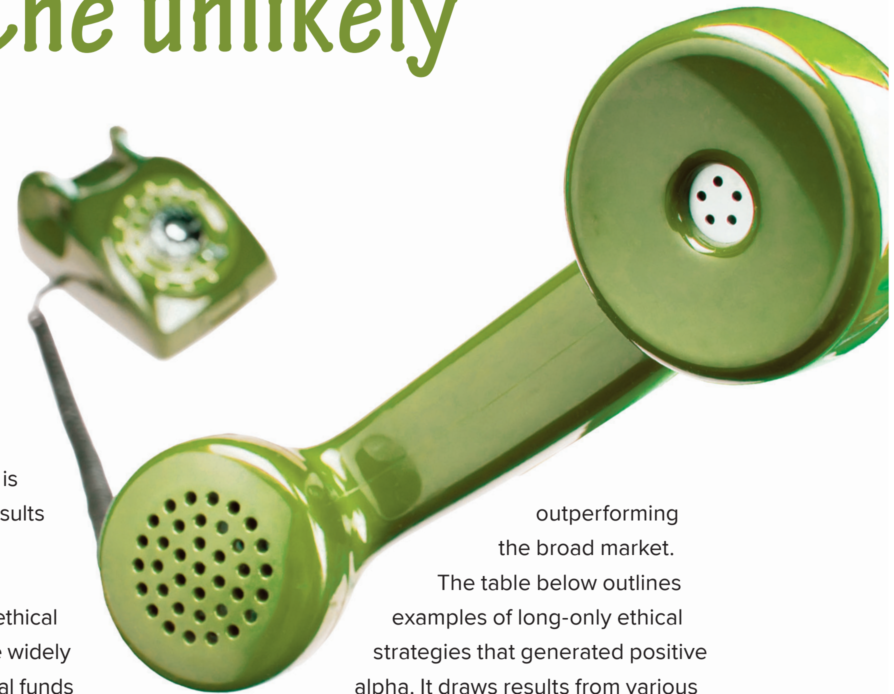
Ethical investing: the unlikely route to alpha?

Although some assume sustainable portfolios have high risk and low returns, research suggests these funds can outperform the wide market



If you heard of an investment strategy that generated significant alpha, you would want to know more. Even better if it was not merely above the market, but also risk-adjusted outperformance, allowing for investment style, stock capitalisation and market trending. Not to mention statistically significant to boot. Several academic studies suggest such a strategy is available. Yet it is currently neglected by mainstream funds.

The studies in question covered periods from eight to 27 years between 1984 and 2011, using sub-strategies of the core approach. Alphas of 1.3%-5.2% per year relative to the market were obtained for long-only portfolios. Using the Carhart four-factor model to allow for the effects of market risk (beta), underlying company capitalisation, value-growth style bias and momentum (or trending) effects, these alphas proved statistically significant.

UNLIKELY ADVANTAGE

Historical analyses can be challenged on the basis they offer no guarantee of future performance. And market conditions may be different looking ahead. You might expect profitable alpha-generating anomalies to be exploited away as they become widely adopted.

But this core strategy was, at most, used by only around 1.26% of assets under management at December 2017. This suggests it is hardly mainstream. Even if the past is no guide to the future, the results should stimulate interest.

What is this strategy? The answer may surprise many: ethical or sustainable investing. The widely accepted wisdom says ethical funds must underperform.

The argument is ethical investment requires screening, which reduces investment choice and diversification. This results in worse returns, higher risk, or both. Another difficulty is whether some fund providers have only a superficial ethical commitment.

Actually, there are fundamental reasons for believing ethical investing can generate superior returns, based on risk and competitive advantage.

Considering risk, harmful corporate behaviours eventually lead to negative consequences, damaging growth and share price. These can include sector emissions constraints, community opposition, increased insurance premiums, decreased access to capital markets, damage to reputation, and litigation threats. Essentially, unethical companies have risks not well reflected in share prices.

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ACADEMIC EVIDENCE

Ethical companies also have a competitive advantage. They avoid the above problems, while also attracting customers by having a good reputation.

Enhanced trust with similarly ethical trading partners also reduces costs and increases business opportunities. They can attract the best staff, find new revenue streams from novel environmental technologies and access capital markets on better terms.

Academic studies suggest various ethical approaches result in outperformance, with portfolios of more 'ethical' companies outperforming the broad market.

The table below outlines examples of long-only ethical strategies that generated positive alpha. It draws results from various studies, including Alex Edmans' 'The link between job satisfaction and firm value, with implications for corporate social responsibility', and Alexander Kempf and Peer Osthoff's 'The effect of socially responsible investing on portfolio performance', and others. These analyses over various time periods use different criteria to define which companies are more (or less) ethical.

STUDIES SHOWING OUTPERFORMANCE BY ETHICAL STRATEGIES

ALPHA, PER YEAR	PERIOD ANALYSED	ETHICAL CRITERIA
1.3% - 4.0%	1995-2003	Environmental
2.3% - 3.6%	1992-2004	Environmental, social
2.3% - 3.8%	1984-2011	Employment quality
3.5%	1990-1999	Governance
3.75 - 5.2% (estimated)	1990-2003	Governance

Ethical might be an outperforming investment strategy regardless of moral considerations. It can reassure advisers that selecting ethical funds for clients is unlikely to be detrimental to portfolio performance.

The analyses above should serve as food for thought for those who assume it is 'obvious' that ethical portfolios 'must' underperform the wider market. It can allay any dilemma faced by advisers considering discussing ethical investing with clients. ■

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