

CHALLENGES IN PERFORMANCE METRICS IN SOCIALLY RESPONSIBLE INVESTMENTS

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Abstract: Sustainability issues have been penetrating the financial world over the decades at corporate and sector levels. In the field of sustainable finance, socially responsible investments (SRI) are a dynamically evolving segment which has become a special industry in asset allocation and investments out of a niche movement. This article aims to highlight the trends, investors' motives and performances of these investments. It concludes that controversies around the terminology, performance metrics and return of socially responsible investments, have not been resolved in academic literature yet.

Keywords: socially responsible investments, portfolio performance, sustainable development

JEL classification: G11, M14, Q01

SRI categories

A report of the Global Sustainable Investment Alliance, GSIA published in 2012 categorizes socially responsible investments as follows:

1. *Negative (exclusionary) screening:* the exclusion of certain sectors, companies or practices based on (environmental, social and governance (ESG) criteria from an investment fund.
2. *Positive (best-in-class) screening:* the stimulation of investments in positive sectors, companies or practices based on ESG performance relative to industry peers
3. *ESG integration:* the systematic inclusion of ESG factors into traditional financial analysis by the investment managers.
4. *Sustainability themed investing:* investments in themes or assets specifically related to sustainability (clean-energy, green technologies, sustainable agriculture).
5. *Impact or community investing:* impact investing includes community investing, where capital is directed to traditionally underserved individuals or communities with a clear social or environmental purpose.
6. *Corporate engagement and shareholder action* based on ESG principles.

Figure 1 summarizes the amount invested in each of the above mentioned strategies by region.

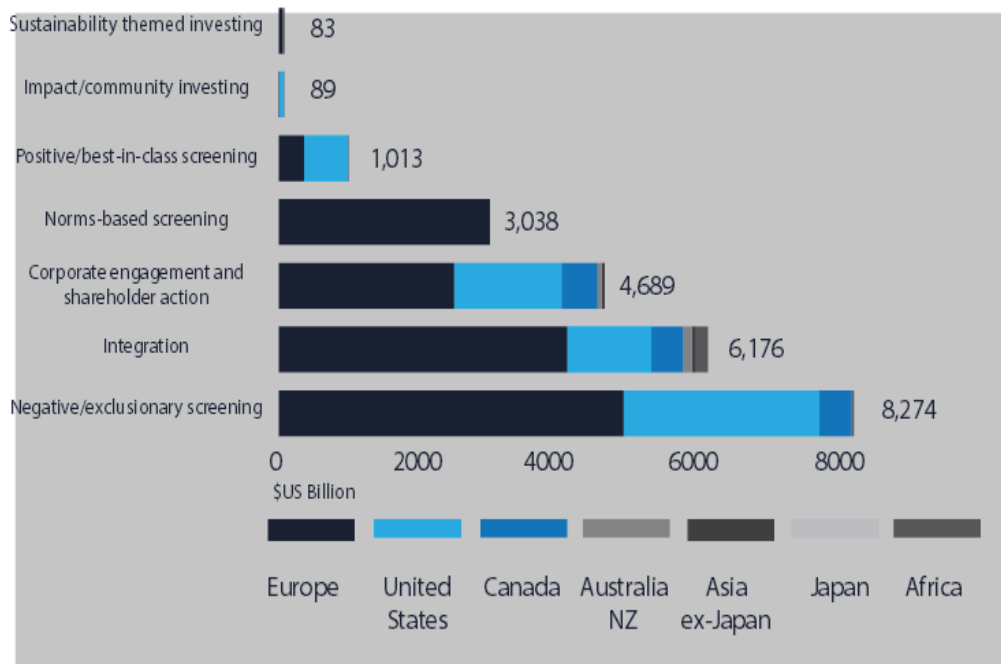


Figure 1: The global aggregation of SRI investments (2011)

Source: GSIA, 2012: 15.

The SRI community

The SRI community is formed by the network of asset owners, asset managers and those supplying supporting services, but in the wider sense this includes consumers, non-governmental organizations and regulators as well. Among those providing supporting services we should mention general international agencies (EIRIS, Vigeo, MSCI ESG Research, etc.), extra-financial information providers (Asset 4, Bloomberg, RepRisk), the specialized agencies (Maplecroft, Solaron, Trucost, etc.) and the local agencies (Gerain and Leconte, 2011). The purpose of ESG rating agencies is to assess the extra-financial performance of public and private companies as well as other issuers of securities with a specifically unique method based on environmental, social and corporate governing aspects. These ESG ratings are used by asset owners and asset managers to design their portfolios.

