Ranking Socially Responsible Mutual Funds

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ABSTRACT

Socially Responsible Investing (SRI), also known as sustainable or ethical investing, corresponds to an investment practice that takes into account not only the usual return-risk criteria, but also other non-financial dimensions, namely in terms of environmental, social and governance concerns. Recently, given the causes of the 2008 financial crisis, these concerns became even more relevant. However, while a diverse set of models have been developed to support investment decision-making based on financial criteria, models including also socially responsible criteria are rather scarce. The main objective of this paper is to contribute to try fulfilling this gap on the financial literature, suggesting a Multicriteria Decision Making tool which allows individual investors to analyze and rank socially responsible mutual funds based on their environmental, social and governance performance and taking into account the individual, subjective, personal preferences of each investor.

Keywords: Environment, Equity Mutual Funds, Governance (ESG) Practices, Multicriteria Decision Analysis, Socially Responsible Attractiveness, Socially Responsible Investment

INTRODUCTION

Socially Responsible Investing (SRI), frequently called Ethical Investing, is broadly defined as an investment process that integrates not only financial but also social, environmental, and ethical (SEE) considerations into investment decision making. SRI has grown rapidly around the world in the last decades. As informed by the Social Investment Forum in its last bi-annual report (SIF, 2007): “Near eleven percent of assets under professional management in the U.S. are now involved in SRI. SRI assets rose more than 324 percent from $639 billion in 1995 to $2.71 trillion in 2007. During the same period, the broader universe of assets under professional management increased less than 260 percent from $7 trillion to $25.1 trillion. From 2005-2007 alone, SRI assets increased more than 18 percent while the broader universe of professionally managed assets increased less than 3 percent.”

Social Responsible mutual funds, also known as invested funds, are one of the main instruments of SRI. The term “fund”, a kind of collective investment, is used to refer to a ready-made financial product where investor’s
money is pooled into a portfolio and a fund/investment manager decides which shares to buy. As reported by the Social Investment Forum (SIF, 2010), during 2009 funds topped their benchmarks across nearly all asset classes, including balanced, large cap, small cap and global funds, as well as bonds\(^1\) (Table 1).

The investment strategies used by socially responsible investors are mainly screening, community investment and shareholder activism. Screening, positive and/or negative, is the practice of evaluating mutual funds based on social, environmental, ethical and/or good corporate governance criteria.

Positive screening implies investing in profitable companies that make positive contributions to society, for example, that have good employer-employee relations, strong environmental practices, products that are safe and useful, and operations that respect human rights around the world.

Conversely, negative screening implies avoiding investing in companies whose products and business practices are harmful to individuals, communities, or the environment.

Community investment is another investment strategy which directs capital from investors to communities that are underserved by traditional financial services institutions. It makes it possible for local organizations to provide financial services to low-income individuals and to supply capital for small businesses and vital community services, such as affordable housing, child care, and healthcare. Finally, shareholder activism involves socially responsible investors who take an active role as the owners of corporate America. These efforts include talking (or “dialoguing”) with companies on issues of social, environmental or governance concerns. Shareholder advocacy also frequently involves filing, and co-filing shareholder resolutions on such topics as corporate governance, climate change, political contributions, gender/racial discrimination, pollution, problem labor practices and a host of other issues. Shareholder resolutions are then presented for a vote to all owners of a corporation.

Screening is the most widely used SRI strategy. The Social Investment Forum (SIF, 2010) reports that more than two-thirds of the funds in the U.S. were looking in 2009 for companies with good records on climate change issues and community development. Virtually all these U.S. mutual funds excluded tobacco companies from their portfolios or restricted their involvement in such firms (https://www.socialinvest.org/) (Table 2).

In its 2007 report, the Social Investment Forum (SIF, 2007) analyses some of the factors that, in their opinion, are key contributors to the robust growth of SRI. These factors seem to be fully justified by the 2008 financial crisis: money managers are increasingly incorporating social and environmental factors into their investing practices; there is a growing concern about climate change and its risk for portfolios. Investors are demanding investments in clean and green technology, alternative and renewable energy, green building and responsible property development, and other environmentally driven businesses; institutional investors are proactively allocating portions of their portfolio to community investing options in order to deepen the social impact of their investments.

SRI is a growing and important investment field and therefore there is an increasing body of the literature which pays attention to it. Nevertheless, most of the academic research is focuses on the discussion on the financial performance of social responsible funds while few indicators have been developed for mutual funds’ socially responsible performance measurement (Michelson et al., 2004; Dunfee, 2003; Hoggett, 2002; Haigh, 2008; Barnett & Salomon, 2006; Renneboog et al., 2008; Lee et al., 2010; Jegourel & Maveyraud, 2010; Scholtens, 2007).

The main conclusion from the revision of the academic literature and from current practice is the necessity of a suitable social responsible level indicator which could allow investors in the evaluation of mutual funds. It is necessary for this indicator to take into account the multiple dimensions of social responsibility related, not only to the companies’ behavior but to the
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