

**SOCIALLY RESPONSIBLE INVESTMENTS AND PORTFOLIO
PERFORMANCE: A CRITICAL LITERATURE REVIEW**

**BY
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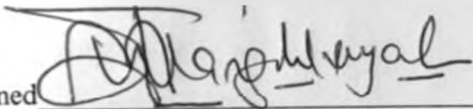
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**AN INDEPENDENT STUDY PAPER SUBMITTED TO THE SCHOOL OF
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DECLARATION

This Independent Study Paper is my original work and has not been presented to any other University for any award.

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This Independent Study Paper has been submitted with my approval as the University supervisor.

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LIST OF ABBREVIATIONS

ALMR	–	At Least Market Returns
BMR	–	Below Market Returns
BOP	–	Bottom Of the Pyramid
CEO	–	Chief Executive Officer
CMA	–	Capital Market Authority
ESG	–	Environmental, Social and Governance
EUROSIF	–	Europe Social Investment Forum
FCB	–	First Community Bank
IT	–	Institutional Theory
KSIF	–	Kenya Social Investment Forum
KSIX	–	Kenya Social Investment Exchange
MFI	–	Micro-Finance Institutions
MPT	–	Modern Portfolio Theory
NGOs	–	Non-Governmental Organizations
PMR	–	Potential for Market Returns
RBA	–	Retirement Benefit Authority
SRI	–	Socially Responsible Investment
ST	–	Stakeholder Theory
US SIF	–	United States Social Investment Forum
USA	–	United States of America

ABSTRACT

Since its introduction in the early 1970s, socially responsible investment (SRI) has gained prominence as both a rival and a complement to conventional investment. SRI is the philosophy and practice of making strategic investment decisions by integrating financial and non-financial considerations, including personal values, societal demands, environmental concerns and corporate governance issues. One of the major concerns in socially responsible investing is whether there is a difference between the performance of socially screened portfolios and that of conventional funds.

This study is a literature review of socially responsible investment and portfolio performance. The objectives of the study are to establish the documented relationship between socially responsible investment (SRI) and portfolio performance; to investigate, from the literature, whether investor demographic characteristics moderate the relationship between socially responsible investment and portfolio performance, to examine whether the relationship between SRI and portfolio performance is intervened by portfolio management process, to identify and document research gaps in socially responsible investment and lastly to establish researchable issues in socially responsible investment. The study presents a conceptual model guided by the modern portfolio theory, the stakeholders' theory, the institutional theory and the new social movement theory.

Literature reviewed on the performance of SRI mutual funds has been inconclusive with three schools of thought emerging: SRI under-performs, over-performs or performs as well as conventional mutual funds. The paper concludes that the conflicting results are caused by the fact that the relationship between SRI and portfolio performances is not direct but is intervened by other variables such as the portfolio management process. Five factors in the portfolio management process that are affected by SRI have been identified (Havemann and Webster, 1999). These are the portfolio diversification process, the size and structure of the investable universe, concentration and the research costs incurred in monitoring the investee companies. Another explanation into the conflicting results is that the relationship between SRI and portfolio performances may be moderated by the investors' demographic characteristics such age, gender,

level of education and amount of funds under management (Nilsson, 2008; Nilsson, 2009; Junkus and Berry, 2010).

A number of research gaps arise from the analysis of the issues examined in this paper. These include: Firstly, lack of consensus on why SRI occurs even when empirical evidence on the impact of SRI on portfolio performance is inconclusive. Secondly, difficulties in assessment of non-financial risk and return created by SRI especially given the inability to quantify social, ethical, governance, moral and environmental issues. Thirdly, most studies have not controlled for any intervening or moderating variable affecting the relationship between SRI and portfolio performance. Variables such as differences in demographic characteristics of the fund managers and portfolio management process may affect the relationship between SRI and portfolio performance.

Arising from the research gaps identified, several areas of further study have been suggested. These include: Firstly, a research instrument be developed to empirically test the variables that impact on socially responsible investment including the moderating and intervening variables. Secondly, a study can be undertaken to investigate the heterogeneity among investor clienteles and its implications for understanding the effects of social values on asset prices. Thirdly, given that investors have different reasons for investing in SRI profiled mutual funds, future research with regard to this segmentation would be to find out the reasons why investors belong to certain groups. Fourthly, further research can be done focusing on the type of mutual funds that could be marketed to the different investors' segments and finally, an index can be developed to quantify the non-financial risk and returns existing in SRI mutual funds.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

Investment, in its broad sense, means the sacrifice of current cash flow for future cash flow. It involves time, risk and returns since the sacrifice takes place in the present, and is certain, while the rewards comes later, and is uncertain (Sharpe, Alexander and Bailey, 2005). Reilly and Brown (2000) on the other hand define investments as a tradeoff of present consumption for higher levels of future consumption. According to these definitions future higher returns is a key determinant of the amount investors want to commit today. The future returns could be quantifiable in the form of monetary gains or qualitative in the form of social benefits. When the returns are mainly social, then the process can be referred to as socially responsible investing.

In contrast to the traditional model of philanthropy, by which people profit-maximize with one hand to then give away profits with the other, the social investment model seeks to co-align financial and ethical interests in a single strategy. The capital itself, rather than a charity run-off, is used to further the mission-interests of the investor, and produce a blended return that is composed of both financial and social or environmental benefits. Statman (2000) explains that together these elements compose a double or in some cases triple bottom line offering a number of key advantages including achieving a greater degree of congruence between investments and the values and beliefs of the investor, leveraging increased social impact through successive redeployments since the capital remains in circulation, encouraging sustainability since market discipline of invested capital obliges socially motivated organizations to engage in profitable activities, minimizing conflicts between profit-maximizing investments and philanthropic activity.

Any individual or group which truly cares about ethical, moral, religious or political principles should in theory at least want to invest their money in accordance with their principles (Miller, 1992). Such investors care about not only risk and return, but also the non-pecuniary benefits of investing. Their social values provide positive emotions from holding socially responsible mutual funds (Anginer, Fisher and Statman, 2008). Although many investors still question the rationale and effectiveness of such an approach, empirical evidence shows that socially

responsible investment (SRI) in developed economies is gradually moving from a fringe investment strategy to a mainstream consideration (Scheuth, 2003).

The increasing influence of socially responsible investment (SRI) is stressed by the exponential growth in its market, both in the America, where SRI encompasses an estimated \$3.07 trillion out of \$25.2 trillion in the U.S. investment marketplace (US SIF, 2011), and in Europe where total SRI represented 10 percent of the asset management industry (EUROSIF, 2011). This growth is stimulated by socially responsible investors who incorporate diverse social and environmental screens into their investment process.

Schueth (2003) indicates that the origins of what we now know as socially responsible investment date back hundreds of years. In early biblical times, Jewish law laid down many directives about how to invest ethically. Mandala (2003) notes that the Quakers, in the United States of America in the 18th Century, were the first investors to screen their investments for moral acceptability although retail mutual funds with an SRI focus only emerged in America in the late 1920s. The Quakers refused to do business with firms involved in the slave trade, tobacco, alcohol, or gambling.

1.1.1 Socially Responsible Investment (SRI)

The field of SRI has been characterized by debate or lack of consensus about definitions. Even the terminology is not settled. Thus broadly similar or related terms which appear in the literature include social (Bruyn, 1987), divergent (Schotland, 1980), green (Simpson, 1991), targeted, development and strategic (Wokutch, Murrmann and Schaffer, 1984) investment. However, the two most common terms are ethical investment (the term favored in the United Kingdom) (Sparkes and Cowton, 2004) and socially responsible investment (the term commonly used in the United States and adopted in this study).

Lozano (2006) defines SRI as an investment, which combines investors' financial objectives with their concerns about Social, Environmental and Ethical issues where investor's practices align those concerns with their investment strategies. However, Statman (2000) states that SRI is any investment which meets certain baseline standards of social and environmental

responsibility, actively engaging those companies to become better, more responsible corporate citizens, and dedicating a portion of assets to community economic development. Dunfee (2003), on the other hand, defines SRI as any investment strategy based upon identifiable non-financial criteria incorporating a social or religious dimension. The extent of adoption of SRI depends on the factors considered by socially responsible investors. Kempf and Osthoff (2007) identify three of these categories to include social, environmental and ethical factors. Schwartz (2003) adds two other categories of moral and governance principles. He states that socially responsible investors need to integrate moral principles as well as environmental, social and governance considerations into investment decision making.

Individuals wanting to invest in a socially responsible way have mainly three SRI strategies they can pursue including social screening, shareholders' activism and community investing. Social screening involves either positive or negative screening. Haigh and Hazelton (2004) describe positive screens as those identifying, and including in the portfolio, companies with superior social or environmental performance while negative screens are those identifying, and excluding from the portfolio, companies engaged in targeted undesirable activities. O'Brien (2002) defines shareholder activism as the process by which shareholders of a listed company, under the provision of securities legislation in various jurisdictions, can requisition its members to meet and vote on specified resolutions while community investing describes the practice of providing capital to people in low-income or at-risk communities who have difficulty accessing it through conventional channels.

1.1.2 Mutual Fund Portfolio Performance

The term portfolio refers to any collection of financial assets such as stocks, bonds and cash. Portfolios may be held by individual investors and/or managed by financial professionals, hedge funds, banks and other financial institutions. It is a generally accepted principle that a portfolio is designed according to the investor's risk tolerance, time frame and investment objectives (Reilly and Brown, 2000). Portfolio theory deals with the selection of optimal portfolio by risk averse investors (Weston and Copeland, 1998). An optimal portfolio is one that provides the highest possible return for any specified degree of risk or the lowest possible risk for any specified degree of return. An optimal portfolio is a well diversified portfolio. Diversification reduces risk

through combining assets with different covariance. Investors are assumed to be risk averse; hence diversification pleases investors by offering expected return at a lower risk than individual securities. The assumption is that combining different types of assets in different proportion can generate an efficient portfolio that provides the maximum return for a given level of risk (Markowitz, 1952). A diversified portfolio carries the advantage of offering protection against the rapid market losses of any particular stock. If stocks lose their value, the effect will be less if they belong to a portfolio that is spread across twenty stocks than if they belong to a portfolio that consists of a single stock.

Financial portfolio theory and the classical theory of the firm suggest that including non-financial restrictions will not benefit portfolio performance. Portfolio theory implies that criteria that constrain an investor's investment possibilities result in lower diversification and greater risk exposure or additional costs. The classical theory of the firm implies that SRI will be less financially efficient than non-restricted investments, since the firms that responsible investors do invest in may incur higher costs. This would make these firms less profitable.

1.1.3 Socially Responsible Investment in Kenya

Socially responsible investment is a relatively new phenomenon in Kenya. Its roots nevertheless go back over 20 years to micro-finance institutions (MFIs) which initially operated as non-governmental organisations (NGOs) focused on providing access to capital and financial services to low income groups excluded from the country's banking system that is, the un-banked. The operations of these organisations were primarily funded by donors whose objectives were typically the promotion of social development. With dwindling donor funding in the late 1990s, these organisations came under pressure to find creative ways of sustaining themselves by finding alternative sources of funding (Alliance, 2006). As these MFIs responded to this challenge, they found themselves tasked with two imperatives; firstly, to continue meeting their social development obligations to bottom of the pyramid (BOP) groups and secondly, to raise funds to ensure the sustainability of these activities. It is significant that with their evolution into commercial outfits, the core markets of many MFIs have remained BOP customers with the implication that the long-term financial sustainability of the organisation is inextricably linked to socio-economic development among their customer base (Allavida, 2011).

Activities that show the importance of social investment in Kenya include the successful launch of a bond issue on the stock market on behalf of microfinance NGO, Faulu in 2005; formation of the Kenya Social Investment Forum (KSIF) in 2006; the establishment of Kenya Social Investment Exchange (KSIX) in 2009 and the licensing by CMA of First Ethical Opportunity Fund in 2011. The Faulu bond issue took place in early 2005, raising Sh500 million (almost US\$7 million). The bond is now listed on the Nairobi Stock Exchange. A year later, in March 2006, the group of organizations behind the bond issue came together with others to form KSIF. KSIF now includes the Nairobi Stock Exchange, a number of stockbrokers and fund managers, some local NGOs and corporations, and Allavida – a UK-based NGO. KSIF aimed at getting major microfinance institutions, including the Kenya Women Finance Trust, Jamii Bora and Equity Bank, with a combined base of over 2 million clients, to access finance through creating bonds listed on the Nairobi Stock Exchange (Alliance, 2006).

Kenya Social Investment Forum (KSIF) aimed at promoting financial transactions intended to achieve social objectives and deliver financial returns to investors. KSIF identified four major benefits of social investment, including increasing employment opportunities, reducing poverty levels, enhancing economic growth and increasing levels of investment and domestic savings. Its main areas of focus were those dealing with basic needs, especially health, education and housing. Of particular emphasis was the issue of creating awareness among all stakeholders, including the government, investors and the beneficiaries (Wandera, 2006).