Every rating agency has its unique methodology. In Europe however there is a standard that qualifying companies adhere to. This is held together by the Association for Responsible Investment Services - ARISE, 2002. Beside the possible investing universe of companies screened on the basis of ESG criteria, the rating agencies provide country sustainability reports, ESG news and different monitoring services.

SRI asset owners can be divided into three groups: retail investors, small and the large institutional investors, among who national, local and private pension funds- as well as sovereign wealth funds. The European SRI market is dominated by institutional investors (Louche and Lyndenberg, 2011). Community investors tend to be dominant in Japan and in the USA.

The *universe of SRI investments* may extend from equity funds, through sustainable bond funds and sustainability index funds to the fund of funds (Table 1).

Table 1: The spectrum of SRI investments

Category		Description
Equity funds	Equity funds	Actively handled funds.
	Ethical funds	Criteria based on principles and religious exclusion.
	Environmental technology funds	Funds focusing on environmental technologies used for cleaner production, recycling, etc.
	Eco-efficient funds	Big companies displaying best-in-class environmental protection practices.
	Funds of leading companies in sustainability	Big companies with best-in-class sustainability practices. (it also focuses on the best possible sectors: the best among the best-in-class).
	Eco-pioneer/venture capital funds	Innovative companies with small- and middle capitalization that focus on environmental technologies and services.
	Environmental resources funds	The theme of these funds is related to environmental resources, e.g. water, energy or sustainable silviculture.
Sustainable bond funds		State/corporate bonds that are chosen based on sustainability criteria.
Sustainability index funds		Passively handled funds in a highly diversified manner with a best-in-class approach.
The fund of funds		The portfolio of the above mentioned funds.

Source: Koellner et al., 2005: 64

According to a survey made among French, German, Italian, Dutch and Swiss pension fund specialists, the majority of experts have the opinion that SRI criteria are going have an increasingly important role in the investment decisions regarding pension funds, moreover they are not going to affect equity investments only, but other asset classes as well (Boersch, 2010).

ESG rating

As members of the SRI community, ESG rating agencies provide information on the analysis of extra-financial criteria of investment decisions. The rating process is as follows: the environmental, social and corporate governance themes are rated based on the inner directives of the rating agency and are adjusted by risk factors; an overall ESG performance score is established. The rating system is agency-specific; the MSCI ESG Research for instance applies a 9-grade scale, while the FTSE4Good ESG Rating uses a 5-grade scale.

The problem with ESG ratings is that they highly depend on the corporate sustainability reports, the disclosed information, the interpretation of CSR and its operationalization, as well as the methodology used by the rating agency and the subjectivity of the analyst. ESG ratings have practically become commodities (Butz and Pictet, 2008). On the market there are both low and high quality ESG ratings, depending on the investments into research. The role of sustainability ratings is to contribute to investors' decision to use sustainability indicators just as well as financial indicators in their SRI portfolio management.

Sustainability reports are unsustainable in their present quality (Hubbard, 2011). There are problems with corporate interpretation of CSR, reporting differences between industry sectors and countries, ambiguous corporate policies and performance targets. There is

no unified form and availability of CSR reports in the world (KPMG, 2011). The ISO 14001, for instance, controls the internal environmental processes of an organization, it is unable to create a comprehensive sustainability framework; furthermore it focuses on the process, not the environmental output. The Eco-Management and Audit Scheme (EMAS) is also wide-spread in Europe, it is also limited to environmental and process-related issues.

The Global Reporting Initiative, the world's leading corporate responsibility standard, may be interpreted in different ways by different rating companies. Many companies do not provide an ESG report, and this is particularly true in the case of SMEs. For instance, high rating depends on whether screening is done based on toxic emission and compliance with regulators or based on environmental policy and the quality of the reports (Delmas and Blass, 2010). The authors have pointed out that there were instances where a company, that was among the best in terms of toxic emission, was listed among the worst based on the reports. Companies, that are leaders in communication and reporting, are often lag behind in the actual environmental performance.

ESG analysts should have professional qualification and analytical skills; furthermore, they should take part in ongoing training in order to be able to deliver relevant critical ratings instead of ticking standard boxes (Butz, 2005). The analysts' subjective judgments and preferences also highly influence the quality of ratings.

