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No more excuses: The returns to ethical investment

Recommendation to Colleges of the University of Oxford and other institutional investors

by Alex Cobham*

In May 2006, the University of Oxford reversed a long-held position and agreed to develop and implement an investment policy based on ethical prinicples. In light of this, and the evidence set out here on the returns to ethical investment, the Colleges of the University have no excuse for further foot-dragging - and other institutional investors should also take note.

Interest in ethical investment, or socially responsible investment strategies (SRI hereafter) has grown dramatically over the last two decades – since the notable success of South African disinvestment campaigns from the 1970s onwards. A range of issues have become common topics of boardroom and investor discussion, including the ethics of industries ranging from defence, aerospace and extractive industries to

MAIN POINTS
The evidence is in - ethical investment does not impose financial costs on investors. If anything, failure to adopt ethical standards is increasingly likely to undermine their risk-adjusted returns. The Colleges of the University of Oxford should embrace ethical investment for their portfolios now.

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food production and financial services, and the appropriate use of sanctions in regard to countries engaged in activities including internal discrimination and external aggression.

A key question for investors (and indeed for corporate leaders) is the likely impact on investment returns of allowing such concerns to guide portfolio allocation. If SRI implies lower returns, then the scale of the effect must be known so that the trade-off between moral wellbeing and financial return can be understood and appropriate decisions made. Corporate boards can inform controversial decisions with an estimate of the likely share price impact. If there is no financial cost to SRI, however, then investors are free to pursue optimal strategy with no trade-off. Corporate decision-making will be correspondingly constrained by the implied possibilities.

This Recommendation provides an answer to this question by surveying the available evidence on the returns to SRI. Its major findings are these:

- Negative 'events' or ethical performance damage the economic performance of individual businesses, while strong environmental performance especially is associated with superior economic performance.

- After an initial period of catching up, the performance of ethical investment funds in each major world economy has been – at worst – indistinguishable from that of their conventional rivals.

- From the mid-1990s onwards, there is growing evidence of a positive effect on the risk-adjusted returns of portfolios that are constrained by SRI: investors who decide against ethical investment are likely to suffer financially.

The implications for the portfolio of an institution which is either morally concerned or simply self-interested in terms of valuing its public image are clear. An ethical investment strategy will not hurt financially, and is increasingly likely over time to actually improve the risk-adjusted returns that are obtained. The growing importance of SRI means that taking an opposing position will threaten that institution in three ways: its financial returns, its public image and its moral self-worth.

THE EVIDENCE

The literature can be divided by type of study carried out: that of particular ethical 'events' or general performance (impact on firms' performance); of theoretical optimal portfolios, ethical and otherwise (implications for investor returns); and of actual investor strategy, considering the performance of investment funds. Sections (i) and (iii) draw heavily on the very useful survey in Fischer & Khoury (2006).

i. Firm performance: ethical and economic

Earlier approaches involved assessment of the impact on firms' performance of particular 'ethical' events. Environmental policies were examined by Feldman, Soyka and Ameer (1997) and by Klassen & McLaughlin (1996). In both cases, the authors found that share price of individual firms was significantly affected by environmental events – producing abnormal returns of up to 5% and 1.5% respectively. Investors therefore face large risks associated with negative environmental assessments of firms or sectors in their portfolio. Gunthorpe (1997) assessed the effect of claims of illegal corporate behaviour, and found a statistically significant share price cost averaging 1.3% in a day, and 2.3% after a week.

An alternative approach is to examine correlations over time between ethical performance and returns. Waddock & Graves (2000) find no link, Vreschoor & Murphy (2002) show that more ethical firms (according to Business Week's ranking) systematically outperform the field. Russo & Fouts (1997) demonstrate a positive correlation between environmental performance and economic outcomes, and show this to be especially strong in high growth industries.

ii. Strategy: fund performance

Bauer, Otten & Rad (2006) and Bauer, Koedijk & Otten (2005) consider the returns to a range of investment funds, ethical and otherwise, in the UK, Germany, the USA and Australia. In every case, they find evidence of an interesting time effect. First, in an earlier period, ethical investment funds are outperformed by their non-ethical counterparts. Then, after what they term as a catching up period (in which ethical funds learn to be as efficient as these rivals), risk-adjusted returns become indistinguishable.

iii. Portfolio studies: investor returns

Guerard (1997) found that constraining portfolio choice by SRI principles had no significant effect on returns, while Diltz

(1995) found higher returns of portfolios were screened for environmental performance or of excluding military and nuclear-related businesses. Earlier studies disagreed: Rudd (1979) and Wagner, Emkin & Dixon (1984) showed that excluding South African-related businesses from the S&P 500 led to somewhat higher risk portfolios.