A survey on social investment in Kenya was undertaken by Allavida (2011) to support the development of the Kenya Social Investment Exchange. The study identified 17 social investors out of the 21 Kenyan investors studied (See Appendix 1). The Kenya Social Investment Exchange (KSIX) was established in 2009 as a company limited by guarantee and is based in Nairobi, Kenya. It was launched on 27th May 2011 and becomes the fourth social exchange in the world and the second one in Africa. The other exchanges are in Brazil, Singapore and South Africa. KSIX objectives are to advocate for the social investment sector, to generate information on the sector and to link social investors and social entrepreneurs (Allavida, 2011).

In line with its strategy of diversifying products and services available in the market, the Capital Markets Authority (CMA) in 2011 gave consent for the registration of First Ethical Opportunities Fund, a unit trust scheme, promoted by First Community Bank (FCB). During its launch the CMA's CEO, Mrs Kilonzo observed that socially responsible investors favour corporate practices that promote environmental stewardship, consumer protection, human rights, and diversity. She announced that FCB's First Ethical Opportunities Fund met the globally acceptable criteria for ethical investing and that the fund was to invest in line with Sharia law (CMA, 2011).

1.2 Statement of the Problem

A key theme that underpins most SRI funds is that they market themselves as having ethical values of a higher standard than their conventional counter parts. Investors may be attracted to SRI funds because they possess personal values that are consistent with the underlying philosophy of these funds (Chandler, 2001). In such cases, the investors are making a deliberate choice to concentrate on a sub-set of investment assets. In a mean-variance theoretical framework, such a strategy can result in a sub-optimal portfolio. Rudd (1981) argues that a constrained portfolio such as one constructed through a socially responsible strategy will suffer poorer performance as a result. The rationale is that the socially responsible guidelines inherently introduce biases such as size that consequently impact on the covariance of returns. Nevertheless, such a portfolio may be a rational outcome if the investor derives sufficient compensatory utility from holding SRI assets.

The empirical analysis of the relationship between SRI and portfolio performance has yet to provide a convincing causal link between the two variables. Most of the studies have mainly focused on whether there is a difference between the performance of socially screened portfolios and that of conventional funds. Results of these studies are conflicting, for example Jones (1996), Diltz (1995) and Kempf and Osthoff (2007) concluded that SRI investors earn higher abnormal returns than conventional investors. Hamilton *et al.* (1993), Stone *et al.* (1997) and Statman (2000) found no significance difference between the performance of SRI and conventional mutual funds. Mallin *et al.* (1995), on the other hand, found a negative relationship between SRI and risk-adjusted portfolio performance.

One explanation into the conflicting results is that the relationship between SRI and portfolio performances is not direct but is intervened by other variables such as the portfolio management process. Havemann and Webster (1999) identify six factors in the portfolio management process that are affected by SRI. These are the portfolio diversification process, the size and structure of the investable universe, concentration and the research costs incurred in monitoring the investee companies. Studies on the effect of SRI on the portfolio management process have also been inconclusive. For example Benson, Brailsford and Humphrey (2006) found little difference in stock-picking ability between SRI and conventional fund managers. Bauer *et al.* (2005) note that SRI fund styles may be changing over time such that they are becoming more like conventional funds as time passes. Another explanation into the conflicting results is that the relationship between SRI and portfolio performances may be moderated by the investors' demographic characteristics. Researchers have looked at the demographic characteristics of socially responsible investors (Nilsson, 2008; Nilsson, 2009; Junkus and Berry, 2010) but not how these characteristics moderate the relationship between SRI and portfolio performance.

The existence of non-financial risks and returns in SRI mutual funds may also explain the conflicting results. This is true given that conventional investors are only interested in financial risk and returns while socially responsible investors are concerned with both financial and social returns. The two mutual funds are therefore not comparable as they are expected to yield different risk and returns. There are also methodological differences in the empirical studies for example Kempf and Osthoff (2007) used the Cahart model to analyze portfolio returns while Hamilton *et al.* (1993) used Jensen alpha for the same analysis. Most of the studies used CAPM based models which assume that the portfolio being analyzed is efficient. SRI mutual funds may not be efficient due to the screening process adapted.

Although several studies on socially responsible investments have been undertaken internationally, social investment in Kenya is at its early stages of development and remains understudied. However a survey on social investment in Kenya was undertaken by Allavida (2011) to support the development of the Kenya Social Investment Exchange. The study was based on a survey of 40 investors: 21 from Kenya, 10 from South Africa and nine from the UK.

Of the 21 Kenyan investors studied 17 were categorized as social investors (See appendix 1). The study however did not consider the relationship between SRI and portfolio performance. It is therefore important to undertake a study on the extent of adoption of SRI and its relationship with portfolio performance in Kenya.

This independent study paper undertakes, using literature review, to answer the following research questions:

- (i) What is the relationship between socially responsible investment and portfolio performance?
- (ii) Do fund managers' demographic characteristics moderate the relationship between socially responsible investment and portfolio performance?
- (iii) Is the relationship between socially responsible investment and portfolio performance intervened by the portfolio management process?
- (iv) What research gaps exist in socially responsible investment literature?
- (v) What further SRI researches can be undertaken?

1.3 Research Objectives

The general objective of this study is to document from literature review the relationship between socially responsible investment and portfolio performance. The specific objectives are to:

- (i) Establish the documented relationship between socially responsible investment and portfolio performance
- (ii) Investigate whether investor demographic characteristics moderate the relationship between socially responsible investment and portfolio performance
- (iii) Examine whether the relationship between socially responsible investment and portfolio performance is intervened by the portfolio management process.
- (iv) Identify and document research gaps in socially responsible investment.
- (v) Establish researchable issues in socially responsible investment.

1.4 Value of the Study

This independent study makes several contributions to finance theory by documenting literature on the relationship between socially responsible investment, portfolio management process, fund managers' demographic characteristics and portfolio performance. A conceptual model is developed depicting these relationships. This assists in broadening the available knowledge of SRI and its influence on portfolio management process and portfolio performance. Understanding the impact of fund manager's demographic characteristics on the relationship between SRI and portfolio performance helps to explain why many studies on the area have found conflicting results. Given that the area has largely been understudied in Kenya, academicians may use the study as a basis for further research. Starting with the findings of this study, they can examine the behavior of socially responsible investors and factors that motivate them to invest in SRI.

The independent study paper also contributes to various stakeholders including investors, fund managers, corporate managers, regulators and the government. These contributions are highlighted as follows: Firstly, investors and fund managers are enlightened on the importance of SRI when making portfolio selection. The effects of SRI on portfolio performance as documented in the study will help investors and fund managers when setting investment objectives, setting investment constraints, constructing and monitoring portfolio.

Secondly, corporate managers will learn more on the impact of their corporate social responsibility on the value of the firm. This is important because many companies spend part of the shareholders' wealth on social responsibility with the hope of creating social value and attracting socially responsible investors to the firm. Since the effect of the company's shares being screened out of many SRI funds is negative, corporate managers will do everything to ensure their company shares remain candidates for inclusion by many fund managers.

Thirdly, investment regulators in the country such as the Capital Market Authority (CMA) and the Retirement Benefit Authority (RBA) will benefit from the study by understanding the relationship between SRI, portfolio management process and portfolio performance. This will guide the regulation process especially when setting limits on the type of investments fund

managers can include in their portfolio and thereby establishing the fund managers' fiduciary responsibility towards their clients. The government can use the findings of this study as an input in policy formulation on SRI especially because of the potential contribution of the much needed capital by the sector.

1.5 Organization of the Paper

This independent study paper is a critical literature review of socially responsible investment (SRI) and portfolio performance. It is organized into four chapters. The first chapter covers the background to the study, a brief discussion of key concepts, the problem statement and value of the study. Chapter two discusses the theoretical literature that informs the existing knowledge on socially responsible investment. Chapter three reviews empirical studies on the study variables and identifies the research gaps. The chapter concludes with a discussion of key research variables and the conceptual model. Chapter four discusses the key findings that emerge from the study including the research and knowledge gaps. It concludes with identification of possible areas for further studies.

CHAPTER TWO: THEORETICAL LITERATURE REVIEW

2.1 Introduction

This chapter examines theoretical literature on socially responsible investment including SRI investment philosophy, SRI inclusion/exclusion criteria, SRI strategies and the reasons for existence of SRI. Key theories among them, the modern portfolio theory, the stakeholders' theory, the institutional theory and the new social movement theory have been discussed in the chapter.

2.2 Socially Responsible Investment

Literature reveals that the practice of socially responsible investing can be traced back to as early as 1758 when the Religious Society of Friends held back from undertaking unethical and immoral business (Schueth, 2003). However, it was not until the late 1960's when the practice of being responsible while investing started to gain fame outside the religious communities. During that decade, a series of social and environmental movements in defense of human rights, the environment and peace brought a number of social and ethical issues to the fore in American society (Schueth, 2003; Schwartz, 2003). The first ethical mutual fund, Pax World Fund, was launched in 1971 in the USA. This fund had a negative screening approach, which excluded shareholdings in companies considered to be unethical.

In recent decades, SRI has seen a spectacular growth in the USA. In the period 2000-2001, portfolios of SRI funds in the USA were estimated to be in excess of two trillion (U.S.) dollars (Dillenburg et al., 2003; Laufer, 2003; Schueth, 2003; Schwartz, 2003). More recent data indicate that SRI encompasses an estimated \$3.07 trillion out of \$25.2 trillion in the U.S. investment marketplace (US SIF, 2011). This notable rise is due partly to the appearance of financial indices that use social responsibility selection criteria, for example, the Dow Jones Sustainability Index, the Domini 400 Social Index and the FTSE4 Good Index. Socially responsible investment can be looked at by considering the philosophy of investment, SRI exclusion/inclusion criteria and the SRI strategies.

2.2.1 Socially Responsible Investment Philosophy

Sparkes (2002) explains that the consideration of both financial return and social responsibility represent a duality of purpose. Given these two distinct parts of SRI, it is reasonable to assume that investor motivation for investing in SRI differs depending on how the individual investor relates to the financial and social elements of the service. The investor, whose primary motivation is in the social part of the purpose, may invest in SRI profiled mutual funds without much consideration of financial results.

The investment philosophy helps in categorizing investors on a spectrum of expected financial returns as shown in figure 2.1 below. The extent to which an investor is concerned with social values as opposed to financial returns helps in fitting the investor within the spectrum.

Figure 2.1 Spectrums of Social Investors

PHILANTHROPIC FOCUS	SOCIAL INVESTORS			PROFIT FOCUS
Only interested in social returns with no interest in any type of financial returns	Possible Market Return (PMR) Social investors predominantly interested in social returns but also interested in potential of profit making by the investee	Below Market Return (BMR) Social investors interested in social returns and below market rate of financial returns	At Least Market Returns (ALMR) Social investors interested in social returns and at least market rate of financial returns	Mainstream investors solely interested in financial returns with no interest in social returns

Adapted from Allavida (2011, 21)

A general characterizing trait in how philanthropists manage risk is that as their grantees do not expect a financial return, managing financial risk is not a priority for them. However, it is common practice now for grant providers to ensure their money is being used effectively and generating optimum impact. Therefore, measures such as ‘Output Based Aid’ have been developed to enable grantees to understand the impact their grants are having on individuals or income-generating activities. As such, many philanthropists now will look to provide grants to individuals and income-generating activities that have elements of sustainability. In other words,

the project has to have a capacity building or training element, or there need to be maintenance mechanisms for machinery, or it has to set in place a process for community ownership (Allavida, 2011)

Allavida (2011) further categorizes social investors into three classes depending on the preferences to both social and financial returns. Potential for Market Return (PMR) social investors are predominately focused on social impact, rather than just making a profit but will not invest unless they can be assured that the recipient will generate income. Below Market Return (BMR) social investors typically provide capital and financial products to recipients who traditionally have not been able to access capital. These previously 'unbanked' sections of society were seen as too risky to invest in because they cannot provide security to the investor that they will provide at least or above market rate returns. At Least Market Return (ALMR) social investors recognize that they are dealing with high risk investments compared to mainstream investors and therefore apply a range of risk management techniques. Mainstream investors, also referred to as conventional investors, are mainly financially risk-averse and therefore will only invest in companies having an established track record of good credit ratings and financial performance.

2.2.2 Socially Responsible Exclusion/Inclusion Criteria

Part of the process of socially responsible investing includes the development of mechanisms which inform actual and potential investors about the involvement of organizations in activities which are seen either as of concern or are attractive in ethical terms (Cullis et al., 1992). Integral to this is the development of exclusion or inclusion criteria. Thus, there are two major ways of establishing whether an investment is ethical. The first is to apply a negative (exclusion) screen whereby certain businesses are avoided while the second way is to apply a positive (inclusion) screen to those firms that remain possible investment targets; in particular, those identified as engaging in socially responsible practices are seen as more attractive investment options. (Tippet, 2001).

