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'Socially responsible' represents 25% of managed assets in U.S.

The world is becoming more and more politically correct. There are certainly notable dissenters, but society at large seems to be summarily punishing those with views that deviate from the zeitgeist. Kevin Spacey, Harvey Weinstein, and investor Marc Faber represent three recent examples. This isn't surprising. There exists a fairly common set of accepted mores, many of which are unwritten, that we expect our peers to live up to. Most of us strive to be good people and live within these bounds.

Robert Cialdini, a professor of psychology, has written about humans' need to be consistent. Once a person makes a decision or takes an action, he or she is compelled to act similarly in the future. Inconsistency is an undesirable trait in our culture. After all, who wants to appear erratic or irrational? We want to think of ourselves as consistent, and we want others to see us as consistent. So, it is not surprising that humans are increasingly injecting their ideals into all aspects of their lives, including their investment portfolios.

Indeed, there has been a movement toward more socially conscious investing. Historically, corporations existed to provide financial benefit to their shareholders. Nonprofit corporations existed to promote social good. Increasingly, the two ideas are being conflated. It is not hard to find businesses promoting the idea of the double bottom line, measuring social impact as well as financial performance.

Today, socially responsible investing, or SRI, accounts for around 25 percent of all managed assets in the U.S. The percentage is even higher in Europe, and is rising fast in parts of Asia. SRI investing can take many forms, but the most popular is negative screening. That means excluding companies that participate in undesirable activities, such as the manufacture of tobacco products, weapons or fossil fuels. However, there are mutual funds targeting many variations on this theme, including Catholic-based values, Islamic-based values and even issues important to Presbyterians. Interestingly, what may be considered socially responsible in one fund could be screened out from another. This makes any sort of standardization difficult in the SRI arena.

That said, there have been a number of studies that have examined the performance of these types of funds. Proponents of SRI funds often discuss the ability of this approach to not only bring about positive social change, but to also earn outsized returns. Some credible empirical studies have indeed shown mar-

ON INVESTING
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ket-beating performance over some periods by SRI strategies.

Other data points are less supportive. For example, last March Norway's $870 billion sovereign wealth fund reported that it has missed out on 1.1 percent of annual return over the past 11 years because of its SRI approach. A loss of 1.1 percent may not sound like much, but because the numbers are so large, the missed opportunity likely cost the people of Norway somewhere around $100 billion. Divesting from tobacco and weapons companies was the primary reason cited for the shortfall. More extensive studies have found that Norway's experience is not unique.

Viewed from another perspective, researchers have shown that vice stocks, the opposite of SRI investing, often provide outsized returns. A study covering the 20-year period 1996 through 2016 showed that vice stocks returned 11.5 percent annually versus 7.8 percent for the S&P 500.

Capital markets data is often noisy. Accordingly, surprising results can occur, and even persist for longer than one would think. So, outperformance by one strategy or another over any period of time does not necessarily prove that the strategy is superior, or that its strong performance will persist into the future. Data is certainly helpful in evaluating investment opportunities, but a foundation of sound theory is essential.

Cliff Asness is a quantitative hedge fund manager known for his research. He recently wrote a position paper on SRI investing, which provides some interesting theory on the debate of whether it is possible to do well and do good at the same time.

Asness argues that, noisy data aside, SRI investors should expect to earn lower returns over time, and they should be happy about this.

Let's address the part about earning lower returns first. Asness points out that constraints, such as investing in only a certain type of stock, has to reduce expected returns. This is because a constraint would be unnecessary if it resulted in higher returns; it would be what investors would do anyway in order to maximize their wealth. If SRI funds truly offered higher expected returns, they would be the default way of investing, and no other style would be considered. Because that is not the case, it seems theoretically unlikely that investors can expect to earn more money by investing in a socially conscious manner.

The second part, about being happy about lower returns, is more interesting. Asness asserts that is the only way to truly bring about the social change SRI investors crave. As a socially conscious person, you want vice companies to do less of what they are doing, whether that is producing fewer cigarettes or guided missiles. SRI investing accomplishes this, but at a cost.

At the end of each trading day, every share of every stock must be owned by someone. If SRI investors own less of a stock, then vice investors must own more. The way to entice them to own more is by providing a higher return. By lowering the price of a stock (less demand from SRI investors will lower the share price), the future expected returns rise.

You may remember from back in business school that expected returns to investors are the same as the cost of capital for companies. A higher cost of capital raises the bar for new projects a company may want to undertake. Fewer projects means less activity from vice companies, and a kinder, gentler world for the socially conscious.

Which approach is right for you? It really depends on your perspective. If you want to feel warm in the cockles of your heart, perhaps SRI investing makes sense, but be aware you likely will have less money in the future. A more neutral approach, that is agnostic to social issues, can earn solid long-term returns, but some vice companies will likely make their way into your portfolio. This is the approach the Gates Foundation has taken. It invests for strong returns, then uses that higher accumulated wealth to bring about social change more directly through its grants. A third approach is to only invest in vice stocks. You may be wrecking the planet, contributing to poor health, and perpetuating violence, but at least you'll have a lot of money, probably.

The investment industry, opportunistic as it is, will happily accommodate all of these approaches. Let your conscience be your guide.

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