Part 2: Investment characteristics of SRI/ESG funds – risk, return, diversification, expenses

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There are SRI/ESG-focused mutual funds that have applied these strategies back to the 1970s. For a long time, while there were some funds that merited attention, there wasn't a broad selection and they did not cover all the asset classes required to be a globally balanced investor.

Today, as more demand from investors has triggered more offerings, you can build a diversified SRI/ESG portfolio at a reasonable cost without sacrificing potential return.

Researchers Gunnar Friede (Deutsche Asset and Wealth Management) and Timo Busch and Alexander Bossen of the University of Hamburg completed a meta-analysis reviewing 2,200 primary studies regarding the relationship between ESG scores and financial performance. This work considered both U.S. and foreign companies and reviewed many different measures of performance related to company financials and stock returns. Their work, published in December 2015, concluded that 90% of the studies found a positive relationship between ESG scores and financial performance.

Other research from Morgan Stanley demonstrated that, across asset classes and over time, investments emphasizing SRI/ESG screening or integration "usually met, and often exceeded, the performance of comparable traditional investments." This was true when measuring absolute returns or risk-adjusted factors.

A recent Charles Schwab newsletter for advisors provided more support that an SRI/ESG-performance drag is a myth. "Schwab analyzed the performance of socially conscious funds in 3-, 5-, and 10-year increments and found they were in line with and sometimes better than the performance of non-socially conscious funds. Additional

Morningstar data shows that on average SRI mutual funds have slightly outperformed their non-socially conscious counterparts in the short, medium, and long terms."

(A list of additional studies on financial performance can be found on at http://www.ussif.org/performance.)

MSCI, primarily an index provider and market analytics firm, utilizes an ESG scoring system to evaluate publicly traded companies. It determined that companies that incorporate ESG considerations in their management may create more financial value in three ways:

- **Higher profitability.** Companies in the top quintile based on their ESG scores have demonstrated higher profitability compared to companies with bottom quintile ESG scores. Additionally, these top quintile companies tended to pay higher dividends.
- **Lower tail risk.** There is a lower frequency of severe pullbacks (stock price declines) by top-quintile companies than bottom quintile companies using ESG analysis. Drastic declines (95% cumulative stock price decline) were three times more likely for the quintile with the lowest ESG scores than the highest-rated quintile.
- **Lower systematic risk.** There is broad-market risk of investing in global stocks that cannot be diversified away. MSCI's review found that the top-rated companies using ESG analysis were not immune to systematic risk but when there were shocks to broad markets, the top-rated companies minimized some of the impacts of systematic risk on a portfolio.

Of course, there is no free return granted just for your virtue. Making a decision with the intent to contribute to the greater good does not guarantee, or give you the right to access, better investment performance than other investors or the broad marketplace as a whole.

Just because a company may be rated highly based on ESG factors and widely viewed as an ethical, responsible company, doesn't mean its stock or bonds are always available at a good price or value. Even companies that align with your values could still be in industries that don't generate tremendous profits or earnings growth (which lead to increasing stock prices). Some companies could be attractive from an emotional standpoint but still be inefficiently operated and not attractive from the standpoint of quantitative analysis. And another factor to be mindful of is investments that are bid up to a premium price based on sentiment rather than measurable value. The lower price you pay, the higher your expected future return should be. If demand for any particular company for any particular reason is high, its price may not trade at a low value. You could overpay for a mediocre investment in an otherwise laudable company.

Another point of evaluation that deserves attention is the fact that in the recent past, there has been a general tilt of SRI/ESG funds to growth-oriented companies rather than to value stocks. The returns of growth stocks have dominated value stocks over the past decade. Energy stocks usually are considered value stocks. Over the last 10 years, if all your SRI strategy did was avoid fossil fuels, the portfolio would lean toward growth stocks and would have picked up a performance boost compared to a broad market index like the S&P 500. If history can be trusted as a guide at all, the cycle of market leadership will shift back from growth to value. At that point, we'll get a better indication of the strength of SRI/ESG strategies in different market cycles. Of course, financial returns are not the only measure of success for some investors. There are some people who would be happy accepting a lower investment return than available elsewhere if it comes from a company that they believe in and want to support by owning the company's stock or bonds.

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