The exclusion/inclusion criteria depend on the factors considered by socially responsible investors. Kempf and Osthoff (2007) identify three of these categories to include social,

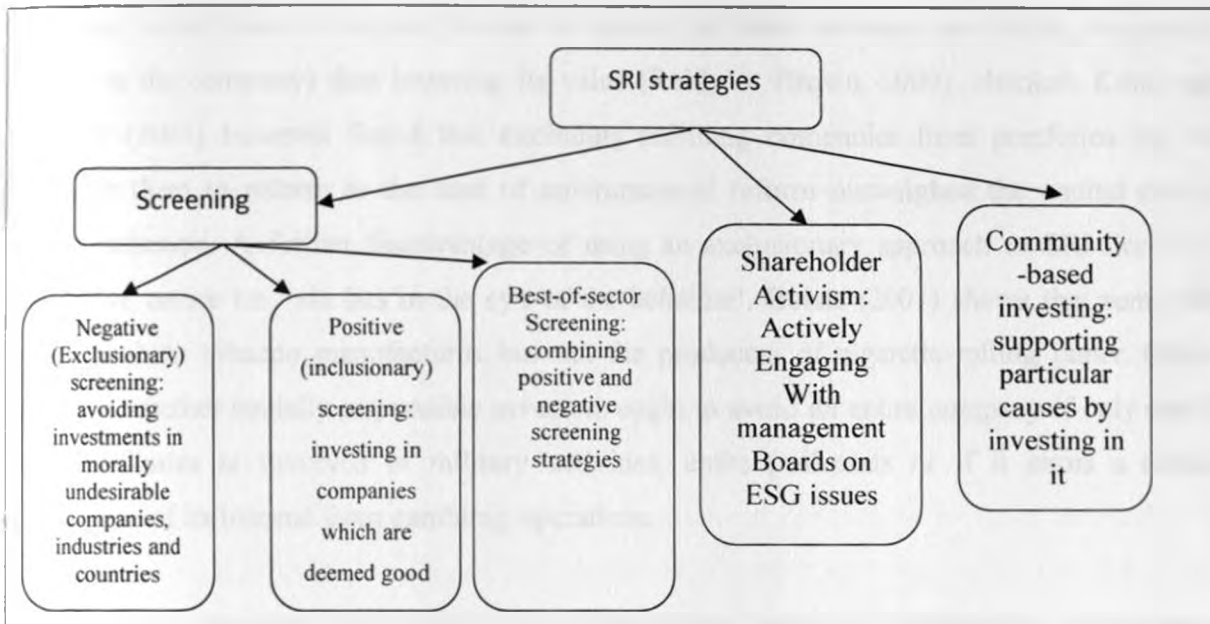
environmental and ethical factors. Examples of social factors are human capital (training and education, working conditions, and health), community development and labour rights (such as the right to unionisation). Environmental factors include urban and industrial pollution, global warming, depletion of some natural resources (such as oil) and restricted access to others (such as clean water), the reduction of the world's flora and fauna populations. Ethical factors on the other hand involve violations of human rights, use of child labour, manufacture or distribution of weapons, inhumane testing of products on animals, implicit support of oppressive political regimes, slavery or forced prostitution.

Schwartz (2003) adds two other categories of moral and governance principles. Corporate governance covers the area of investigation into the rights and responsibilities of the management of a company – its board, shareholders and the various stakeholders in that company. It is mainly concerned with management structure, employee relations and executive compensation. Moral factors require avoidance of 'sin' stocks, such as companies in the gambling, alcohol, tobacco and firearms industries, from the investment portfolio.

2.2.3 Socially Responsible Investment Strategies

Three overall SRI investment strategies include social screening, shareholder advocacy and community investing. Figure 2.2 illustrates these strategies. Kinder & Domini (1997) define a social screen as the expression of an investor's social, ethical or religious concern in a form that permits an investment manager to apply it in the investment decision making process. However, Schueth (2003) considers screening to be the practice of including or excluding companies from portfolios based on social and/or environmental criteria. Generally, socially conscious investors seek to own profitable companies that make positive contributions to society. They require investment managers to overlay a qualitative analysis of corporate policies, practices, attitudes and impacts on the traditional quantitative determination of profit potential.

Figure 2.2: Prominent SRI Strategies



Adapted from Geczy *et al.* (2005), O'Brien (2002) and Schueth (2002)

Geczy *et al.* (2005) summarises three types of investment screening normally considered when looking at an SRI fund's investment strategy (see Appendix 2). These include positive, negative and best-of-sector screening. Positive screening involves establishing a set of ethical guidelines based on the evaluation of the company's or entire industry's work on such activities. Negative screening involves applying ethical criteria to exclude companies through simple screens, such as excluding companies involved in the manufacture of weapons, tobacco, pornography or cosmetics tested on animals, and norms-based screens excluding companies whose operations do not comply with international labour, human rights and environmental conventions. Finally best-of-sector screening combines both positive and negative screening strategies.

The first major drawback of an investment screening strategy is that it reduces efficient portfolio diversification (Sparkes & Cowton, 2004). This drawback is of particular concern for Kenyan investors given the relatively small size of the Nairobi Securities Exchange (NSE) compared with global securities exchanges. The exclusion of certain NSE listed companies or entire sectors will significantly reduce investors' options and will result in poorly diversified portfolios. A second major criticism of exclusionary screening is that ostracizing 'bad companies' doesn't

necessarily reform them. From a theoretical perspective it could be argued that exclusionary screening would raise a company's cost of capital (as fewer investors are willing to provide capital to the company) thus lowering its value (Reilly & Brown, 2000). Heinkel, Krauz and Zechner (2001) however found that excluding polluting companies from portfolios did not persuade them to reform as the cost of environmental reform outweighed the capital cost of being eschewed. A further disadvantage of using an exclusionary approach to SRI lies in its subjective nature i.e. 'sin lies in the eye of the beholder'. Belsie (2001) shows that some SRI funds exclude tobacco manufactures but not the producers of cigarette-rolling paper. Others question whether socially responsible investors ought to avoid an entire company if only one of its subsidiaries is involved in military activities, emits pollutants or if it earns a certain percentage of its income from gambling operations.

Shareholders' advocacy (also referred to as shareholders' activism) describes the actions many socially aware investors take in their role as owners of corporate entities. These efforts include engaging in dialogue with companies on issues of concern, and submitting proxy resolutions. Advocacy efforts are aimed at positively influencing corporate behavior. O'Brien (2002) referred to shareholder advocacy as active shareholdership which he defined as the process of using ones power as a shareholder to influence corporations on particular issues or actions. He identified four key components of shareholder advocacy to include proxy voting, corporate engagement, shareholder resolution and divestment.

The main shortcoming of a shareholder activism approach is that, in order for it to be effective, shareholders need to have a significant stake in a company. As such, this approach calls for the support of large institutional investors such as pension funds, insurance companies and commercial banks. Another problem associated with shareholder activism relates to the time and resources required to analyze companies' products, policies and practices with regard to ESG considerations, to obtain support for resolutions, to attend meetings and to formulate policies on issues of materiality. Many shareholders lack this time.

Community investing provides capital to people in low-income, at-risk communities who have difficulty accessing it through conventional channels. Many social investors earmark a small

percentage of their investment funds to Community Development Financial Institutions (CDFIs) with missions focused on providing low income housing and small business development financing in disadvantaged communities. Strandberg (2004) highlights alternative term for community investing to include cause-based, socially directed, social impact or alternative investing. He defines it as investing that supports development initiatives in low-income or restructuring communities including the emerging field of social and environmental enterprise. It is an opportunity for the average investor or financial consumer to allocate a portion of their investment portfolio, or to invest their savings with financial intermediaries, that are dedicated to improving local or third world socio-economic and environmental conditions.

Community investment provides opportunities for community investors to place their money in investment vehicles and savings accounts that create jobs and affordable housing, assist communities going through economic restructuring, develop local enterprise, provide community services such as child care, improve the environment, empower workers or consumers and reduce overall world poverty (Schueth, 2003). Community investors generally place money in community investment funds or intermediaries providing capital to local entrepreneurs, co-operative or community-oriented enterprises. A community investment (CI) fund is defined as a pool of capital that is used to make loans, loan guarantees and/or provide equity capital, in conjunction with technical assistance, to low income individuals, micro-enterprises/small businesses, affordable housing projects, non-profits and environmental projects. Sources of capital for community investment funds may include contributions and loans from private donors, private investors, faith-based institutions, foundations, governments, financial institutions, pension funds, and other institutions (Sun, Nagata and Onoda, 2011).

Leeman (2005) states that the major problems associated with a cause based investment strategy relate to the fact that they are often private equity based. It is well documented that private equity investments lack regular market valuations which makes it difficult to assess investment returns. Furthermore, private equity investments are fairly illiquid investments as capital is often tied up for three to seven years. Private equity investments also have a much higher risk of default. In this regard Barrow, Brown and Clarke (2001) estimate that approximately one third of all private equity investments are failures, another third merely produce enough profits to survive, a further

25 percent only offer modest returns and a meager 10 percent of all private equity investments generate superior returns.

2.3 Reasons for Existence of SRI

Researchers have identified three propositions on why SRI exists. These are the corporate change proposition, superior financial returns proposition and an *apologia* for the status quo proposition (Haigh and Hazelton, 2004; Mackenzie and Lewis, 1999; Abelson, 2002; Bruyn, 1987). These propositions are discussed below:

2.3.1 Corporate Change Proposition

Mackenzie and Lewis (1999) found that investors are attracted to SRI funds because they believe that SRI can change companies. SRI fund managers commonly claim that investing in SRI funds promotes normatively desirable activities while discouraging relatively detrimental activities. These fund managers claim that SRI funds affect corporate change by reducing the cost of capital for 'good' companies relative to 'bad' ones. Bruyn (1987) refer to this argument as the 'cost of capital' argument.

The cost of capital argument is twofold. When an SRI fund selects a 'good' company for investment, the increased supply of capital to that company reduces its cost of capital, hence allowing the company to pursue more capital projects. Similarly, maintaining an investment in a company guarantees a company's supply of capital for the period of investment, allowing it to control its cost of capital. Conversely, choosing to ignore or divest from a 'bad' company (the negative screen) decreases a company's capital supply, hence increasing its cost of capital funding. Consequently, the profitability of planned capital investments is expected to suffer, which would lead to an abandonment of capital projects and a consequent fall in share price. To avoid this, a company will change their operations to meet the demands of SRI funds (Haigh and Hazelton, 2004).

The cost of capital argument can only be true if the relative size of SRI funds can create economic effects. However, analysis of the market share of SRI funds in Europe and the U.S. show that this claim is unlikely to hold. For example in the U.S. only about 12 percent of

professional assets under management is involved in SRI (US SIF, 2011) while in Europe SRI funds accounted for 10 percent of the total funds under management (EUROSIF, 2011).

Therefore, companies that fail to meet SRI screens have ample alternative funds available for their investments. Statman (2000) argued that even if SRI funds constituted a significant proportion of equity markets, the cost of capital argument is unlikely to be borne out in practice since socially responsible investors can raise the cost of capital of companies only in the absence of numerous conventional investors who stand ready to provide substitute capital at the same cost.

2.3.2 Superior Financial Returns Proposition

Claims of superior financial returns by SRI funds have mainly emanated from socially responsible investment managers (Kreander, *et al.*, 2002; Kumar, Lamb and Wokutch, 2002). The claim is usually presented as a type of strategic action for the firm, the investor and the fund. The outperformance argument of SRI fund managers relies on the identification and subsequent pricing of externalities. Abelson (2002) defined an externality of production as any positive (beneficial) or negative (harmful) effect that market exchanges have on firms or individuals who do not participate directly in those exchanges. The essence of the argument is that SRI funds invest in those companies in which they have identified positive, but un-priced, externalities of production.

Abelson (2002) points out that government may encourage production of goods which have positive externalities in production either by financing the activity directly or by providing financial assistance to the private sector. Subsidies to private firms may take the form of financial contributions towards an activity, for example afforestation or soil conservation, or a tax concession.

Jones (1996) supports this line of argument holding that SRI fund managers make investments in companies which, by being socially responsible, have proactively anticipated and evaded costly government regulation. By so doing, these firms are believed to be in a position to exploit opportunities arising from the eventual pricing of negative and positive externalities, creating

competitive advantages over their less socially responsible competitors. Superior market performance therefore is expected to follow.

Lane (1986) demonstrated that companies with the highest marks for social justice and environmental concerns actually outperformed the Russell 3000 benchmark by an annual return of 2.53%. He further observed that to proponents, SRI is a powerful vehicle for achieving both competitive portfolio returns and positive social change. For skeptics, however, SRI is ineffective at best and politically correct marketing hype at worst.

