Socially Responsible Investing:

Is there a trade-off between values and investment returns?

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Objective and summary of findings

According to Morningstar, assets in socially screened portfolios now exceed $6 trillion, up from $639 billion in 1995. Socially screened or influenced mutual funds increased at a steady rate over the past decade, in response to growing demand from individual investors. A recent Morgan Stanley survey of individual investors highlights the coming demand for socially responsible investments (SRI), with 71% of respondents (and 84% of millennial investors) expressing interest in sustainable investing.

This paper provides a brief history of socially responsible investment (SRI), the evolution of SRI-influenced investment strategies, and different approaches used by SRI practitioners. Historical background provides context for the central focus of our research: a review of the performance, risk and cost of SRI-focused mutual funds.

We examined a broad universe of actively-managed U.S. large cap mutual funds, as well as the subset of mutual funds categorized as SRI funds by Morningstar.

Table 1: Largest SRI Mutual Funds		
Name		**Size [$]**
1	Parnassus Core Equity	11.7 B
2	Calvert Equity	2.8 B
3	TIAA-CREF Social Choice Equity	2.8 B
4	Neuberger Berman Socially Responsive	2.3 B
5	Invesco Summit	1.9 B
6	Vanguard FTSE Social Index	1.8 B
7	American Century NT Large Company Value	1.5 B
8	American Century NT Equity Growth	1.4 B
9	Parnassus Endeavor Fund	1.2 B
10	American Century NT Growth	1.1 B
Source: Morningstar Direct as of 6/30/2015.		

We compared the performance, risk and cost of actively managed SRI mutual funds to non-SRI funds in their respective Morningstar category, following a similar path covered by prior researchers attempting to determine whether actively managed SRI mutual funds provide materially different performance results than actively managed mutual funds that don't incorporate social screening methods. We updated the time horizon for analysis, and also looked at sub-periods that we thought would provide interesting context for the performance comparison.

Some observers might argue that research studies have attempted to answer the wrong question. Proponents of index investing say that instead of asking: "Do actively managed SRI funds perform as well

as conventional actively managed funds?", that the right question to answer is "Do actively managed funds perform as well as a passive index?" Our research examines the active/passive comparison as well as the active/active comparison.

Results were more favorable from the comparison of actively managed SRI mutual funds to actively managed conventional mutual funds, reflecting the risk-adjusted outperformance for SRI mutual funds in the large cap blend and large cap growth categories over the ten-year period ending December 31, 2014.

Results were far less favorable when comparing the performance of actively managed SRI mutual funds to a representative index. Actively managed SRI funds lagged the index over most periods reviewed, often at a higher risk than the broader index. The high cost of many SRI strategies may have some impact, serving to erode returns and reinforcing the frequently heard refrain that low cost, low turnover, disciplined strategies "win" in many asset classes.

One caveat to our findings is the small sample size of SRI mutual fund universe, and the relatively small number of funds within the universe that have a performance history of greater than ten years. The limited time horizon and rapidly evolving approach to SRI increases the possibility that the next ten years will be different than the past ten years.

Background

Socially responsible investing is a strategy that considers both societal and investment factors in creating an investment portfolio. The roots of SRI are commonly thought to date back to the Quakers, who in the mid-1700s prohibited members from participating in the slave trade. John Wesley, one of the founders of Methodism, has been cited for his leadership in establishing basic tenets of the SRI movement. Wesley was opposed to the slave trade and called for employers to avoid harming workers and urged his followers to shun profiting at the expense of their neighbors. SRI was most commonly a faith-based phenomenon for many years, applied through investment mandates that avoided "sin" stocks such as alcohol and tobacco.

During the 1960s, dissatisfaction about the war in Vietnam led to a broadening of interest from investors wanting to avoid investing in companies fueling the war effort. In subsequent years, the protest movement against the apartheid regime in South Africa was a seminal event in the evolution of SRI, as college students called upon corporate pension plans, university endowments, and public pension plans to divest from South Africa. The movement to divest from South Africa was a prelude to today's movement led by 350.org to promote divestment of fossil fuel stocks. Advisor Partners, in prior research work, has examined the investment implications of fossil fuel divestment. (Available at http://www.advisorpartners.com/uploads/4/8/5/3/48535043/fossil_fuel_study-2015_final.pdf)

Environmental, Social and Governance Screening

The exclusionary approach to SRI – such as avoidance of sin stocks, weapons manufacturers, repressive regimes and major polluters – reflects the heritage of the initial proponents for SRI or value-influenced

investing. The religious heritage of SRI investing is found in the currently popular exclusions of "sin" stocks such as alcohol, tobacco and pornography. The exclusion of weapons and defense stocks has roots in faith-based organizations as well as from baby boomers protesting the war in Vietnam. Additionally, the anti-nuclear movement and heightened awareness of environmental considerations led to a wide range of environmentally focused exclusions.

