The price of conscience: analyses supporting ethical out-performance

By Quintin Rayer | March 22, 2018

In earlier articles, Quintin Rayer looked at different approaches to sustainable (environmental, social and governance, or ESG) investing [1], [2] and fund selection [3]. This article is the second of two considering the 'price of conscience', challenging the view that ethical investments may under-perform. Previously, logical arguments were explored [4], the current article reviews studies showing ethical out-performance.

Introduction

A significant question is how ethical and conventional investments compare, with concerns about under-performance, further clouded by worries that 'ethical' or 'green' labels have been applied for marketing advantage. The problem is distinguishing between fund providers with only a superficial commitment to ethical investing and those with genuine commitment and skills, an area where advisers may benefit from input from wealth managers experienced in this field [3].

Beyond ensuring selection of genuine ethical funds, there remain questions about whether such funds must underperform in the wider market. The argument for underperformance proceeds as follows: ethical investment requires screening, thereby

reducing investment choices and diversification, resulting in worse returns, higher risk, or both [5].

However, several academic studies suggest that ethical investing may actually generate significant out-performance relative to broader markets, even after allowing for relative risk and other factors.

Why should we expect out-performance?

Reasons to expect ethical investment strategies to out-perform were reviewed previously [4]. These can be summarised in terms of risk and competitive advantage. In outline, looking at 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 unethical companies have risks that are not well reflected in share prices.

On the other hand, ethical companies have a competitive advantage including a good reputation to attract customers, 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 for out-performance

So what evidence is there to support this? Academic studies suggest that various ethical approaches do indeed result in out-performance, with portfolios of more ‘ethical’ companies out-performing the broad market.

The studies reviewed covered periods from eight to 27 years between 1984 and 2011, using a variety of ethical strategies. Relative to the market, alphas of 1.3% to 5.2% per annum were obtained for long-only portfolios. Using the Carhart four-factor model [6] to allow for the effects of market risk (beta), company capitalisation, value-growth style bias and momentum effects, these alphas proved statistically significant.

The table on the following page outlines how in these studies the long-only portfolios of more ‘ethical’ companies out-performed the broad market. These involve analyses over various time-periods using differing criteria to define which companies are more (or less) ethical.

Alpha, per year	Period Analysed	Ethical Criteria	Source
1.3 – 4.0%	1995-2003	Environmental	[7]
2.3 – 3.6%	1992-2004	Environmental, Social	[8]
2.3 – 3.8%	1984-2011	Employment quality	[9]
3.5%	1990-1999	Governance	[10]
3.7 – 5.2% (estimated)	1990-2003	Governance	[11]

Table: Studies showing out-performance by ethical strategies

Such historical analyses can always be challenged on the basis that they offer no guarantee of future performance (which is undoubtedly true). Equally, market conditions may be different looking forwards, and perhaps several environmental, social and governance factors are now better addressed by companies. However, they should serve to give pause for thought for those who are tempted to assume that it is 'obvious' that ethical portfolios 'must' underperform the wider market and help to allay the dilemma faced by advisers considering discussing ethical investing with their clients.

How this helps Advisers

Clients increasingly wish to invest ethically, but advisers can be concerned that ethical strategies are likely to under-perform and may be reluctant to recommend them as a result. The academic studies indicate periods when ethical strategies have out-performed, which may reassure advisers considering them for their clients.

Many younger people may regard ethical considerations as 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 [12]. The Investment Association reports £15.0 billion assets in the UK ethical funds sector in November 2017, a yearly increase of £3.0 billion [13].

Advisers will wish to know how to best meet clients' needs either by selecting the most appropriate ethical funds or, when necessary, accessing the skills of wealth managers who can support them in this significant and growing area.

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