Although the literature (Statman, 2000; Kreander, 2001; Cummings, 2000; and Kurtz . 2002) is inconclusive regarding systematic SRI outperformance, it does suggest that actively managed SRI funds do not underperform their conventional counterparts. Indeed, the performance of SRI funds appears correlated more with the performance of broad market indices than with socially responsible market indices.

2.3.3 *Apologia for the Status Quo Proposition*

This perspective offers a plausible explanation for the motivation of some retail investors in SRI funds. Both consumers and suppliers of SRI funds appear to be motivated by prospects other than that of superior economic returns. Mackenzie and Lewis (1999) finding that many investors chose to direct only a small portion of their investment monies into SRI funds, suggested that SRI allows investors to assuage their consciences and legitimize their concurrent holdings of more conventional investment vehicles.

Institutional legitimacy was explored by Smith (1990), who argued that corporations (and by extension, capital markets) must find ways to legitimize their power. By offering SRI funds, financial markets can show evidence that they can effectively deal with the externalities of capitalist production, thus diffusing the demands of governments and society to regulate financial markets (Bruyn, 1987).

Freeman and Gilbert (1992) viewed corporate social responsibility (and by extension, would view SRI) as a kind of *apologia for the status quo* arguing that these types of social movements

create a need more for legitimacy than for ethical principles. The aversion that SRI funds, show to governments suggests that financial institutions find SRI funds a convenient legitimizing device.

2.4 Cost Benefit Analysis of SRI

Cost-benefit analysis (CBA) is often used by governments and other organizations, such as private sector businesses, to evaluate the desirability of a given policy. It is an analysis of the expected balance of benefits and costs, including an account of foregone alternatives and the *status quo*. CBA helps predict whether the benefits of a policy outweigh its costs, and by how much relative to other alternatives (Weimer, 2008). Generally, accurate cost-benefit analysis identifies choices that increase welfare from a utilitarian perspective. Assuming an accurate CBA, changing the status quo by implementing the alternative with the lowest cost-benefit ratio can improve pareto efficiency. An analyst using CBA should recognize that perfect evaluation of all present and future costs and benefits is difficult, and while CBA can offer a well-educated estimate of the best alternative, perfection in terms of economic efficiency and social welfare are not guaranteed.

Do the benefits of CSP outweigh the costs, do the costs outweigh the benefits, or are they more or less equal? Commonsense, theory, and a growing body of empirics have supported all of the above contradictory positions. SRI researchers have long sought to resolve this debate. However, the end result thus far has been more than “25 years of incomparable research” (Griffin & Mahon, 1997). Researchers have employed varying theoretical perspectives and conflicting data sources to arrive at different answers to incompatible questions, generally categorized under the framework of the search for a link between “people and profits” (Margolis & Walsh, 2001) or “money and morality” (Lowry, 1991). Despite the intensity of study directed at it, the relationship between CSP and corporate financial performance (CFP) remains in dispute.

The belief that corporations can be both profitable and socially responsible underlies the concept of socially responsible investing (SRI). Investors who are attracted to SRI tend to fall into two often complimentary categories: those who want to feel socially good about their investments and those who are concerned with effecting social change (Schueth, 2003). The “feel good”

investors, commit to put their money to work in a manner that is more closely aligned with their values to feel better about themselves and their portfolios. The other group commits to put their investment capital to work in a way that brings about “social change” and improvements to the quality of life.

Investors require companies to pass both qualitative and quantitative tests. The quantitative analysis gauges corporate profitability and performance, while the qualitative analysis reviews corporate policies and practices. The screening process, therefore, introduces subjectivity into the equation. As Waddock and Graves (1997) explain, the difficulty in measuring corporate social responsibility is further compounded by the diverse nature of issues that fall under it. He summarized key multiple factors to consider: inputs (e.g. investments in pollution control equipment or other environmental strategies), internal behavior and processes (e.g. treatment of women and minorities, nature of the products produced), and outputs (community relations, and philanthropic programs). These dimensions occur across a range of distinctive industries with significantly different characteristics and make screening decisions less clear cut. Therefore, it is the goal of investors and money managers to seek out, not the perfect companies, which do not exist, but the better managed companies. The shortcomings of these screens make it nearly impossible to develop a standard system for ranking firms with respect to corporate social responsibility.

In a cost and benefit analysis, SRI implies short-term expenditures, but grants long-term sustainable investment streams. In the short run, screened funds have a higher expense ratio in comparison to unscreened ones – that is social responsibility imposes an instantaneous ‘ethical penalty’ of decreased immediate shareholder revenue (Tippet, 2001). In addition, searching for information and learning about CSR is associated with cognitive costs. Screening requires an extra analytical decision making step – especially positive screens are believed to be more cognitively intensive than negative ones. In addition, screening out financial options lowers the degrees of freedom of a full-choice market spectrum and risk diversification possibilities.

On the long run, however, SRI options offer higher stability, lower turnover and failure rates compared to general assets (Geczy, Stambaugh & Levin, 2005; Stone, Guerard, Gületkin &

Adams, 2001). Being based on more elaborate decision making, once investors have made their socially responsible decision, they are more likely to stay with their choice. As a matter of fact, SRI options are less volatile and more robust regarding cyclical changes.

2.5 Theoretical Framework

There are several theories that can explain the relationship between SRI and portfolio performance including the Modern Portfolio Theory (MPT) of Markowitz (1952), the Stakeholder Theory (ST) of Freeman (1984), the Institutional Theory (IT) of DiMaggio and Powell (1983) and the New Social Movement (NSM) theory of Benford and Snow (2000). These theories, together with their implications to SRI are discussed below.

2.5.1 The Modern Portfolio Theory (MPT)

In 1959 Harry Markowitz proposed that investors expect to be compensated for taking additional risk, and that an infinite number of "efficient" portfolios exist along a curve defined by three variables: standard deviation, correlation coefficient, and return. The efficient-frontier curve consists of portfolios with the maximum return for a given level of risk or the minimum risk for a given level of return. The algorithm used to generate the curve is known as mean variance optimization (MVO), since what is being optimized is return versus standard deviation (Markowitz, 1952). This is the origin of modern portfolio theory.

MPT is a mathematical formulation of the concept of diversification in investing, with the aim of selecting a collection of investment assets that has collectively lower risk than any individual asset. That this is possible can be seen intuitively because different types of assets often change in value in opposite ways. For example, to the extent prices in the stock market move differently from prices in the bond market, a collection of both types of assets can in theory face lower overall risk than either individually. But diversification lowers risk even if assets' returns are not negatively correlated—indeed, even if they are positively correlated (Bhalla, 2010).

According to MPT, an investment bears two types of risk: systematic and unsystematic (Markowitz, 1952; Sharpe, 1964). Systematic risk is the risk inherent in the volatility of the entire capital market, while specific (unsystematic) risk is associated with the volatility of an

individual security. Investors may assemble portfolios in such a way that the specific risk carried by any individual security within the portfolio is offset by the specific risk carried by another. This is referred to as diversification. Sharpe (1964) holds that efficient capital markets reward investors for bearing systematic risk, but because diversification is possible, investors are not rewarded for bearing specific risk. That is, when a fund carries specific risk, it fails to reach the efficient frontier, wherein the risk/return trade-off is optimized.

Despite its theoretical importance, Brodie *et al.* (2009) indicate that critics of MPT question whether it is an ideal investing strategy, because its model of financial markets does not match the real world in many ways. Efforts to translate the theoretical foundation into a viable portfolio construction algorithm have been plagued by technical difficulties stemming from the instability of the original optimization problem with respect to the available data. Murphy (1977) cites four studies that found that realised returns appear to be higher than expected low-risk securities and lower than expected for high-risk securities implying that the risk-reward relationship was far weaker than expected. He concludes that there often may be virtually no relationship between return achieved and risk taken; and that high volatility unit trusts were not compensated by greater returns.

Based on this theory SRI funds should experience decreased risk-adjusted returns since they exclude certain firms, industries, and sectors, and thus bearing a substantial degree of specific risk (Barnett and Salomon, 2006; Kurtz, 1999). Portfolio management process and portfolio performance will be affected by adoption of socially responsible investments mainly due to reduction in the structure and size of the investable universe. However, a mutual fund can achieve diversification to effectively eliminate most specific risk even if it does not select the entire universe of securities. Barnett and Salomon (2006) hold that a fund can closely approximate a well-diversified portfolio with as few as 20 or 30 randomly selected stocks. SRI portfolios are not randomly chosen but rather are intentionally selected based on a set of screening criteria. Thus, one can expect SRI funds, even those with large and relatively diverse holdings, to bear specific risk. Researchers have also found that there are financial costs associated with the lack of diversification of SRI funds. Temper (1991) estimated that funds that chose their portfolios based on social criteria bore a one percent loss in returns relative to

diversified funds while Rudd (1981) found a four percent loss in returns for portfolios that screened out firms with holdings in South Africa.

Critics to the use of MPT in explaining the performance of SRI funds points to several researchers who found that SRI funds yield returns that equal or exceed those of conventional mutual funds. For example, Diltz (1995), Guerard (1997), and Hamilton *et al.* (1993) all found that there were no significant differences between the risk-adjusted returns of SRI portfolios and conventional portfolios. Barnett and Salomon (2006) argue that, though modern portfolio theory rightfully assesses the costs to limiting investment choices through social screening, it does not account for the benefits that social screening may bring. Portfolio theory assesses only the ability of a given stock to push a portfolio toward or away from the efficient frontier, wherein risk-adjusted return is maximized (Markowitz, 1952). However, it takes no account of any variation in the ability of a firm, upon which a stock's value is based, to create value. Rather, under the assumption of perfectly efficient markets, each stock is treated as homogeneous in all factors but its volatility relative to the market.

SRI proponents hold that while SRI portfolio managers are constrained from choosing amongst the entire universe of stocks, the pool of stocks from which they do choose is superior to that of the overall market and therein more likely to provide favourable financial returns over time. Firms are embedded in a social environment and must build favourable relations with those groups that compose this environment so as to maintain legitimacy and attract resources (Granovetter, 1985). Strong social performance is an indicator that a firm possesses superior management talent that understands how to improve internal and external relationships through socially responsible activities (Moskowitz, 1972). From this perspective, social responsibility is not a cost but an investment which can be explained by Stakeholder Theory.

2.5.2 The Stakeholder Theory

Freeman (1984) defines a stakeholder as any group or individual who can affect or is affected by the achievement of the organizations objective. Stakeholder theory posits that firms possess both explicit and implicit contracts with various constituents, and are responsible for honoring all contracts (Freeman, 1984; Donaldson and Preston, 1995; Jones, 1995). As a result of honoring

contracts, a company develops a reputation that helps determine the terms of trade it can negotiate with various stakeholders. While explicit contracts legally define the relationship between a firm and its stakeholders, implicit contracts have no legal standing and are referred to in the economic literature as self-enforcing relational contracts. Since implicit contracts can be breached at any time, Telser (1980) argues that they become self-enforcing when the present value of a firm's gains from maintaining its reputation (and, therefore, future terms of trade) is greater than the loss if the firm reneges on its implied contracts.

Jones (1995) concluded that firms that contract with their stakeholders on the basis of mutual trust and cooperation will have a competitive advantage over firms that do not. This advantage comes from reduced agency costs, transaction costs, and costs associated with team production. More specifically, monitoring costs, bonding costs, search costs, warranty costs, and residual losses will be reduced.

The introduction of stakeholder theory allows these seemingly opposing views of management's responsibility to be combined (Freeman, 1984). Stakeholder theory places shareholders as one of the multiple stakeholder groups managers must consider in their decision making process. These stakeholder groups include internal, external, and environmental constituents. Like shareholders, the other stakeholders may place demands upon the firm, bestowing societal legitimacy. Firms must address these demands or else face negative confrontations from non-shareholder groups, which can lead to diminished shareholder value, through boycotts, lawsuits, or protests.

The appeal of stakeholder theory for management theorists is both empirical and normative (Cragg, 2002). Empirically, stakeholder theory rests on an observation of what we might call a fact since organizations have stakeholders that have the potential to influence them both positively and negatively. Likewise, the activities of organizations impact on individuals whose interests may be affected either favourably or adversely. According to Freeman (1999) stakeholder management is fundamentally a pragmatic concept since an effective firm will manage the relationships that are important regardless of its purpose. Cragg (2002) further asserts that stakeholder theory may also be considered to be normative if it conveys the notion that fundamental moral principles may influence corporate activities. This holds the universal

appeal of the attribution of morality to both actors and subjects in that it requires that we respect others as human beings and account for our actions towards them. SRI proponents believe that this aspect of the theory is what is fundamental in determining the firm's performance.

