Socially Responsible Investments: alpha on earth or alpha in heaven?

By Theo Vermaelen

In recent years we have seen a remarkable growth in funds that call themselves Socially Responsible Investments (SRI). In order to qualify as a SRI some funds work with an exclusion list: for example, they exclude companies that make guns, tobacco or cluster bombs. Others follow the opposite approach: invest in companies that are screened for ESG (Environmental, Social and Governance) criteria. They only invest in companies with high ESG scores. This has created work for consultants who advise on measuring ESG as well as accountants who produce triple bottom line (Economic, Ecological and Social) reports.

Some portfolio managers justify these funds as win–win situations: they claim that socially responsible behaviour is good for shareholder value, but the market only understands this in the long run. The argument is that consumers as well as employees are becoming more sensitive to corporate socially responsible behavior, which increases demand as well as labor productivity. Moreover, as a result of being more socially responsible, a firm can lower its reputation risk. At the same time, investors fail to realize this, at least in the short run. In other words, the market is not efficient in the sense that it does not understand that socially responsible behaviour is good for shareholder value. Hence these portfolio managers promise abnormal returns (alpha) on earth as well as alpha in heaven: not only will you earn excess returns on earth, but you are also helping your soul by doing good.

Others argue that it is impossible to beat the market, i.e. alpha on earth is zero, so you may as well get some alpha in heaven. This assumes that any beneficial effect of the socially responsible policies is already reflected in stock prices, so that investors earn the same risk-adjusted return as in other funds. Note that in this case the optimal alpha-on-earth strategy should be to invest in socially *irresponsible* companies and engage with the management trying to make them more socially responsible. For example, invest in a coal producer a convince them to diversify into wind farms.

The worst potential result for socially responsible investors is that there are too many investors like them so that socially responsible funds earn a lower risk adjusted return than other investments. Indeed, finance theory predicts that high risk stocks earn higher expected returns than low risk stocks because investors don't like risk. With the same logic, if the investors who set stock prices stock prices like social responsibility, they will, ceteris paribus, require a lower rate of return on socially responsible investments. So, although shareholder *value* increases because the cost of equity goes down, it also means that investors in sin stocks such as tobacco, alcohol and gambling will earn higher risk-adjusted returns than other stocks. Evidence that sin stocks earn excess returns of 2.5 % per year is provided in a study of Hong and Kacperzyk (2009)[1]. This would mean that now the socially responsible investors trade off negative alpha on earth against positive alpha in heaven. For example, investors who invested in the Dow Jones Alternative Energy Index ($DWCEAG) since its launch in 2008 have lost 95% of their wealth by now. They should console themselves with the idea that, although they lost a lot of money, they helped fight global warming.

Which scenario is true is ultimately an empirical question. Empirical tests are difficult as the predictions are about *expected* returns, which require studying long time horizons, and the SRI industry is relatively young. Moreover, numerous studies who support one argument or another don't adjust properly for risk. According to current financial wisdom, expected returns are driven by beta, market-to-book, size and momentum. One recent study that uses these risk factors and finds evidence in support for positive alpha on earth is the study of Ionannis Ioannou and George Serafeim[2]. Ioannou and Serafeim go back 20 years as they want to invest before socially responsible investment became a popular strategy, giving more chance to the market underreaction hypothesis. They calculate the returns of 90 sustainable US firms over a twenty year period and compare it with 90 control firms and find positive excess returns. However, another recent study of Renneboog et al (2011[3]) find significant negative alphas in a global sample of global socially responsible funds in the period 1992-2003.

So while the jury is still out on whether there is alpha on earth, the fact is that for many investors alpha in heaven is real.   This is not only true for investors, but also for portfolio managers. A recent study by Hong and Kostovetsky (2012)[4] finds that portfolio managers who give more money to Democrat candidates invest in more socially responsible companies. This means that not only investors but also portfolio managers are making investment decisions on the basis of “values” rather than simple risk-return considerations predicted by finance theory. Moreover, these strategies can be attractive to many fund managers as they don’t have to prove that they can beat the market, an increasingly difficult challenge in a world with thousands of funds looking for alpha on earth. This may also explain why money flows in these funds is not driven by past performance (alpha on earth) in contrast to the rest of the asset management industry.

[1] Hong H. and M. Kacperszyk :”The price of sin : the effect of social norms on markets”, Journal of Financial economics (2009)

[2] Ioannis Ioannou and George Serafeim : “The impact of corporate culture of sustainability and corporate behaviour and performance”, Harvard Business school working paper(2012)

[3] Luk Renneboog, Jenke Ter Horst en Chendi Zhang : “Is ethical money financially smart ?” Journal of Financial Intermediation (2011)

[4] Hong,H. , Kostovetsk, L. , 2012, “Red and blue investing : values and finance”, Journal of Financial Economics

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