Socially conscious investors in recent years have strived to make a broader impact with their investment dollars by going beyond purely exclusionary screening. Today's leaders in SRI supplement the exclusionary screening approach, using environmental, social and governance (ESG) factors to identify potential sources of added value and to uncover hidden risks. The central belief of investors using ESG factors is that companies with strong ESG characteristics will be superior stock market performers to companies with poor ESG characteristics. The movement toward integrating ESG characteristics in order to "do well by doing good" has been embraced by many firms and supported by some academic research on the topic.

SRI strategies as applied today

Although the SRI universe has a relatively small number of participants, values-focused investors have a wide variety of strategic choices. On one end of the spectrum are index funds such as the Green Century Equity Fund and the Vanguard FTSE Social Index Fund. Green Century manages its index fund to track the MSCI KLD 400 Social ex Fossil Fuels Index, which removes fossil fuel companies from the longest-running socially responsible index, the MSCI KLD 400 Social Index. Vanguard's index fund is designed to track the FTSE 4Good U.S. Select Index.

The TIAA-CREF Social Choice Fund offers a slightly different approach. It does not track an ESG index, but uses ESG screening services offered by MSCI. TIAA-CREF provides high level criteria for MSCI to use in creating a universe of acceptable investments from an SRI perspective. From that broad-based potential universe, TIAA-CREF uses a quantitative process to attempt to track the risk characteristics of the standard Russell 3000 Index, holding about 800 individual stocks. The fund may differ meaningfully from the index at the stock level, with major companies such as Apple and Exxon Mobil excluded for ESG reasons. These exclusions may help or hinder returns over time. TIAA-CREF Social Choice Fund's sector weightings and other risk characteristics look more like an index fund than those of many actively managed SRI funds. The fund's fees are also closer to that of an index fund, currently 0.46% for its retail share class.

Calvert is one of the firms with the longest history of managing SRI portfolios. Calvert's approach is founded upon a belief that integrating financial and ESG analysis leads to better investment decision-making. They emphasize the early warning signs that ESG analysis can provide, that a brand may be at risk of being tarnished or that margins may be compromised due to factors not identified by standard financial metrics. Calvert's approach for one of its flagship mutual funds, the Calvert Equity Portfolio, differs from TIAA-CREF in the way that ESG analysis is fully integrated into the stock selection process rather than used as an up-front screening device. The Calvert Equity Portfolio is managed with the help of Calvert's sub-advisor, Atlanta Capital, who constructs a preliminary portfolio based on fundamental analysis, and then refines that portfolio after applying Calvert's ESG analysis to each position. The

Calvert Equity Portfolio is more of a purely actively managed fund than the TIAA-CREF Social Choice Fund, holding approximately 100 positions and with an expense ratio above 1%.

One of the oldest and best performing SRI funds in recent years is the Parnassus Fund. Parnassus also integrates ESG factors into its process, while explicitly excluding fossil fuel companies. Parnassus has a bottom-up stock selection orientation, attempting to identify good businesses at good prices. Parnassus has a much more concentrated portfolio than the TIAA-CREF Social Choice Fund and Calvert Equity Portfolio, holding about 40 positions and concentrating nearly 40% of its portfolio in Technology stocks. The concentrated approach has worked for Parnassus in recent years, though concentrated strategies are often more volatile than broadly diversified strategies.

Methodology

We examined the universe of actively-managed U.S. large cap mutual funds, representing a significant portion of mutual fund assets dedicated to SRI strategies. Over the ten year period ending December 31, 2014, the universe included more than 3,000 mutual funds managed using conventional strategies and 23 that were categorized as SRI by Morningstar. The population of SRI mutual funds has grown in recent years, but still is a relative small 73 funds as of May 31, 2015.

We compared the performance, risk and cost of actively managed SRI mutual funds to conventional funds in their respective Morningstar category as well as a representative index for the category. We examined multiple time periods, though we were constrained by the limitations associated with the limited number of SRI mutual funds available prior to 2000. Our objective is to provide an empirical framework to evaluate whether SRI funds provide both performance and values, or whether there is an implicit cost to investing in alignment with values. Our objective was shaped by our sense that earlier generations of SRI investors were willing to accept below market-rate returns in exchange for positive social and/or environmental impact but that today's investors demand positive social impact as well as market-rate returns.

