

Investor and Management Commitment in Socially Responsible Mutual Funds

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Abstract

We explore the behavior of investors and managers of socially responsible mutual funds in order to gain insight into their commitment to ethical investing. Management fees, fund turnover, loads, and fund flows are contrasted between matched samples of ethical and traditional mutual funds. Our findings indicate that both managers and investors exhibit commitment in that they appear willing to sacrifice fee revenue and financial returns, respectively, for their ethical goals.

I. Introduction

A considerable body of research has been devoted to the examination of issues relating to ethical or socially responsible mutual funds. Perhaps the two most significant questions that have been asked are i) what are the returns to socially responsible funds and ii) does socially responsible investing influence the actions of corporate management in a socially desirable way? While these are important questions, this paper addresses two other distinct, yet related questions. First, how ethical is the behavior of socially responsible fund managers toward their investors? More specifically, are these managers purely profit-motivated or do they share a commitment to ethical, socially responsible behavior in their roles as the investors' agents. Second, how committed to ethical ideals are socially responsible investors relative to their desires for financial returns?

II. Socially Responsible Fund Management and Investor Behavior

As we've suggested, the ability of socially responsible investing to persuade corporate management to act in a socially desirable manner is clearly a question of interest. This is difficult to answer, in part because of difficulties in defining what constitutes a socially desirable outcome. Cullis, Jones and Lewis (2006) provide a thorough review of the related literature and conclude that socially responsible investing seems to be capable of influencing firm behavior, at least to some extent. The question remains as to how significantly corporate behavior is influenced. This is an important question because, as Cullis, Jones and Lewis' review suggests, socially responsible investors may realize lower risk-adjusted returns, relative to other less constrained investors. Socially responsible investors may be willing to incur such a financial penalty if they knew their behavior was going to influence firms to act in a socially responsible manner. They likely would not be willing to incur this penalty if the influence on firms was insignificant.

We believe it is important to examine the behavior of the management of socially responsible funds. Arguably, fund managers more committed to the idea of ethical behavior or social responsibility could be expected to better achieve the desired outcome of positively affecting firm behavior. If fund managers instead were motivated solely by

by profit and not committed to the concept of social responsibility, they may be less determined to pursue investment that would have the desired effect on firms' actions.

A fund's fee structure and turnover ratio can provide an indication of the fund manager's commitment to ethics and social responsibility. Mutual funds committed to social responsibility should be more likely to limit the costs of trading (management fees, marketing fees, and transactions costs as a result of turnover) to investors. Mutual funds not interested in social responsibility are more likely to maximize management fees.

As noted in Cullis, Jones, and Lewis (2006), there is mixed evidence regarding the financial performance of socially responsible funds. Most evidence suggests that social funds return comparable, or lower, risk-adjusted returns relative to unconstrained firms. While the evidence one way or another is not conclusive, there may be a financial trade-off for investing in socially responsible funds. Thus, we might expect socially responsible investors to accept the chance of a financial penalty as a trade-off for realizing the non-financial utility of investing in socially responsible firms.

Sirri and Tufano (1998) suggest that investors tend to chase returns. Mutual funds that exhibit superior performance in a certain period attract higher flows into the fund the next period, other things constant. Mutual funds that exhibit inferior performance have lower flows subsequently, but the magnitude of the flow change is not as great as is seen on the positive side. Given that socially responsible investors apparently place less relative importance on financial returns than other investors, we expect that flows into and out of socially responsible mutual funds would be less sensitive to return performance, in comparison to traditional funds.

III. Data and Sample

We collected domestic socially responsible mutual funds and a matching sample of conventional mutual funds from MorningStar.com. Domestic equity ethical funds were selected using Morningstar's screening feature, and then we chose matching domestic equity funds based on fund investment styles identified by Morningstar (small, medium and large company equity growth funds; small, medium and large company equity income funds; and small, medium and large company equity blended funds). Both groups were constrained so that for any fund family (e.g., Vanguard, Franklin, etc.) only one fund was included for each of the investment styles. Fund returns and characteristics are taken from the CRSP Survivor-Biasfree U.S. Mutual Fund Database. Our sample spans January 1990 to December 2007, and yielded 120 ethical funds and 157 matching funds.