The return of SRI investments

The SRI investor is willing to sacrifice a part of the financial return for a higher social and environmental performance; this trade-off relationship leads to the „sustainability utility fuction“ (Butz and Pictet, 2008). According to the authors, comprehensive performance is determined by the interdependencies between three dimensions (Figure 2). This can be linked to the so-called *eco-efficient premium puzzle* which was formulated when a portfolio with high eco-efficiency characteristics provided higher returns compared to its low-ranked counterpart over the period of 1995-2003. The performance differential could not be explained by market sensitivity, investment style, other industry-specific components or transactions costs. (Derwall et al., 2004).

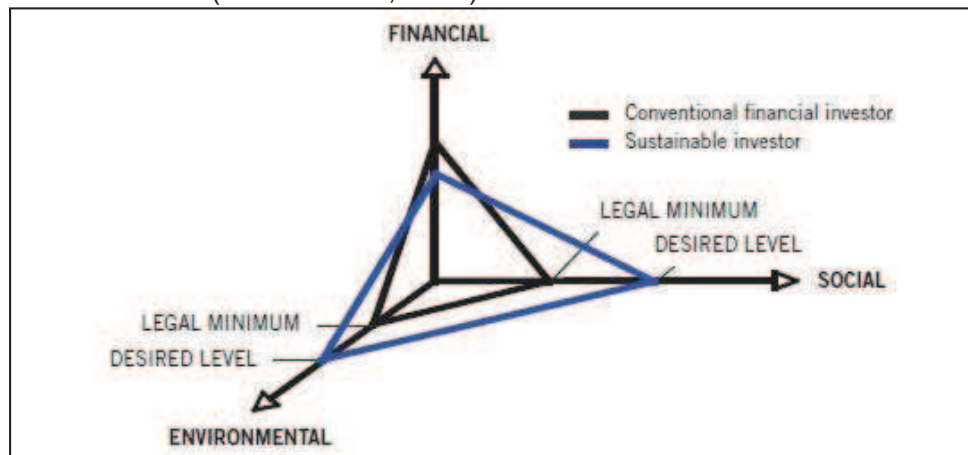


Figure 2: The threefold return: environmental, social and financial

Source: Butz and Pictet, 2008: 24

The SRI is an investment that achieves the highest possible, risk-adjusted rate of return, while it takes into consideration the social, ethical and environmental aspects as well (Derwall et al., 2011; Sandberg et al., 2009). It is important to understand, how investors weigh the financial and moral issues in their decisions in reality. A Norwegian bank

(Skandiabanken) wanted to label its responsible investment funds, and made a survey beforehand. They divided 140 000 investors into two groups: one group, the wealth-frame investors, received financially framed information through email, while the other group received morally-framed information. The research showed that wealth issues have an increased relative importance compared to moral concerns in socially responsible investment decisions in the information search and investment behavior stages (Doskeland and Pedersen, 2013).

According to a meta-study (Margolis and Walsh, 2003), 54 articles out of 127 indicate a positive connection between financial and social performance, 48 indicate a non-existent or mixed connection, and a few show negative connection. Ter Horst and his co-authors (2006) have demonstrated that SRI fund investors are more interested in social and ethical issues than in the performance of the investment fund when making investment decisions. During their research they have found that an SRI investor chases past returns and is less interested in the risks and costs of the investment fund.

According to a meta-study that analyzes 21 scientific articles published between 2008 and 2010, based on risk-adjusted returns, 7 articles state that SRI investment funds have similar performances to conventional funds, 5 state that they outperform them, 3 state that they fall short of them, while 6 present mixed results (Sjöström, 2011). Based on a sample extending to 145 investors, an Australian study demonstrates that socially responsible investors seek financial return as well as non-financial benefits; furthermore social conscience and social health are relevant for them as opposed to environmental issues. Another interesting interrelation is that SR investors tend to be middle-aged, middle-income professionals and have tertiary qualifications. (Perez-Gladish et al., 2012).

When analyzing the performance of SRI funds one specific research direction is the impact of different applications of screening. During the management of SRI portfolios, beyond consideration the financial return, such screenings are used with which certain investments can be excluded (negative screening) or preferred (positive screening), furthermore the owner's right to vote is used for promoting the inclusion of CSR into portfolio companies (Crifo and Forget, 2012). "Perhaps the most frequent criticism concerning socially responsible investment funds is that the introduction of non-financial screening restricts investment opportunities, reduces the efficiency of diversification and thus has a contrary effect on performance" (Lee et al., 2010: 351). SRI funds are less diversified during the traditional mean-variance analyses because the investments were made into a limited number of companies because of screening; therefore they have underperformed during the crisis (Guenster, 2012). Another study, however, contradicts this idea stating that SRI funds outperform conventional investment funds during market crisis, but are underperforming during non-crisis periods (Varma and Nofsinger, 2012).