Thus, even though SRI funds must draw from a limited pool of firms, they draw from a richer pool—one that is more likely to contain well-run, stable firms that outperform the broader market over the long run. The competitive advantage these individual firms possess aggregate into superior financial returns at the portfolio level (Barnett and Salomon, 2006). According to this theory therefore, SRI results in superior portfolio performance by reducing costs incurred in the portfolio management process such as monitoring costs, bonding costs or search costs.

Stakeholder theory has acquired opponents from various areas including classical economics, industrial relations and management. Sternberg (1997) argues that the principles of stakeholder theory undermine the property rights of the owners of the company, compromise the mechanism of the free market, destabilize the operations of governments and thus subvert the very nature of capitalism. Stoney and Winstanley (2001) holds that stakeholder theory is limited in its explanation of how the different interests of stakeholder groups arise and are generated in society; that stakeholder theory provides an overly-simplistic conceptualization of power as a commodity that can be negotiated between the organization and the stakeholder groups; and that stakeholder theory assumes the separation of economic and political processes. Everett and Jamal (2004) also critic the theory on its treatment of power as a positive sum commodity over which management can arbitrate in order to manufacture a win-win compromise between competing stakeholders

2.5.3 The Institutional Theory

DiMaggio & Powell (1991) points out that institutional theory has proven to be a popular theoretical foundation for exploring a wide variety of topics in different domains ranging from institutional economics and political science to organization theory. Institutional theory adopts a sociological perspective to explain organizational structures and behavior. It draws attention to the social and cultural factors that influence organizational decision-making, and in particular how rationalized meanings or myths are adopted by organizations (Meyer & Rowan, 1977).

These myths become taken for granted and so are followed in a rule-like fashion when making decisions. They become the institutionalized logic that guides organizational behavior.

Socially responsible mutual funds develop a rationalized logic that uses environmental, social and governance, moral and ethical factors in selecting and managing their investments. These social criteria become the technical means for choosing their investments. They are the rationalized investment-making perceptions of the socially responsible mutual fund. This is consistent with Meyer and Rowan's (1977) definition of rationalized myths as rationalized and impersonal prescriptions that identify various social purposes as technical ones and specify in a rule-like way the appropriate means to pursue these technical purposes rationally. For these mutual funds, socially responsible factors are taken for granted as being legitimate criteria, and they become part of the normal evaluation process for identifying potential investments.

Part of the embedded logic of socially responsible mutual funds is that they will screen potential investments based on environmental, social and governance variables. Furthermore, socially responsible mutual funds advocate that their investees strengthen their corporate governance by increasing their transparency. O'Neill and Cook (2009) found that mutual funds tend to vote in a management-friendly manner, with the exception of socially responsible funds that show strong support for shareholder resolutions requiring more disclosure concerning executive compensation, board of director voting, and firm behaviour, especially with respect to human rights. These additional disclosure requirements reduce the research costs incurred by SRI mutual funds in monitoring the activities of the investee companies and thereby affecting the portfolio management process.

DiMaggio and Powell (1983) argue that firms facing similar environmental forces will adopt similar organizational structures. Becoming isomorphic with a firm's environment increases the perceived legitimacy of the firm, and so the firm's behaviour is less likely to be challenged and questioned. They contend that isomorphism occurs as a result of coercive, mimetic, and normative pressures. These three powerful institutional forces diffuse organizational templates that cause firms to adopt common organizational structures, procedures, and decision-making routines. However, this traditional approach to isomorphism tends to view the diffusion of

organizational norms and standards as a two-stage process, whereby early adopters are motivated by technical considerations and later adopters engage in mindless imitation fuelled by anxiety-driven pressures to conform (Lounsbury, 2008). The underlying assumption is that the firms that are members of these professional networks passively accept the norms provided by the network. The impetus is from the network and the firm then accepts it.

SRI mutual funds have a similar rationalized logic that guides decision-making based on principles of socially responsible investing. They use environmental, social and governance factors in determining their investments. As such, these funds, through their managers, should probably be members of a professional network that promotes socially responsible investing.

2.5.4 New Social Movements Theory (NSM)

One approach to the study of social movements in contemporary society is the new social movements approach. In this approach, Rao *et al.* (2003) holds that social movements are seen as representing both symptoms of contradictions as well as the solutions to these contradictions in the society. Beyond this, the approach makes a clear analytical distinction between the so-called old social movements that existed in industrial society (pre-1950 for instance) and the new social movements, which exist in the contemporary post-industrial society. It argues that because the industrial society produced mainly contradictions in classes (i.e., on the basis of material possession/access), old social movements arose specifically to redress this perceived material imbalance. But the post-industrial society has broadened the basis of contradiction, a contradiction that emerges from the dissonance between the increasing autonomy and freedom of the individual and the increasing regulation of all spheres of life by the society. The contradiction here is basically nonmaterial and touches different spheres of life, such as the issue of ecology, gender, religion, warfare, and governance. Perhaps, the increase in the basis of contradiction in the post-industrial society explains the proliferation of social movements in such a society.

Probably, the greatest weakness of this approach apart from a methodological broadness that nullifies its usage for any peculiar case (it is too-general an explanation) is its failure to establish the precise origin of social movements. New conflicts arise in the areas of cultural reproduction, social integration, and socialization and that even where conflicts arise over the political system,

such a conflict may equally be driven by the struggle for the control of material or economic resources of society (McAdam and Scott, 2005).

Benford and Snow (2000) define new Social movement theory as a collective action theory which studies how and why social movements aim at changing existing institutions. Unlike collective institutional entrepreneurship, social movement theory enables the theorization of collective agency at stake in a process of institutional change. It also allows the introduction of higher motivations than personal interests in conducting institutional change, such as society choices conveyed by the Sustainable Development project. Over the past decades, a new generation of social movements has appeared. It includes movements like recycling militants, shareholder activism and civil society organizations. They namely differentiate from previous social movements by their focus on economic institutions, from which they can originate (e.g. shareholder activism). These new social movements strive to restore social responsibility within economic institutions: they are known as Corporate Social Responsibility (CSR) movements (Scherer & Palazzo, 2007).

Scherer & Palazzo (2007) further argue that CSR movements gather the four features of the new social movements including: a collective identity, the share of individual resources for a common purpose, an opposition to existing institutions and the research of a new general orientation for the society. The Socially Responsible Investment (SRI) movement which aims at bringing social responsibility within the asset management sector is one of them. While historically the SRI movement appeared as a marginalized movement composed by ethical activists, it has achieved in the last few years a rise in influence and credibility.

According to previous studies (Lounsbury et al., 2003; Rao et al., 2003), at least two outcomes linked to the success of a social movement can be identified: firstly, changes in the existing institutional logics and consequently in the field; secondly, the creation of alternative institutional logics which add to the previous ones. The second outcome refers to the creation of a new field by a social movement. Fligstein (2001) however, holds that if the only goal of a social movement is altering existing institutional logics, its success leads to its death. When a social movement also strives to create a new field, the two purposes inevitably collide. Indeed,

by downplaying the differences between challengers and incumbents, the success of the first goal 'changing the existing field' jeopardizes the success of the second goal 'creating a new field'. As a result, the survival of the social movement is threatened by its success.

CHAPTER THREE: EMPIRICAL LITERATURE REVIEW

3.1 Introduction

This chapter looks at the empirical literature on portfolio performance, the relationship between SRI and portfolio performance, and the impact of both portfolio management process and demographic characteristics on this relationship. For each study identified, a description of the objectives, methodology and results is undertaken. Summary of the empirical literature identifying the research gap is also presented and forms a basis for the development of the proposed conceptual model.

3.2 Mutual Funds' Portfolio performance

Portfolio performance evaluation is viewed as a feedback and control mechanism that can make the investment process more effective. It is both expensive and time consuming to analyze and select securities for a portfolio, therefore, institutions must determine whether the effort is worth the time and money invested in it. It is therefore not surprising that investors managing their own portfolios evaluate their performance as well as those who pay one or several professional fund managers (Diltz, 1995). The essence of performance evaluation is to measure the value of the services (if any) provided by the portfolio management industry. It is to investigate whether a fund manager helps enlarge the investment opportunity set faced by the investing public and, if so, to what extent the manager enlarges it.

Chen and Knez (1996) identify four minimal conditions that must exist in a good performance measurement. First, the measurement assigns zero performance to every portfolio in some reference set. For instance, if the uninformed investors constitute the investing public, the reference set will then contain all portfolio returns that are achievable by any uninformed investor. More generally, the reference portfolio set can be enlarged to include all dynamic portfolios that are obtainable using public information. Second, the function is linear so that a manager cannot create better or worse performance by simply re-bundling other funds. This ensures that superior performance is only a result of superior information. Third, the function is continuous, which guarantees that any two funds whose returns are indistinguishable from one another will always be assigned performance values that are arbitrarily close. This imposes some

sense of fairness to all fund managers. Finally, the function is nontrivial in the sense that if a fund's excess return over a reference portfolio is proportional to some traded security's payoff, the fund will not be assigned a zero performance.

The main idea in most of the classical measures of investment performance is essentially to compare the return of a managed portfolio over some evaluation period to the return of a benchmark portfolio. The benchmark portfolio should represent a feasible investment alternative to the managed portfolio being evaluated. The main portfolio performance measures include the Sharpe ratio (Sharpe, 1966), Treynor index (Treynor, 1965) and Jensen information ratio (Jensen, 1968). These measures are discussed below:

3.2.1 Treynor Model

Treynor (1965) developed the T ratio which indicates the risk premium return per unit of systematic risk. This is a composite measure of portfolio risk. Treynor indicates that the risk component includes risk produced by the general market fluctuations and risk resulting from unique fluctuations in the portfolio securities. To identify risk due to market fluctuation, he introduced the characteristic line, which defines the relationship between the rate of return for a portfolio over time and the rate of return for an appropriate market portfolio. The slope of the characteristic line is the Beta. The characteristic line measures the relative volatility of the portfolio returns in relation to return for the aggregate market. Deviation from the characteristic line indicates unique return for the portfolio relative to the market. The Treynor measure is written as;

$$T = \frac{R_p - R_f}{\beta_p}$$

Where;

T is the Treynor's index

R_p is the average return for portfolio p during a specified time period

R_f is the average rate of return on a risk free investment during the same time period

β_p is the slope of the fund characteristic line (portfolio relative volatility)

The larger the T value the better the portfolio to all investors regardless of their preference. The numerator $[R_p - R_f]$ is the risk premium while the denominator is a measure of systematic risk. All risk averse investors would like to maximize this value. The beta value measures systematic risk and implicitly assumes a completely diversified portfolio. Comparing a portfolio's T value to a similar measure for the market portfolio indicates whether the portfolio would plot above the Security Market Line (SML). If a portfolio plots above the SML, then, it has a superior risk adjusted performance.

3.2.2 Sharpe Model

Sharpe (1966) developed a measure which deals with return and risk in terms of the Capital Market Line (CML). It measures the return of a portfolio, in excess of the risk-free rate, relative to its total risk, as shown below;

$$S_i = \frac{R_p - R_f}{\sigma_p}$$

Where:

S_i is the Sharpe Index

R_p is the average return on portfolio p

R_f is the risk free rate of return

σ_p is the standard deviation of the return of portfolio p

The index, S_i measures the slope of the line emanating from the risk free rate outward to the portfolio in question. The Sharpe index summarizes the risk and return characteristics of a portfolio through a single index on a risk adjusted basis. The larger the S_i the better the portfolio has performed.

3.2.3 Jensen Model

Jensen (1968) came up with a model that requires the regression of the monthly differences between portfolio returns and the treasury bill rate for the particular portfolio. This gives the return earned on the portfolio in excess of the risk free rate. The equation is thus,

$$(R_p - R_f) = \alpha_i + \beta_p (R_m - R_f)$$

Where:

R_p is the average return for portfolio p during a specified time period

R_f is the average rate of return on a risk free investment during the same time period

β_p is the slope of the fund characteristic line (portfolio relative volatility)

α is the alpha coefficient which represents a measure of the bonus performance owing to superior portfolio management and

$$R_p = R_f + \beta_p (R_m - R_f)$$

This is the expected return from the portfolio, given the risk free rate, the portfolio beta, and the return on the market portfolio. To get the total returns, the alpha value is added to this return.

3.3 Relationship between SRI and Portfolio Performance

Kempf and Osthoff (2007) investigated the impact of various socially responsible criteria on the performance of screened stock portfolios. They analyzed whether investors can increase their performance by following a simple trading strategy based on SRI ratings; buying stocks with high SRI ratings and selling stocks with low SRI ratings. The researchers employed negative, positive, and best-in-class screens. They used these ratings to form one portfolio of stocks with high SRI ratings and another one of stocks with low SRI ratings. They studied the performance of these portfolios over the period 1992–2004 and measured performance using the Carhart (1997) model. The results of the study indicated that investors can earn remarkable high abnormal returns by buying stocks with high SRI ratings and selling stocks with low SRI ratings. Overall, the study results suggested that SRI ratings are valuable information for investors and a simple trading strategy based on publicly available information leads to high abnormal returns. The study however did not attempt to explain where the extra profit stems from. Does it result from a temporary mispricing in the market or does it compensate for an additional risk factor? Another weakness with the study is that Carhart model used is an improvement of CAPM which requires the portfolio to be efficient.

