DOES ETHICAL INVESTING REDUCE RETURNS

John Evans

- Ethical v Sustainable investments: *Used interchangeably in the literature*
- What are sustainable/ ethical securities? *Investments where the corporation positively aims for best practice in dealing with stakeholders*

Research Objective

- To understand if companies that adopt acceptable ethical criteria in their dealings with stakeholders have inferior returns relative to the market, ie does ethical filtering cost investors in terms of performance?

Why this approach?

- Historical analysis that has looked at out performance has been inconclusive
- What matters to trustees of pension funds and investors making investment choices with ethical biases is whether they can expect to under perform broad markets

Previous Analysis

Period	Positive	Neutral	Negative
1970s	12/17	4/17	1/17
1980s	14/35	5/35	16/35
1990s	7/10	0/10	3/10

Corporate Studies

- Mostly looked at the relationship between the extent to which corporations had “ethical” behaviour and stock price return
- Problem: looked at correlations which does not consider cause and effect
- Problem: mostly did not consider other causes of return such as growth v value, and big v small cap issues
- Generally suffered from “Data mining” issues

Portfolio Analysis Issues

- Different definitions of “ethical” securities
- Different benchmarks
- Did not recognise portfolio construction issues

Portfolio Analysis Corrections

- Fund size and duration of fund: nothing conclusive regarding ethical v non ethical
- Size selection bias: non conclusive
- Multi factor Carhart model: after controlling for investment style, non conclusive
- M squared adjustment for risk: found ethical funds outperformed benchmarks

Portfolio Analysis Corrections

- Theoretical portfolios constructed using ethical criteria generally marginally underperformed benchmarks due to increased industry specific risk, and a small cap bias

Methodology

- Database of 90 global securities (equities) chosen only for their ethical rankings
- Basic statistical analysis of securities grouped by country and industry sector to see what was their performance relative to benchmarks
- Fama French factor analysis to ascertain if performance could be explained by market cap, growth/value bias

Methodology

- Analysis to see if inclusion of ethical portfolios would change the risk/ return profile of already diversified portfolios

Methodology Objective

- Is there evidence of non underperformance of ethically constructed portfolios?
- Can factor analysis identify by deduction there is/ is not an ethical factor?

Summary Statistics
(1998~2003)

	Ethical	MSCI Country
Mean (% per month)	0.5%	-0.3%
SD	6.9%	5.3%
Skewness	-18.8%	1.2%

Fama French Global Factor Analysis

- Constructed for each country a small value, medium value, big value, small growth, medium growth and big growth portfolios
- Global factors constructed from value weighting the country portfolios
- Tested if the alpha was significantly different to zero (Wald with small sample adjustment as per Fisher & Sim)
- Tested if the alpha was significantly less than zero (Wolak)

Fama French Global Factor Analysis

- Analysis could not reject the hypothesis that the alphas of the securities were significantly different to zero
- Analysis could not reject the hypothesis that the alphas of the securities were significantly different to zero
- Analysis indicated that the performance of the securities could be substantially explained by market cap & Book/ Market factors

Fama French Global Sector Analysis

- Also constructed benchmark portfolios for global sectors
- The hypothesis that the alpha for ethical securities was significantly different to zero was rejected as was the hypothesis that the alpha was negative

Modelling Issues

- The database is small (90 stocks over 5 years)
- The definition of “ethical” is specific to one organisation

Conclusions

- There is no evidence that ethically selected securities will under perform broad markets
- There does not appear to be an “ethical” factor driving performance of the ethically selected securities with Fama French factors able to explain most of the security performance

Implication

- Investors can use ethical filters to select securities without an expected performance cost, provided they also diversify by the normal factors (value v growth, big cap v small cap)

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