Doing Good by Investing in Sin

By Theo Vermaelen , INSEAD Professor of Finance

Diverting investments away from “sin” doesn’t necessarily make the world a better place.

The recent growth in ethically and socially responsible funds now represents trillions of dollars of mandates. Many of these funds engage in negative screening – excluding investments that are involved in activities that are considered unethical or socially irresponsible such as defence, guns, alcohol, tobacco, adult entertainment, gambling, nuclear energy and, most recently, fossil fuels. The argument of the sellers of these funds is that investing ethically with them will make the world a better place.

Many of these funds tell their investors that it will be a “win-win” situation: you are “doing good” and you also create “alpha”, i.e. you beat the market. Their argument is that the market undervalues the long-term negative consequences of being involved in socially irresponsible activities. Fund managers are now, for example, asked to incorporate climate change risk in their investment process.

Some large investors push the corporate social responsibility (CSR) agenda even further by becoming impact investors (different from activists, who focus on shareholder value). For example, the Dutch pension fund, ABP, one of the largest pension funds in the world, sent me a letter (I am a beneficiary) proudly announcing that thanks to its efforts Shell had given up searching for oil in the Arctic seas:

“Because of the fight against global warming the demand for oil will go down. In these circumstances is it responsible to invest in a vulnerable area such as the North Pole? Are there no better alternatives? Why not invest in Brazil instead?”

So the pension fund manager believes that he is smarter than the Shell executive who is apparently investing in negative NPV (net present value) projects, without realising it. Shell’s decision to abandon the Arctic drilling project was announced on September 28th, 2015. On that day its stock price fell by 3 percent, roughly in line with the oil stock index and the S&P 500. If markets believed that this was a negative NPV investment, its stock should have risen, or at least fall less than the S&P 500. So the market disagreed with the ABP pension fund manager.

The tenuous impact

The idea that avoiding “unethical” stocks makes the world a better place is even more questionable. If, for example, you sell shares of Smith & Wesson, the gun manufacturer, because you believe that manufacturing guns is unethical, someone else (who does not agree with your values) will buy them. Nothing happens to Smith & Wesson. The number of guns sold in America is not affected. So the claim that you make the world a better place when you invest in funds that exclude sin stocks is obviously false. Fund managers seem to exploit naive investors who don’t seem to understand that buying a stock is not the same as giving money to the company. Only in the case of IPOs or secondary offerings you affect the company’s cash flows. Moreover, serious **academic research** by LBS professors Elroy Dimson, Paul Marsh and Mike Staunton shows that sin stocks beat the market, which is the opposite of the claim that “doing good” generates higher alpha. This is not surprising as they are good theoretical reasons for this: if an asset is not wanted because investors feel bad about owning it, its expected return has to be higher to compensate for this bad feeling. However, this also means that investors who don’t care about ethics will earn a higher expected return. Socially responsible investment funds, if they become important enough to have an impact on asset prices, will be a prime example of “good intentions with bad results”.

Ironically, this is admitted by the CSR advocates who claim that socially responsible companies increase shareholder value because they lower the cost of capital. But if the cost of capital is lower, the expected return on equity will be lower as well. The argument that these stocks nevertheless are good investments is based on a convoluted hypothesis that the market underestimates the reduction in the cost of capital and/or the increase in the cash flows, but over time, the market will incorporate the wisdom of the CSR fund manager.

The case for sin reporting

Rather than misleading investors by making them believe that investing in a fund makes the world a better place, I would like to propose a new approach that actually achieves this social objective without sacrificing alpha.

First, the portfolio manager is given absolute freedom to pick stocks according to the best of his or ability, with no restrictions on the universe of stocks he or she can invest in. In other words, the manager is free to maximise alpha.

Second, each quarter the fund would report separately the total profits, and profits per share made on the stocks that would qualify as "sinful" or stocks with low social responsibility scores. This will allow each investor to calculate to what extent he or she has benefited from "sinful" activity.

Third, the fund will keep a "sin balance sheet" where all cumulative net profits from sinful investment are recorded. This may, of course, include subsequent losses. Although sin stocks are expected to beat the market on average, in the long run, this is not necessarily true each year.

Fourth, investors can then reconcile their social and investment goals by donating the profits from "sin" to a good cause that directly makes the world a better place. They could do this by asking the portfolio manager to sell some sin stocks in the portfolio but they could also use other funds, of course.

For example, consider an investor who invests US$100,000 in a fund that has 5 percent of its assets in Smith & Wesson in January 2012, so the investor has invested US$5,000 indirectly in Smith & Wesson. Since January 2012, S&W's stock price has increased by 433 percent from US$4.50 to US$24, largely as a result of terrorist attacks and gun owners' fears that US

President Barack Obama would take away their guns. The socially responsible investor could then use his profits (US$21,650) to donate to a group that lobbies against the National Rifle Association.

I understand that it will take time for my proposal to be adopted as it requires rational, rather than emotional thinking about investments. The success of the socially responsible investment industry shows that marketing based on exploiting emotions and irrationality – unfortunately – works.

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