Most recently, Fischer & Khoury (2006) have demonstrated with Canadian data the powerful impact of a series of ethical screening scores on portfolio returns. They consider the effect on returns of the number of ethical 'concern' scores, and their findings are worth quoting at some length:

"The analysis also shows that a portfolio of stocks with zero concerns outperforms portfolios comprising securities with one, two and three or more concerns. Furthermore, there is a significant decline in portfolio risk-adjusted returns as exposure to the number of concerns increases.

"From the investor's point of view, our research indicates that there is good reason for relying on the number of concern scores in screening securities for portfolio composition. The viability of this strategy in terms of portfolio performance indicates that such ethical screening is not about to go away soon."

An explanation for the different findings in earlier and later periods can be given by considering the growing importance of SRI strategies over the whole period. In contrast to the catching-up thesis of Bauer et al., or more sensibly as a complementary hypothesis, the important of SRI as noted by Fischer & Khoury suggests that as increasing proportions of investment are allocated with some SRI basis, the resulting flows of funds will lead to higher returns to SRI-compatible securities. In effect, changing social mores can be self-rewarding as SRI principles become increasingly common. The implications for businesses are likely also to be important:

"From the point of view of corporate governance, the findings of this paper suggest that ignoring ethical concerns may trigger a negative reaction from investors, as they defect to firms that display higher ethical standards. Thus, although the implementation of strict ethical standards can undoubtedly increase operating costs for corporations, and could decrease the quantity produced, ignoring them could result in loss of wealth to shareholders that may exceed those costs. These findings also suggest that ethical issues may increasingly become a consideration in corporate governance that cannot be overlooked by corporate directors without penalty to the market value of their companies. Indeed, if the trend identified in this research persists, investors are likely to increase the pressure on directors for the implementation of sound ethical standards and practices in order to avoid the market penalties. Alternatively, corporate raiders may be able to extract rent by acquiring undervalued firms and devising ethical standards and policies for them. Corporations should therefore be proactive as regards the level of ethical concerns they wish to signal to the market, and to conduct their business policy accordingly."

A final, open question relates to the direction of SRI strategies. Increasing shareholder activism and a broader corporate governance agenda, coupled with the resurgence of international campaigning and issue awareness (see e.g. the recent Day for Darfur), investors would be well advised – for purely financial reasons – to consider which ethical areas are likely to draw fire in the future. The evidence indicates that early adoption of higher standards or new issues may be penalised by markets in the short term, but is the superior long-term strategy. An institution might be well advised to take this into account in its portfolio deliberations.

RECOMMENDATIONS

1. The Colleges of the University of Oxford should, without delay, adopt a serious code of socially responsible investment for their large investment portfolios. Whether the primary motivation is financial, moral or from self-regard, adoption of SRI will only benefit these institutions. Continued prevarication will undermine each of these.

2. While investment committees should retain ultimate responsibility, colleges should follow the University in establishing oversight committees including representatives of their stakeholders, not least JCR and MCR students.

3. Finally, to ensure that oversight committees function effectively and that SRI strategies are appropriate and adhered to, colleges should publish (including on their websites) regular statements of their investment positions.

The evidence shows that there are no longer financial costs to ethical investment behaviour. In the absence of any trade-off then, those who would oppose SRI strategies should recognise that they are defending for its own sake an ethical position which explicitly refuses to draw any lines at all. The argument that SRI opens the door to untold ethical dilemmas cannot be solved by taking this extreme position - but rather by ensuring adequate discussion of competing claims. Transparency and oversight are the simple mechanisms by which the Colleges - and other institutions - can achieve this.

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