Hamilton, Hoje and Statman (1993) tested three alternative hypotheses about the relative returns of socially responsible portfolios and conventional portfolios. The first hypothesis was that the risk-adjusted expected returns of socially responsible portfolios are equal to the risk-adjusted expected returns of conventional portfolios. The second hypothesis was that the expected returns

of socially responsible portfolios are lower than the expected returns of conventional portfolios. The third and last hypothesis was that the expected returns of stocks of socially responsible portfolios are higher than the expected returns of conventional portfolios. They referred to the last hypothesis as *doing well while doing good*. They analyzed the performance of 32 mutual funds for the period 1981 to 1990. They measured excess returns using Jensen alpha and found that socially responsible mutual funds do not earn statistically significant excess returns and that the performance of such mutual funds is not statistically different from the performance of conventional mutual funds. The results from this study may be questioned due to the excess return measure used. This is because Jensen alpha is a CAPM based measure which assumes that assets are held in a well diversified portfolio which may not be the case in an SRI portfolio due to limits in diversification.

Stone, Guerard, Mustafa and Adams (1997) did a study on socially responsible investment screening to determine whether there is any significant cost for socially screened, actively managed and value focused portfolios. The Kinder, Lydenberg and Domini (KLD) social screens were used in this study. The time period was 1984-1997. This included the market break of October 1987 and the down market of 1989-90. They found out that there was no significant cost as a result of applying social screens for major sub periods: 1984-88, 1989-93, and 1994-97. Most importantly results for the screened and unscreened upper quartile funds were remarkably consistent on a quarter-to-quarter and year-to-year basis. The conclusion of no significant cost/benefit was consistent both in the short run and in the long-run.

Diltz (1995) and Guerard (1997) examined various dimensions of socially responsible investing for the US stock market. Diltz (1995) found that employing environmental and military screens leads to a significantly positive performance, while all other screens do not have a significant impact on performance. Guerard (1997) concluded that socially screened portfolios do not differ from unscreened portfolios with respect to performance.

Mallin *et al.* (1995) argued that ethical funds have their own characteristics that may make the comparison with benchmarks, such as FTSE, somewhat misleading. They examined the performance of 29 ethical funds by comparing each ethical fund to a non-ethical one having the

same formation date and fund size. They found that beta is lower for the ethical funds. This implies that the non-ethical trusts are riskier than the ethical trusts. On a risk-adjusted basis, they found weak superior performance of ethical funds in the sample.

Brzeczczynski and McIntosh (2011) investigated whether the portfolios composed of the British socially responsible stocks can outperform the market. They used the Global 100 Most Sustainable Corporations in the World list (known also as: Global-100) to select the SRI stocks and found that in the period of years 2000-2010 the returns of the SRI portfolios were superior compared with the corresponding returns of market index FTSE-100 and the index FTSE4GOOD. The annual average outperformance of SRI portfolios was 10.71 percent relative to FTSE-100 and 11.07 percent relative to FTSE4GOOD. Superior performance of SRI stocks was confirmed also using risk-adjusted measures such as Sharpe ratio and Treynor index.

Mill (2006) empirically examined the financial performance of a UK unit trust that was initially "conventional" and later adopted socially responsible investment principles. He compared the SRI unit trust with three similar conventional funds whose investment objectives remained unchanged. Results showed a temporary increase in variability of returns, followed by a return to previous levels after around 4 years. He concluded that the increased variability is associated with the adoption of SRI rather than with a change in fund management. Possible explanations for the subsequent reduction in variability include the spread of corporate social responsibility activities by firms and learning by fund managers.

The empirical analysis of SRI and portfolio performance has yet to provide a convincing causal link between the two factors. A reasonable conclusion, based on the prior research, is that SRI neither over-perform nor under-perform their non-SRI counterparts. The single objective of generating financial returns cannot, therefore, explain ethical investment.

3.4 Mutual Fund Portfolio Management Process

Portfolio management process outlines the steps in creating a portfolio, and emphasizes the sequence of actions involved from understanding the investor's risk preferences to asset allocation and selection to performance evaluation. By emphasizing the sequence, it provides for

an orderly way in which an investor can create his or her own portfolio or a portfolio for someone else. The portfolio management process provides a structure that allows investors to see the source of different investment strategies and philosophies (Bodie, Kane and Marcus, 2002).

Reilly and Brown (2000) identify four steps of the portfolio management process including construction of a policy statement, security analysis, portfolio construction and continuous monitoring of the investors' needs and capital market conditions. Bodie, Kane and Marcus (2002) however, identify slightly different steps of the portfolio management process including specifying investment objectives, specifying investment constraints, formulating investment policy and lastly monitoring and updating the portfolio.

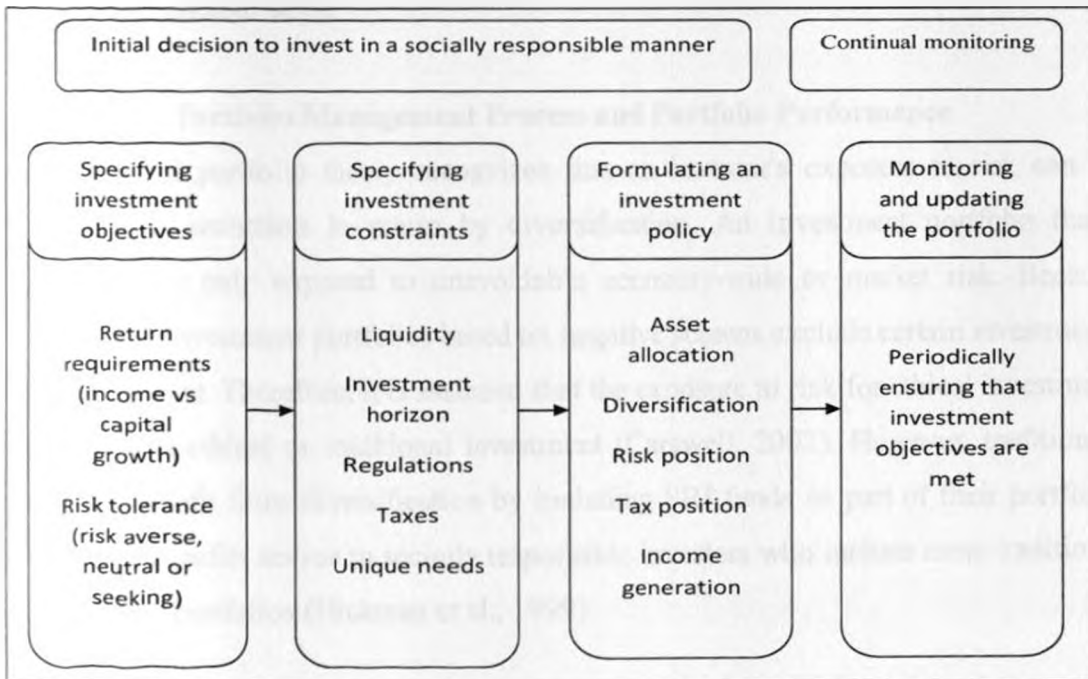
It is important to note that SRI is not distinct from conventional investing as it also focuses on issues such as capital allocation, asset allocation and security selection. The main difference, however, is socially responsible investors also integrate moral and environmental, social, and governance concerns during the four stages of the investment process.

Boasson, Boasson and Cheng (2006) define a mutual fund as an investment company whose objective is to achieve a satisfactory level of return for its fund clients at a predefined level of risk. Mutual fund managers have the fiduciary responsibility to serve its clients by managing the money contributed by the fund holders with prudence and market wisdom. The Capital Markets Act (CAP 485A of the laws of Kenya), however, define a mutual fund as a collective investment scheme set up as a body corporate whereby the assets of the scheme belong beneficially to and are managed by or on behalf of the body corporate, the investments of the participants are represented by shares of that body corporate and the body corporate is authorized by its articles of association to redeem or repurchase its shares. Mutual funds are diverse stock holdings which are managed on behalf of the investors who buy into the fund and thereby allowing investors to take advantage of a diversified portfolio without the need of investing a large sum of money. The problem for small investors is that they usually don't have enough funds to buy a variety of stocks. Despite their limited funds, small investors benefit from diversification through mutual funds.

Mutual funds have become an increasingly effective means for income generation, capital appreciation, and diversification benefits to investors. They provide investors with professional money management, asset liquidity and the benefit of diversification in an attempt to gain market share. Chordia (1996) and Edelen (1999) argue that mutual fund investors receive not only valuation expertise but also diversified equity positions that limit risk. Investors select mutual fund objectives based on specific risk tolerances and time horizons. A portfolio manager's selection of securities should be consistent with the mutual fund's investment objective, which is stated in the fund's prospectus.

Bodie, Kane and Marcus (2002) view mutual funds portfolio management process as a four step process including specifying investment objectives, specifying investment constraints, formulating an investment policy and lastly monitoring and updating the portfolio as shown by figure 2.3 below:

FIGURE 3.1: Stages in the socially responsible portfolio management process



Adapted from Bodie, Kane and Marcus (2002, 940)

The difference between SRI and conventional portfolio management process occurs in the first three steps. Firstly, SRI investment objectives are defined to include both social and financial returns and a higher risk tolerance since social investors are willing to take a higher risk so as to accommodate their investment philosophy (Statman, 2000). Secondly, in specifying investment constraints, socially responsible investors include social, environmental, ethical, moral and governance constraints (Kempf and Osthoff, 2007; Schwartz, 2003). Thirdly, the investment policy will be different due to reduced diversification as a result of reduction in the investable universe and differences in the size and structure of the portfolio. There will also be increased research costs to determine investment candidates (Haigh and Hazelton, 2004).

Langbein and Posner (1980) also observed that social screening tends to eliminate large firms from the investment universe and as a result remaining firms tend to be smaller and have more volatile returns. Further, diversification may be hindered to the extent that social criteria eliminates or favors certain industries. Moreover, socially responsible investment may involve higher risk but should not yield significantly worse returns since SRI investors do not invest in clearly unprofitable stock.

3.5 SRI, Portfolio Management Process and Portfolio Performance

Conventional portfolio theory recognizes that an investor's exposure to risk can be reduced without any reduction in return by diversification. An investment portfolio that is highly diversified is only exposed to unavoidable economy-wide or market risk. Because socially responsible investment portfolios based on negative screens exclude certain investments, they are less diversified. Therefore, it is assumed that the exposure to risk for ethical investment is higher than for non-ethical or traditional investment (Carswell, 2002). However, traditional investors can still benefit from diversification by including SRI funds as part of their portfolio strategy. Similarly, benefits accrue to socially responsible investors who include more traditional funds as part of their portfolios (Hickman et al., 1999).

It has been argued too, that SRI funds attract higher transaction costs and management fees due to the relatively small size of the funds, and the need to collect specialized information concerning the ethical practices of firms (Michelson *et al.*, (2004). Managers responsible for

implementing social screens do indeed consult a wide range of sources of information, and do this on a regular basis (Stone *et al.*, 2001). This finding is not surprising given the lack of standardized social data on corporate behavior. Consequently, it appears that ethical fund managers invest considerable time and effort assessing and reassessing a firm's social performance. This will invariably add to operating costs since, as argued by Tippet (2001), small size may mean that the ratio of management fees and expenses to total income of the funds is high.

Believers in the efficient market hypothesis argue that it is impossible that SRI funds outperform their conventional peers. Screening portfolios based on public information such as corporate social responsibility issues cannot generate abnormal returns. However, it is also possible that SRI screening processes generate value-relevant information otherwise not available to investors. This may help fund managers to select securities and consequently generate better risk-adjusted returns than conventional mutual funds. In this case, investors may do (financially) well while doing (socially) good, that is investors earn positive risk-adjusted returns while at the same time contributing to a good cause (Renneboog, Horst and Zhang, 2008).

Opponents of SRI highlight the adverse costs and effects that social screening may involve. They argue that the potential hidden costs associated with implementing social screens adversely affect investment performance and therefore should not be ignored (Sauer, 1997). Temper (1991) notes that unscreened benchmarks may outperform socially responsible investment since using social investing criteria may affect portfolio management process by causing additional screening and monitoring costs, availability of a smaller investment universe, and restricted potential for diversification.

Langbein and Posner (1980) also observed that social screening tends to eliminate large firms from the investment universe and as a result remaining firms tend to be smaller and have more volatile returns. Further, diversification may be hindered to the extent that social criteria eliminates or favors certain industries. Moreover, socially responsible investment may involve higher risk but should not yield significantly worse returns since SRI investors do not invest in clearly unprofitable stock.