Comparison of actively managed SRI mutual funds to actively managed non-SRI funds

Results varied over different time horizons, but provided some support to SRI proponents. For the ten year period ending December 31, 2014, the average actively managed SRI large cap blend mutual fund returned 7.90% per year, beating the conventional large cap blend category average of 7.05%. SRI funds also performed well from a risk perspective, with a standard deviation of 15.09% compared to a standard deviation of 15.33% for the conventional category (Table 2).

Table 2: Large Cap Blend Active SRI Fund Performance Characteristics, Ten Years 2005-2014

	Return	Standard Deviation	Upmarket Capture	Downmarket Capture
Best SRI Performer	10.23%	13.09%	94.86	78.20
SRI Group Average	7.90%	15.09%	100.59	99.57
Non-SRI Group Average	7.05%	15.33%	99.79	103.29
Worst SRI Performer	6.60%	15.72%	100.03	106.20

Source: Morningstar Direct. Best SRI Performer was Parnassus Core Equity. Worst SRI Performer was

Domini Social Equity. Upmarket and downmarket capture versus S&P 500.

Similar results were reported for the five year period ending December 31, 2014, with the average SRI large cap blend fund returning 16.66% per year with 14.95% standard deviation, and the conventional peer group returning 15.94% per year with 15.23% standard deviation.

The eight year period spanning the aftermath of the technology bubble and the heart of the financial crisis provided less definitive results. SRI mutual funds in the large blend category returned -2.63% per year, slightly trailing the conventional peer group returns of -2.44% (Table 3).

Table 3: Large Cap Blend Active SRI Fund Performance Characteristics, Eight Years 2001-2008

	Return	Standard Deviation	Upmarket Capture	Downmarket Capture
Best SRI Performer	4.17%	12.45%	92.80	60.95
Non-SRI Group Average	-2.44%	15.39%	100.09	98.04
SRI Group Average	-2.63%	15.36%	98.35	97.55
Worst SRI Performer	-6.73%	16.55%	94.84	114.49

Source: Morningstar Direct. Best SRI Performer was Parnassus Core Equity. Worst SRI Performer was Dreyfus Third Century. Upmarket and downmarket capture versus S&P 500.

Results in the Large Cap Growth category provided less favorable absolute performance results but more favorable risk metrics. Large cap growth SRI mutual funds returned 7.26% per year for the ten year period ending December 31, 2014, trailing the conventional large cap growth category average of 7.72%. Standard deviation was considerably lower, however, at 15.47% for SRI compared to 16.24% for the conventional peers (Table 4).

Table 4: Large Cap Growth Active SRI Fund Performance Characteristics, Ten Years 2005-2014

	Return	Standard Deviation	Upmarket Capture	Downmarket Capture
Best SRI Performer	9.99%	19.10%	120.28	121.57
Non-SRI Group Average	7.72%	16.24%	105.46	113.29
SRI Group Average	7.26%	15.47%	100.20	108.20
Worst SRI Performer	6.01%	15.30%	95.90	109.48

Source: Morningstar Direct. Best SRI Performer was Parnassus. Worst SRI Performer was LKCM Aquinas Growth. Upmarket and downmarket capture versus S&P 500 Growth.

The eight year period spanning the aftermath of the technology bubble and the financial crisis was a success story for large cap growth SRI funds relative to the Large Cap growth category. Large cap growth SRI funds provided superior performance, lower risk as measured by standard deviation, and lower downside capture than the conventional category constituents (Table 5).

Table 5: Large Cap Growth Active SRI Fund Performance Characteristics, Eight Years 2001-2008				
	Return	**Standard Deviation**	**Upmarket Capture**	**Downmarket Capture**
Best SRI Performer	0.39%	15.45%	110.20	87.92
SRI Group Average	-3.34%	16.47%	105.84	102.10
Non-SRI Group Average	-4.93%	17.93%	113.42	115.71
Worst SRI Performer	-6.70%	18.51%	102.24	115.56
Source: Morningstar Direct. Best SRI Performer was Neuberger Berman Socially Responsive. Worst SRI Performer was Integrity Growth & Income. Upmarket and downmarket capture versus S&P 500 Growth.				

Active vs. index comparison

Results were less favorable across categories and time horizons when comparing the returns of actively managed SRI mutual funds to an index. Actively managed SRI funds in the Large Cap Blend category lagged the S&P 500 Index for the five years ending December 31, 2014, returning 16.66% per year while the index returned 17.22%. The five years ending December 31, 2000 were also unfavorable, with SRI mutual funds returning 15.93% per year while the index returned 21.34%.

