The price of conscience: analysing ethical performance

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Biography

Quintin has worked for actuarial and investment consultancy firms and a multi-national European bank, including wide experience in quantitative fund and risk analysis. He is a Fellow of the Institute of Physics, a Chartered Fellow of the CISI and a Chartered Wealth Manager. Quintin has applied skills gained from his Oxford University Physics Doctorate and while working in engineering to finance. He is the second UK graduate from the Sustainable Investment Professional Certification (SIPC) programme and joined P1 Investment Management in January 2017, founding their ethical and sustainable investing proposition.

Introduction

Earlier articles asked why ethical investment matters [1], introduced sustainable (environmental, social and governance, or ESG) investing [2]; or looked at different approaches [3], [4], including fund selection [5]. This article is the second examining the 'price of conscience', testing the view that ethical investments are more likely to underperform. The earlier article explored arguments for ethical out-performance [6]; the focus here is on performance studies.

Might ethical investments tend to under-perform their conventional counterparts? Could 'ethical' or 'green' labels have been applied for marketing advantage? One issue is distinguishing between fund providers with only a superficial commitment to ethical investing and those with genuine skills. This is an area where investors may benefit from input from wealth managers experienced in this field [5].

Apart from identifying genuine ethical funds, might such funds underperform? The argument for underperformance seems to be that ethical investment requires screening, thus reducing investment choices and diversification, resulting in worse returns, higher risk, or both [7]. However, several academic studies suggest the reverse, i.e that ethical investing may instead generate out-performance relative to broader markets, even after allowing for risk and other factors.

Should we expect out-performance?

Reasons to expect out-performance by ethical investment strategies were reviewed previously [6]. They focused on risk and competitive advantage. In terms of risk, harmful corporate behaviours eventually lead to negative consequences, harming growth and share price. These can include community opposition to projects, increased insurance premiums, decreased access to capital markets, damage to reputation, and litigation threats. Essentially, the share prices of unethical companies may not fully reflect their risks.

On the other hand, ethical companies have a competitive advantage from a good reputation to attract customers. They also enjoy enhanced trust with trading partners reducing costs and increasing business opportunities, the ability to attract the best staff and access to capital markets on better terms.

Evidence on performance

Is there evidence to support this? Academic studies suggest that various ethical approaches have resulted in out-performance, with portfolios of more 'ethical' companies out-performing the broad market.

The studies below covered periods from eight to 27 years between 1984 and 2011, using a variety of ethical strategies. Out-performance 'alphas' of 1.3% to 5.2% per annum relative to the market were seen for long-only portfolios. Market models ranging in sophistication up to the Carhart four-factor model [8] were used to allow for the effects of market risk (beta), company capitalisation, value-growth style bias and momentum effects. In many cases, the alphas proved to be statistically significant.

The table summarises how in these studies long-only portfolios of more 'ethical' companies out-performed the broad market. The analyses covered various time-periods with differing criteria to define which companies were more (or less) ethical.

Alpha, per year	Period Analysed	Ethical Criteria	Source
1.3 – 4.0%	1995-2003	Environmental	[9]
2.3 – 3.6%	1992-2004	Environmental, Social	[10]
2.3 – 3.8%	1984-2011	Employment quality	[11]
3.5%	1990-1999	Governance	[12]
3.7 – 5.2% (estimated)	1990-2003	Governance	[13]

Table: Studies showing out-performance by ethical strategies

Of course, out-performance cannot be guaranteed and much depends on the skill of the fund manager not only screening, but also in selecting in which companies to invest.

For another perspective, consider the argument that ethical investing reduces investment choice, resulting in worse performance. A Grantham Institute study suggests that this may not be so [14]. The initial focus was fossil divestment, particularly the exclusion of oil extraction companies from portfolios. Using the S&P500 (the index of 500 large companies listed on the New York Stock Exchange), they excluded one of ten different sectors from a portfolio. They found that over the period 1989-2017 this changed annualised returns by 0.5%. The annualised S&P500 return was 9.71%, while portfolios with one sector excluded returned between 9.44% and 9.94%. Over lengthier periods, the results remained similar. From 1957-2017 a sector exclusion changed annualised returns by 0.61%, and over 1925-2017 by 0.54%. They concluded that one could divest from oil, or pretty much any other sector, without much consequence. While this does not point to out-performance, it undermines the notion that ethical sector exclusions

are likely to cause underperformance.

Historical analyses should be challenged on the basis that they offer no guarantee of future performance (which is undoubtedly true). Also, market conditions may be different in future, and perhaps several environmental, social and governance factors are now better addressed by companies. However, they should give pause for thought for those who are tempted to assume that it is 'obvious' that ethical portfolios 'must' underperform the broader market. This may help allay the dilemma faced by those considering investing ethically.

How this helps Investors

Individuals increasingly wish to invest ethically, often with specific concerns in mind. Younger people may give this a higher priority than older generations, with twice as many 18- to 34-year-olds feeling their pensions should be invested ethically, compared with those above 45 [15]. The Investment Association reports £25.5 billion assets in the UK responsible funds sector in March 2020, an increase of £7.3 billion since March 2019 [16].

Individuals will wish to be confident that ethical investing is unlikely to be detrimental to portfolio performance, but must remember that, in common with more traditional approaches, capital is at risk; an investor may get back less than originally invested. The academic studies indicate periods when ethical strategies have outperformed, or where exclusions have made little difference, which may offer reassurance. However, the selection of suitable ethical funds is a complex area. So, some investors are likely to wish to access the skills of wealth managers who can support them in this significant and growing field.

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