both outperformed, but the improvers outperformed at double the rate.

But the most interesting article is one by Statman and Glushkov (2016)[4]. They created what they called "Top Minus Bottom" (TMB) where stocks were ranked on their ESG criteria and then modelled how being long the 'better ranked' versus the 'worse ranked' performed. This concept is similar to the studies above and could be called the "good screen".

The innovation was to look at "Accepted Minus Shunned" (AMS) separately. Here the authors looked at the returns from stocks commonly accepted in SRI funds versus those that are typically avoided - shunned companies are those with operations in the tobacco, alcohol, gambling, military, firearms and nuclear industries. Call this the "negative screen".

Like the earlier studies, it was found TMB outperformed the broader market but interestingly the AMS (the bad screen) stocks didn't outperform, i.e. the excluded stocks did better than the broader market.

But here is the interesting thing: AMS under performed by less than the TMB screen outperformed, i.e. it was a net positive for investors. I think it is this AMS effect that fund managers have focused on in their view that SRI/ESG does not work.

WHAT DOES THIS MEAN FOR FUND MANAGERS?

Investors globally are demanding more focus from their fund managers on ESG issues. The implications of these studies is that ESG does not detract from returns and investors are therefore not irrational to ask for more focus on ESG and SRI issues by their money managers.

But it also says running a positive screen in combination with running a negative screen is a better way to generate returns for investors whilst also satisfying investor's ethical investment needs.

1. Academic Research Monitor: ESG Quant Investing. Dec 2016. Please email us if you'd like a copy of the paper.

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2. ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification. Verheyden, T., Eccles, R. G., & Feiner, A. Journal of Applied Corporate Finance, 28(2), 47-55, 2016

3. Nagy, Z., Kassam, A. & Lee, Linda-Eling. (2016) Can ESG Add Alpha? An Analysis of ESG Tilt and Momentum Strategies, Journal of Investing, Vol. 25, No. 2, pp. 113-124.

4. Statman, M., & Glushkov, D. (2016). Classifying and Measuring the Performance of Socially Responsible Mutual Funds. Journal of Portfolio Management, 42(2), 140-151.

ABOUT THE AUTHOR

CHAD SLATER, CFA

Joint CIO, Morphic Asset Management

Chad co-founded Morphic Asset Management in 2012. He was previously a Portfolio Manager and Head of Currency and Macroeconomics at Hunter Hall for five years. He has worked at BT Investment Management, Putnam and the Federal Treasury over his 15 year career.