Bello (2005) examines the performance of SRI funds relative to conventional mutual funds, but varies from other studies in that he also examines empirically the association between social screening and characteristics, such as diversification and size of companies in the portfolio. The overall conclusion is that all characteristics of socially responsible mutual funds are not significantly different from that of conventional funds.

3.6 The Effects of Demographic Characteristics on Socially Responsible Investments

It might be assumed by some that those who invest in ethical or socially responsible funds do not invest at all in non-ethical funds. While there will be individuals for whom this claim is accurate, some research evidence reveals that it is common for people to invest both in socially responsible and more standardised or conventional funds. The motivations of socially responsible investors appear to be quite complicated in reality (Mackenzie and Lewis, 1999).

Demographic characteristics of fund managers are likely to play a significant role in shaping their perceptions and behavior concerning socially responsible investments. Rest (1986) was one of the first to develop a theory of ethical decision-making which used demographic characteristics to explain (and predict) how individuals think about, and react to, ethically charged situations. The theory argues that an individual's perception of moral intensity is moderated by individual and organizational characteristics and varies across different situations. In particular, McLachlan and Gardner (2004) found a statistically significant difference in the perception of moral intensity among SRIs and conventional investors. Harrison (1995) has also argued that demographic information is useful when segmenting markets on the basis of attitudes.

Studies have directly associated demographic factors with differences in the amount of funds committed to SRI (Nilsson, 2008; Nilsson, 2009; Junkus and Berry, 2010). These studies have mainly looked at demographic characteristics of fund managers inclusive of gender, age, level of education and job experience, job title and size of fund managed. Their results demonstrate that younger and female fund managers are more likely to believe that a company's social and environmental performance is as important as its financial performance. Female fund managers

and those managing large funds are the most likely to believe that companies should be as responsible to their shareholders as to the broader society. In addition, younger fund managers, those with high incomes and those who have attained higher education levels regard socially responsible companies as at least as profitable as other companies.

McLachlan and Gardner (2004) include a number of demographic issues in their research as part of the variables induced. The education level, age and income level were described as factors directly affecting an ethical investor. The findings indicate that investors from a lower age group with a high education and higher income tended to make ethical decisions in terms of investing. A certain level of contemplation for others is also included as one of the characteristics of a socially responsible investor as specified by O'Neil and Pienta (1994), even though it did not fall under the same line of reasoning as demographic issues. Singhapakdi (1999), in addition, has conducted a similar study to measure the demographic figures and reached similar findings in line with other studies previously conducted. The elements of education and income level together with gender and religiousness have also played an important part in executing ethical intention.

Junkus and Berry (2010) investigated four demographic factors; namely the level of education, ethnicity, gender and the size of funds managed in order to determine the relationship between demographic factors and the ethical investment behaviour of a general insurance fund manager. They found no significant differences between the general insurance fund manager levels of education and the behaviour of socially responsible investors and also no presence of significant differences between the ethnicity of general insurance fund managers and their investment behaviour. The study was inconclusive on the other two variables.

3.7 Summary of Empirical Literature Review and Research Gaps

The empirical analysis of relationship between socially responsibility investment, portfolio management process, demographic characteristics and portfolio performance has yet to provide a convincing causal link between these factors. A reasonable conclusion, based on the prior research, is that SRI neither over-perform nor under-perform their non-SRI counterparts. It can also be concluded that SRI affects the portfolio management process by limiting diversification,

constraining the size and structure of investable universe and increasing the research costs of monitoring the investee companies. On relationship between demographic characteristics and SRI, it has been concluded that factors such as age, gender, level of education and the amount of funds under management can be used to segment socially responsible investors.

The inconsistency of findings is attributed to manifold SRI expression forms and measurement deficiencies. Positively screened SRI funds – that more likely feature IT-technology and alternative energy industries attracting innovative venture capital – tend to be more volatile, yet if successful, grant high profitability – e.g., solar energy funds have significantly outperformed the market in recent years and remained relatively stable during the 2008/09 World Financial Crisis. As for excluding high-return, high-volatility industries such as petroleum, defense and addictive substances, negatively screened options are more likely to underperform in the market. At the same time negative screened market options are robust to overall market changes. Negative screening asset holders are more loyal to their choice in times of crises, which contributes to the stability of these options. Data on the profitability of political divestiture indicates a potential first mover advantage for early divestiture.

The unclear picture whether SRI leads to an in- or decrease in market value may stem from Financial Social Responsibility measurement deficiencies ranging from intangible and time-inconsistent pay-offs. SRI studies are methodologically limited by small sample sizes due to the relative novelty of Financial Social Responsibility, inconsistencies in the short time frames under scrutiny and differing modeling techniques used to estimate investment returns (Jones et al., 2008; McWilliams & Siegel, 1996; Mohr et al., 2001; Ngassam, 1992; Teoh, Welch & Wazzan, 1999). Most SRI studies do not take externalities on the wider constituency group into consideration, which lowers the external validity of the results and calls for a more whole-rounded examination of SRI (McWilliams et al., 1999).

Some critics of SRI studies have argued that the strong financial performance of some SRI funds could be an indication that the relationship between social responsibility and financial performance is actually negative. These critics suggest that many SRI funds have become strong financial performers only because their 'once-strict screening criteria have turned porous'

(Goetz, 1997). That is, the improved financial performance of SRI funds is a result of gradually minimizing social performance standards for those firms to be included in their portfolios. SRI funds have 'opened the door to less-than-angelic companies whose high returns have helped SRI gain the upper hand in the longstanding performance debate'. Therefore, social performance must indeed be sacrificed to gain financial returns. This argument points to the need to account for heterogeneity in the standards of social responsibility employed by SRI funds. The standard approach in research on SRI funds is to contrast the financial performance of a set of screened funds with that of a set of unscreened funds or the overall market (e.g., Guerard, 1997; Hamilton *et al.*, 1993). This approach confounds a range of screening practices within SRI funds. Because some SRI funds have more stringent social screening standards than others, the SRI literature must examine variances within screened funds to better determine the underlying nature of the relationship between financial and social performance.

There are three main arguments against mainstreaming SRI funds, which directly relate to how SRI funds are empirically measured. First, there is a suspicion that these portfolios have increased costs and risk due to reduced diversification (Geczy *et al.*, 2005; Renneboog *et al.*, 2006). Second, there is a suspicion of increased monitoring costs from SRI managers (Bauer *et al.*, 2007). Third, SRI may lead to decreased returns, leading financial managers to a breach of their fiduciary duty to provide the highest possible return with the lowest possible risk (Bauer *et al.*, 2005). To investigate the impact of these issues, SRI studies employ multiple methods of risk and return analysis, derived mainly from modern portfolio theory. Empirical evaluation techniques employed include capital asset pricing models (CAPM), multi-index models, multi-factor models and arbitrage pricing theory. As such, SRI studies rely on conventional portfolio evaluation, a body of empirical literature that has taken over 50 years to develop and test. The motivation of many SRI studies is to develop estimates of the average returns of a population of SRI funds with low bias and estimation errors (e.g. Bauer *et al.*, 2005). This implies that the SRI fund's empirical average returns must be consistent, i.e. a good estimate of the SRI population's returns, and efficient, i.e. with the smallest possible variance (Greene, 2008).

A number of research gaps arise from the analysis of the issues examined in this chapter. These include: Firstly, lack of consensus on why SRI occurs even when empirical evidence on the impact of SRI on portfolio performance is inconclusive. Secondly, difficulties in assessment of

non-financial risk created by SRI especially given the inability to quantify social, ethical, governance, moral and environmental issues. Thirdly, most studies have not controlled for any intervening or moderating variable affecting the relationship between SRI and portfolio performance. Variables such as differences in demographic characteristics of the fund managers and portfolio management process may affect the relationship between SRI and portfolio performance. Table 3.1 summarizes some of the reviewed studies and indicates the limitations of each. The research gaps are apparent from the stated limitations.

Author	Year	Methodology	Findings	Limitations
Alquist	2002	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2003	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2005	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2006	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2007	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2008	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2009	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2010	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2011	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2012	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2013	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2014	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2015	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2016	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2017	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2018	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2019	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2020	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2021	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers
Chang and Chi	2022	Panel data regression	Positive relationship between SRI and performance	Did not control for demographic characteristics of fund managers

Table 3.1: Summary of empirical literature and research gaps

RESEARCHER(S)	TITLE OF THE STUDY	RESULTS	LIMITATIONS (RESEARCH GAPS)
Kempf and Osthoff (2007)	The effects of socially responsible investment on portfolio performance	SRI results in high abnormal returns	<ul style="list-style-type: none"> - The study did not attempt to explain where the extra profit stems from. Does it result from a temporary mispricing in the market or does it compensate for an additional risk factor? - The study considered screening strategy only in forming SRI portfolio but did not consider shareholder advocacy or community investing
Hamilton <i>et al.</i> (1993)	Doing well while doing good: The investment performance of socially responsible mutual funds	SRI funds do not earn statistically significant excess returns	<ul style="list-style-type: none"> - The study considered only screening strategy - Excess returns were measured using Jensen alpha but no tests on the efficiency of portfolio were undertaken
Stone <i>et al.</i> (1997)	Socially responsible investment screening: strong evidence of no significant costs for actively managed portfolio	There is no significant costs of applying social screens	<ul style="list-style-type: none"> - Considered only screening strategy - Did not consider effects of SRI on portfolio performance and demographic characteristics
Diltz (1995)	Does social screening affect portfolio performance?	Employing environmental and military screens leads to positive performance. Others screens do not have any impact on performance	<ul style="list-style-type: none"> - Did not consider shareholders' advocacy and community investing strategies - Did not consider effects of any intervening or moderating variables on the relationship between SRI and performance
Mallin <i>et al.</i> (1995)	The financial performance of ethical investment funds	Ethical funds have lower risk and lower risk adjusted performance	Did not consider effects of SRI on portfolio management process and demographic characteristics

Mill (2006)	The financial performance of socially responsible investment over time and a possible link with CSR	SRI results in increased variability of returns	Did not consider effects of SRI on portfolio management process and demographic characteristics
Junkus and Berry (2010)	The demographic profile of socially responsible investors	Female investors were more likely to be socially responsible and socially responsible investors tend to be younger and better educated.	<ul style="list-style-type: none"> - Failed to take into account whether the higher risk aversion of women SRIs and their greater concern for the environment is responsible for their results. - The study did not examine any statistical relationships between demographic characteristics of the SRIs and portfolio performance
Nilsson (2009)	Segmenting socially responsible mutual fund investors: the influence of financial return and social responsibility	SRIs were found to be predominantly female and have a university degree. The gender and level of education were useful in explaining those SRIs who value both return and social responsibility	<ul style="list-style-type: none"> - The study only used respondents from one SR investment provider and the sample concentrated on older respondents - The study did not examine any statistical relationships between demographic characteristics of the SRIs and portfolio performance

3.8 The Conceptual Framework

This study adopts the modern portfolio theory, the stakeholder theory and the institutional theory in examining socially responsible investment and its impact on portfolio management process, demographic characteristics and portfolio performance. A discussion of the dependent, independent, intervening and moderating variables is undertaken followed by the conceptual model.