Performance for the ten years ending December 31, 2014 and the eight years ending December 31, 2008 was slightly better than that of the S&P 500 Index, though in both cases with a higher standard deviation (Tables 6 and 7).

Table 6: Large Cap Blend Active SRI Fund Performance Characteristics		
Versus Index, Ten Years 2005-2014		
	Return	**Standard Deviation**
SRI Group Average	7.90%	15.09%
S&P 500 Index	7.67%	14.67%
Source: Morningstar Direct.		

Table 7: Large Cap Blend Active SRI Fund Performance Characteristics		
Versus Index, Eight Years 2001-2008		
	Return	**Standard Deviation**
SRI Group Average	-2.63%	15.36%
S&P 500 Index	-2.89%	15.05%
Source: Morningstar Direct.		

Actively managed SRI funds in the Large Cap Growth category lagged the S&P 500 Growth Index in most periods examined and in each period had considerably higher standard deviation. Return and risk comparisons were particularly unfavorable for the ten year period ending December 31, 2014 (Table 8).

Table 8: Large Cap Growth Active SRI Fund Performance Characteristics Versus Index, Ten Years 2005-2014		
	Return	**Standard Deviation**
SRI Group Average	7.26%	15.47%
S&P 500 Growth Index	8.55%	14.11%
Source: Morningstar Direct.		

Fund Expenses

Expenses can be "silent killers", eroding returns for often unsuspecting investors. Investing in actively managed SRI mutual funds can be an expensive proposition. Expense ratios for actively managed SRI funds average approximately 1.2%, and range from a low of 0.84% to 1.5%. Average expenses for SRI mutual funds are slightly lower than that of actively managed funds in the same category but are considerably higher than that of index funds, even index funds with an SRI overlay component.

Conclusion

One caveat to our findings is that performance analysis is limited given how few SRI mutual funds have long-term track records. The limited time horizon and rapidly evolving approach to SRI increases the possibility that the next ten or twenty years may look different than the recent past.

The comparison of actively managed SRI mutual funds to actively managed non-SRI mutual funds provides additional data supporting prior studies that indicated there hasn't been a material performance sacrifice associated with socially responsible investing. Results were generally favorable from the comparison of actively managed SRI mutual funds to actively managed non-SRI mutual funds, reflecting the risk-adjusted outperformance for SRI mutual funds in the large cap blend and large cap growth categories over the ten-year period ending December 31, 2014. This suggests that in some situations there may be something to the idea of "doing well by doing good."

However, in returning to the debate about the relative merits of active and index investing, the results are far less favorable to proponents of active SRI strategies. Actively managed SRI funds have had the same difficulty in beating passive commercial benchmarks that their non-SRI peers have had. Results were far less favorable when comparing the performance of actively managed SRI mutual funds to a representative index. Actively managed SRI funds lagged the index over most periods reviewed, often at a higher risk than the broader index. The high cost of many SRI strategies may have some impact, serving to erode returns and reinforcing the frequently heard refrain that low cost, low turnover, disciplined strategies "win" in many asset classes. We expect the active/passive debate to continue, and will be interested in seeing research extend into less "efficient" asset classes such as small cap and

emerging markets. We're also interested in seeing research into which ESG factors have shown the most and least correlation with stock market returns.

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About the Authors

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Dan drives the vision and strategy for Advisor Partners and oversees all aspects of company operations. As CIO, he establishes the investment philosophy and process for Advisor Partners. Prior to joining the firm in 2011, Dan was Managing Director and Portfolio Manager for Charles Schwab Investment Management. He managed asset allocation funds, including target funds, from October 2008 to July 2011. Prior to 2009, headed Schwab's product development and served as CFO of a fund company. Before Schwab, he was Managing Director and Principal for Montgomery Asset Management.

Dan is a graduate of Brandeis University and earned his MBA in Finance from the University of California, Berkeley. He is a CFA Charterholder and a former president of the CFA Society of San Francisco.

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Gerard is responsible for asset allocation models and for the selection of ETFs and mutual funds for multi-manager products at Advisor Partners. He also assists in the ongoing oversight of portfolios, including construction, risk management and cash management. Previously, Gerard was a research analyst at Charles Schwab Investment Advisory, where he performed manager due diligence for separately managed accounts and mutual funds. He covered alternative investment strategies, specialty sector strategies and asset allocation investment strategies. Prior to his investment career, Gerard worked in the computer hardware and environmental services industries.

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