The financial loss of SRI funds due to poor diversification is offset as social screening intensifies because better managed and more stable firms are selected into the portfolio (Barnett and Salomon, 2006: 2). The authors find that there is a curvilinear relationship between financial and social performance, moreover it varies with the types of social screens used: community-based screening increases financial performance, while environmental and labor related screening decreases financial performance.

It appears as a criticism that in many cases the highest rate of financial return is only attainable through social injustice and environmental degradation, namely the externalization of costs on people, the future and the environment (Hawken, 2004). After surveying 600 investment funds, it turned out that over 90% of the Fortune 500 company is included in SRI investment fund portfolios, which demonstrates a very wide and loose interpretation of SRI, thus SRI appears as a marketing strategy only, without the portfolio-managers actually adopting the philosophy itself (Hawken, 2004). Since there is no generally accepted definition for SRI, its interpretation depends on whether the effort is

formulated from perspective of the individual, the company or the organization (Chieffe and Lahey, 2009).

Challenges in SRI Performance Metrics

The measurement of the triple return of SRI investments is problematic. The conflict between the shareholder value maximization and ethics cannot be resolved unambiguously. The discretionary interpretation of sustainable development may lead to dubious trade-off relationships when choosing a purpose.

Social accounting and sustainability indicators may function as a benchmark so that social and environmental performance may be measured. Up until now, social accounting has mainly touched upon narrative reporting models in corporate financial statements. The social and environmental costs and profits of business activities are not reflected in financial reports (KPMG, 2005). Sustainability indicators are also rather experimental concepts. These measures turn ecological and social data into performance-standards which do not have to be quantified financially, furthermore, they do not specify how performance standards should be complied with. Sustainability indicators are not adequately set up for the portfolios of financial institutions. Investors can analyze financial performance with several different devices, but no similar instruments are available for measuring extra-financial performance. Financial performance indicators are unambiguous and structured, environmental performance indicators are heterogeneous; because of the use of different metrics, the authenticity of SRI screening is questionable, moreover, managers may not know how to rank their investments to improve sustainability performance (Delmas and Blass, 2010).

SRI investments are intended to create a positive impact on society and on environment. In contrast to financial returns, the non-financial impact is usually not assessed in a systematic manner. Similarly to standard financial analysis techniques, performance measures of social and environmental impacts would move the obstacles from the compatibility issues inherent in financial and non-financing metrics.

Measuring the impact of SRI should comprise both intended and unintended positive and negative impact from the perspective of all stakeholders and the total investment portfolio. However, none of the metrics used by the dominant standards and principles (Table 2) are suitable for impact measurement, that is there are no ready-to-use indicators for the sustainability impact assessment of SRIs (Weber, 2013).

Table 2: A review of SRI metrics

CSR practices	Review of metrics
Global Reporting Initiative (GRI, 2011) Financial Sector Supplement	There is no indicator that could measure the sustainability impact of the financial sector.
Principles for Responsible Investing (PRI, 2006)	It does not focus on the social, environmental and sustainability impact of SRIs.
The Equator Principles (2011)	It cannot measure the impact of financial products, services.
Impact Reporting and Investment Standards (IRIS, Global Impact Investing Network, 2012)	Indicators concentrate on creating new jobs; renewable energy, health and education are not covered. They only measure positive impacts.
Global Alliance for Banking on Values (GABV, 2012)	It does not provide systematic insights into the impact of the financial sector on the society or the environment.

Outreach Measurement in Microfinance	It does not deliver a valid and reliable impact measurement for the financial sector itself.
Social Return on Investment (SROI)	A real measure of financial product and service impact, however there is no systematic application of it in the financial sector.

Source: personal editing based on Weber, 2013

Environmental (EIA), Social (SIA) and Sustainability Impact Assessment are methods of measuring impact on the environment and society caused by projects, businesses or other economic activities. Both positive and negative impacts are quantified, and they realize the integration of all the affected stakeholders. Social and environmental measures can be used to capture the long-term value creation potential of the company and the risks related to it.

Conclusions

There has been a growing demand for socially responsible investments where investors are willing to give up a part of their financial return for higher ESG return. A lot of research has been done on whether socially responsible investments outperform or underperform the return of traditional investment funds. Academic literature is still divided in answering this question, presenting and clashing contradictory opinions, results and views. Concerning the performance metrics of SRI investments, the comparability of results is a challenge based on the scope, geographic location, ESG characteristics and time of sampling.

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