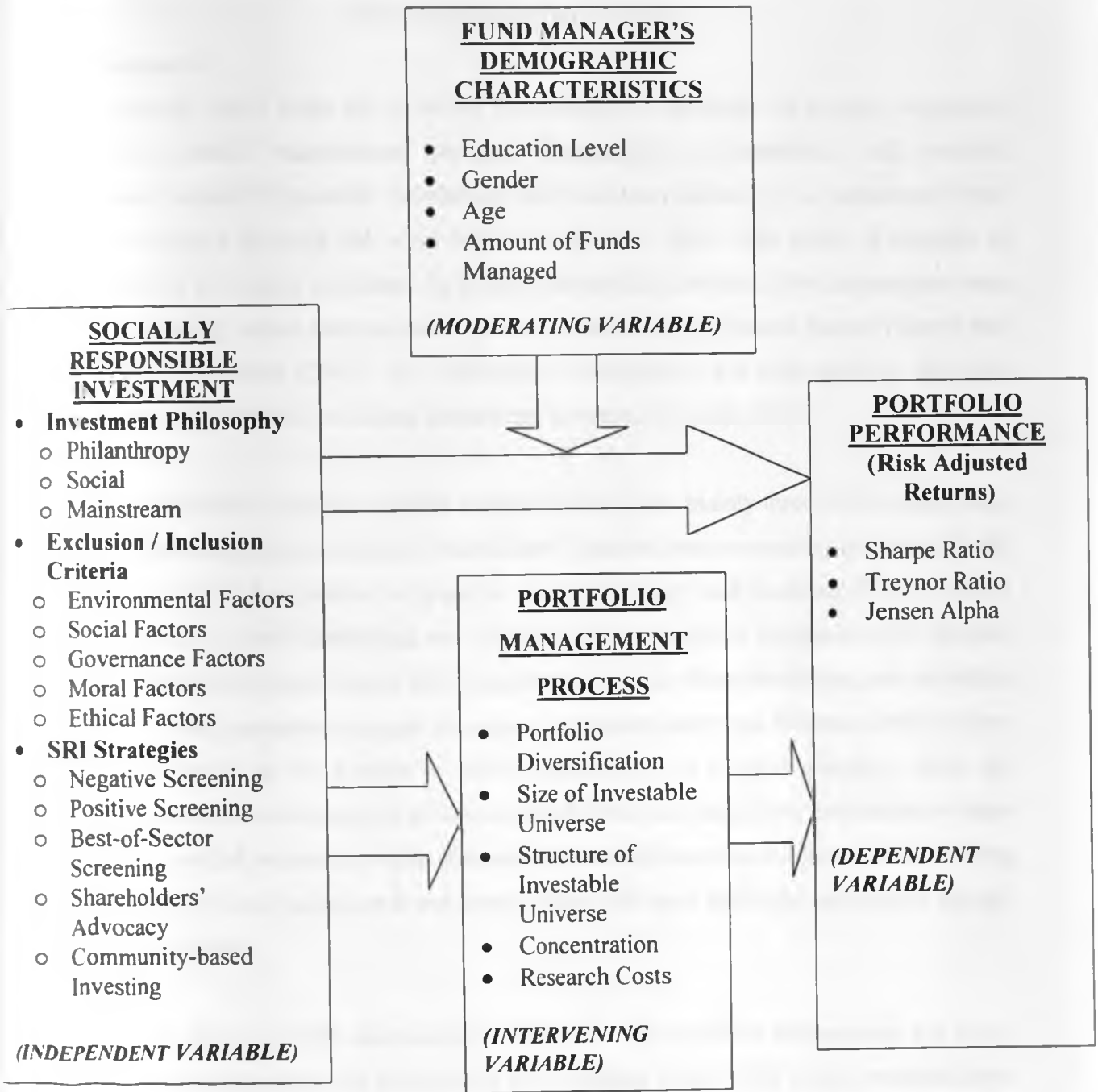
The dependent variable in this study is the risk adjusted portfolio performance of a given mutual fund. This is represented by composite portfolio performance measures of Sharpe ratio, Treynor ratio and Jensen alpha

The independent variable is SRI as represented by philosophy of investing which includes philanthropic, social or conventional investing; the exclusion/inclusion criteria depending on whether a mutual fund screens for environmental, social, governance, moral or ethical factors; and the SRI strategies used by adopters which may include negative screening, positive screening, best of sector screening, shareholders' advocacy or community based investing. A likert scale can be used to measure this variable.

The portfolio management process will be considered as the intervening variable. The main concerns in the process will be the extent of portfolio diversification, the size and structure of the investable universe, the amount of concentration by the portfolio manager and research cost incurred to monitor the investee companies. A likert scale can also be used to measure this variable.

The relationship between SRI and portfolio management process will be moderated by the fund manager's demographic characteristics including age, gender, level of education and amount of funds managed. Figure 3.1 shows the conceptual model

Figure 3.2: The Conceptual Model



Source: Researcher (2012)

CHAPTER FOUR: SUMMARY, CONCLUSION AND RECOMMENDATIONS

4.1 Summary

This independent study paper has provided an overview of literature on socially responsible investment, portfolio management process, demographic characteristics and portfolio performance. Socially Responsible Investment (SRI) has been defined as an investment which combines investor's financial and social objectives (Lozano, 2006). The extent of adoption of SRI depends on the factors considered by socially responsible investors. Five factors have been identified including social, environmental, ethical, moral and governance factors (Kempf and Osthoff, 2007; Schwartz (2003). The philosophy of investment has been used to categorize investors into philanthropic, social and mainstream investors (Allavida, 2011).

Individuals wanting to invest in a socially responsible way have mainly three SRI strategies they can pursue including social screening, shareholders' activism and community investing. Social screening involves either positive or negative screening. Haigh and Hazelton (2004) describe positive screens as those identifying, and including in the portfolio, companies with superior social or environmental performance while negative screens are those identifying, and excluding from the portfolio, companies engaged in targeted undesirable activities. O'Brien (2002) defines shareholder activism as the process by which shareholders of a listed company, under the provisioning of securities legislation in various jurisdictions, can requisition its members to meet and vote on specified resolutions while community investing describes the practice of providing capital to people in low-income or at-risk communities who have difficulty accessing it through conventional channels.

The empirical analysis of the relationship between SRI and portfolio performance has yet to provide a convincing causal link between the two variables. Most of the studies reviewed have mainly focused on whether there is a difference between the performance of socially screened portfolios and that of conventional funds. Results of these studies are conflicting, for example Jones (1996), Diltz (1995) and Kempf and Osthoff (2007) concluded that SRI investors earn higher abnormal returns than conventional investors. Hamilton *et al.* (1993), Stone *et al.* (1997) and Statman (2000) found no significant difference between the performance of SRI and

conventional mutual funds. Mallin *et al.* (1995), on the other hand, found a negative relationship between SRI and risk-adjusted portfolio performance.

In Kenya, the first steps in socially responsible investment have been taken by creating the Kenya Social Investment Exchange (KSIX) and the licensing by capital market authority of the first ethical fund in 2011. However, there does not seem to have been much progress in the application and development of SRI mutual funds. In other words, there is still a long way to go in this area if Kenya is to match the development of SRI in other countries.

4.2 Conclusion

This study has demonstrated the complexity of many of the issues raised by this topic including the motives of socially responsible investors, the different types of SRI strategies, the mixed evidence concerning the effects of SRI on portfolio performance, and how the relationship between the variables can be explained by the modern portfolio theory, the stakeholders' theory, the institutional theory and the new social movement theory. The papers illustrate the breadth of research taking place in connection with SRI and the variety of perspectives that can be brought to bear on the topic.

The paper concludes that the conflicting results are caused by the fact that the relationship between SRI and portfolio performances is not direct but is intervened by other variables such as the portfolio management process. Five factors in the portfolio management process that are affected by SRI have been identified (Havemann and Webster, 1999). These are the portfolio diversification process, the size and structure of the investable universe, concentration and the research costs incurred in monitoring the investee companies. Another explanation into the conflicting results is that the relationship between SRI and portfolio performances may be moderated by the investors' demographic characteristics such age, gender, level of education and amount of funds under management. Studies show that young, highly educated and female investors are more likely to invest in SRI mutual funds (Nilsson, 2008; Nilsson, 2009; Junkus and Berry, 2010). The different methodology adapted by different studies may also explain the conflicting results.

4.2 Knowledge Gaps Identified

A number of knowledge gaps arise from the analysis of the issues examined in this paper. Firstly, empirical analysis of relationship between socially responsible investment and portfolio performance has yet to provide a convincing causal link between the two factors. A reasonable conclusion, based on the prior research, is that SRIs neither over- nor under-perform their non-SRI counterparts. The single objective of generating financial returns cannot, therefore, explain ethical investment, implying lack of consensus on why SRI occurs.

Secondly, traditional financial analysis methods have been formulated to measure financial risk and return, and therefore fall short in assessing non-financial risk and returns created by social and environmental issues. The inability to quantify social, ethical, governance, moral and environmental issues may explain why socially responsible investors continue to invest even when SRI funds appear to underperform conventional funds.

Thirdly, most studies on the performance of SRI funds have not controlled for any intervening or moderating variable. If variables such as the differences in demographic characteristics of the fund managers and portfolio management process are introduced in the model, then results of studies on the relationship between SRI and portfolio performance may be different. Fourthly, a major limitation with most of the researches undertaken so far is that they consider only two of the variables under study (SRI, portfolio management process, fund managers demographic characteristics and portfolio performance) at a time. None of the studies has considered the effects of the four variables taken together.

4.3 Possible Areas for Further Research

It is firstly suggested that a research instrument be developed to empirically test the variables depicted in the conceptual model (Figure 3.2). Such a study will shed more light on the variables that impact on socially responsible investment and may provided more conclusive results on the impact of SRI on portfolio performance.

Secondly, there is much potential for future studies to investigate the heterogeneity among investor clienteles. The evidence that socially responsible investors are heterogeneous also has

implications for understanding the effects of social values on asset prices. Given the large growth in the SRI movement, it becomes more important to better understand this process. Future researchers can extend work in this direction.

Thirdly, this study has documented that investors have different reasons for investing in SRI profiled mutual funds. An interesting area for future research with regard to this segmentation would be to find out the reasons why investors belong to certain groups. Issues that could be focused on here include why some investors put social responsibility over financial return and why some investors prefer the opposite. What reasons do socially responsible investors have for the choices and preferences that they have? Is it possible to change these preferences so that they invest more of their portfolio in SRI?

Finally, suggestion for future research is to focus on what kind of mutual funds could be marketed to the different investors' segments. As the study shows that investors have differing reasons to invest in SRI, they are also likely to be appealed by different applications of social responsibility in the mutual fund. By focusing on what characteristics of the mutual funds is attractive to the different segments, it would make it easier for the SRI industry to target and position, based on the segments presented in the study.

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APPENDIX 1: Social Investors in Kenya Identified by Allavida

	INVESTOR	CLASSIFICATION
1	Equity Group Foundation	Philanthropist
2	KCB Foundation	Philanthropist
3	Safaricom Foundation	Philanthropist
4	NCKK	Possible Market Return (PMR)
5	USAID	Possible Market Return (PMR)
6	Root Capital	Possible Market Return (PMR)
7	Family Bank	Possible Market Return (PMR)
8	Sc Johnson	Below Market Return (BMR)
9	Growth Africa	Below Market Return (BMR)
10	East Africa Capital Partners	Below Market Return (BMR)
11	Yehu Microfinance	Below Market Return (BMR)
12	Acumen Fund	Below Market Return (BMR)
13	Faulu Kenya	Below Market Return (BMR)
14	Kenya Women Finance Trust	Below Market Return (BMR)
15	Micro Africa	Below Market Return (BMR)
16	In Return Capital	At Least Market Return (ALMR)
17	Fanisi Venture Capital Fund	At Least Market Return (ALMR)

APPENDIX 2: Screens Employed by Socially Responsible Mutual Funds

A. Negative Screens

screens	Definitions
Alcohol	Firms that produce, market, or otherwise promote the consumption of alcoholic beverages
Tobacco	Manufacturers of tobacco products
Gambling	Casinos and suppliers of gambling equipment
Nuclear Power	Manufacturers of nuclear reactors and related equipment and companies that operate power plants
Firearms	Companies producing firearms for personal use Defence Contracting (Military) Production of weapons for domestic or Weapons foreign militaries
Irresponsible Foreign Operations	Investment in oppressive regimes such as Burma or China and mistreatment of indigenous people
Abortion/Birth Control	Abortion providers; drug manufacturers that manufacture and distribute abortifacients; insurance companies that pay for elective abortions (where not mandated by law); or companies that provide financial support to Planned Parenthood; Manufacturers of birth control products
Usury	Predatory lending, bonds, fixed income securities
Pornography	Pornographic magazines; production studios that produce offensive video and audio tapes; companies that are major sponsors of graphic sex and violence or television

B. Positive or Negative Screens

screens	Definitions
Products/Services	Strong investment in R&D, quality assurance, product safety; avoidance of antitrust violations, consumer fraud, and marketing scandals
Animal Rights	Seek promotion of humane treatment of animals; avoids animal testing, hunting/trapping equipment, and the use of animals in the end products
Labour Relations and Workplace	Avoids worker exploitation and sweatshops; seeks strong union Conditions relationships, employee empowerment, and/or profit sharing
Diversity	Minorities, women, gays/lesbians, and/or disabled persons recruited and represented among senior management and the board of directors
Environment	Avoids companies that pollute, produce toxic products, and contribute to global warming; seeks proactive involvement in recycling, waste reduction, and environment cleanup
Human Rights	Avoids companies directly or indirectly complicit in human rights violations; seeks companies promoting human rights standards

c. Positive Screens

screens	Definitions
Renewable Energy	Power derived from sources such as hydroelectric dams, fuel cells geothermal energy, and/or wind energy
Community Involvement/investment	Proactive investment in surrounding communities by sponsoring charitable donations, employee volunteerism, and/or housing and education programs
*Fund Participation	The mutual fund itself invests in Community Development Financial Institutions (CDFIs)
*Shareholder Activism	The mutual funds attempts to influence company policies and actions through direct engagement with management and/or sponsoring shareholder resolutions.

**These categories apply to the investment and management policies of the socially responsible mutual fund itself, rather than those of the companies in which it invests.*

Source: Geczy *et al.* (2005)