Table I provides several characteristics of the funds over the sample period, such as mean ages, size (TNA), turnover, the percentage of firms with either front-end or back-end loads, 12b1 (marketing) fees and non-12b1 (management) fees for both ethical funds and matching funds. As can be seen, the socially responsible funds are significantly younger and smaller than the control funds. The variables relating to fees and turnover

are of more interest as they are indicative of management's commitment to social responsibility.

Table I. Characteristics of U.S. Ethical Funds and Controlling Mutual Funds

This table presents the characteristics of U.S. ethical funds and the matching conventional mutual funds (control funds) during the period of 1990 to 2007. Total net assets (TNA), turnover, load, 12b1 fees (in percentage) and non12b1 fees (in percentage) are first averaged across funds each month, and then averaged over the whole time period. The turnover ratio is the minimum of aggregate purchases of securities or aggregate sales of securities, divided by the average total net assets of the fund. Load is the percentage of

	Age	TNA (Million)	12b1Fee (%)	Non12b1Fee(%)	Turnover	Load
Ethical Funds	5.47 (1.00)	109.86 (28.17)	0.32 (0.04)	1.09 (0.12)	0.73 (0.22)	0.36 (0.17)
Control Funds	8.21 (1.20)	390.95 (147.25)	0.18 (0.02)	1.14 (0.08)	0.96 (0.32)	0.47 (0.12)
Difference	-2.75*** (1.11)	-281.09*** (107.34)	0.14*** (0.03)	-0.05*** (0.10)	-0.23*** (0.28)	-0.11*** (0.15)

funds that charge either front-end load or back-end load. Age is the average life of funds in the sample, in terms of years, where fund life is defined as the time between the first and last reported monthly returns. Inside parentheses are the standard deviations. *** denotes significance at 1% level.

Marketing activities generally would be expected to benefit the fund itself more than the investors in the fund (Freeman, 2007). If socially responsible fund managers are committed to ethical behavior, we would expect 12b1 fees, associated with marketing the fund, to be lower for the ethical firms. However, 12b1 fees are significantly higher for the ethical group. This may be an indication that socially responsible funds are not fully committed to ethical behavior. Alternatively, these funds may believe that additional marketing expenses are necessary because of the unique challenges of promoting socially responsible funds. Traditional funds may be able to self-promote based on their return performance, but if social funds are perceived by investors to provide lower returns relative to comparable traditional funds, higher marketing expenditures may be necessary to keep the fund, along with its social agenda, alive.

Non-12b1 fees are significantly lower for ethical funds. This provides some evidence in support of the hypothesis that socially responsible fund managers are interested in ethical behavior. However, because of the higher 12b1 fees, total expense fees are significantly higher for the socially responsible sample.

The turnover ratio is significantly lower for socially responsible funds. This is contrasted with ethical behavior by socially responsible fund managers as it indicates that they are reluctant to pass on the additional transaction costs to investors. However, we should note that ethical funds' lower turnover may be because the ethical behavior of the firms in their portfolios is more stable than a typical firm's less predictable financial performance. So, while a company's financial performance may fluctuate greatly, causing the firm to go in and out of analysts' favor (necessitating higher portfolio turnover), the ethical/non-ethical behavior of a particular firm is likely less variable. Finally, turnover may be lower for socially responsible firms simply because there is a smaller universe of ethical firms to choose from.

Our evidence documents a significantly lower percentage of socially responsible funds charge either a front-end or back-end load. This is consistent with ethical behavior by socially responsible fund managers, especially considering the well-established negative relationship between loads and performance.

Table II reports the financial performance, in terms of monthly returns, of the ethical funds and the control sample. We observe no significant difference in either raw or risk adjusted returns for the two groups.

Table II. Performance of Ethical Mutual Funds

This table reports the average of cross-sectional fund raw returns and risk adjusted performance (Alpha). Alpha is estimated with the Carhart (1997) 4-factor model. Inside parentheses are the standard deviations.

	RawReturns	Alpha
Ethical Funds	0.79 (3.15)	-0.11 (0.66)
Control Funds	1.04 (4.24)	-0.43 (4.71)
Difference	-0.26 (3.75)	0.33 (3.33)
P-value (Difference)	0.49	0.40

Next, we examine investors' response to financial performance. We estimate the following regression equation:

$$FLOW_{i,t} = a + B_1Expense_{i,t-1} + B_2Size_{i,t-1} + B_3RawRet_{i,t-1} + B_4RawRet*EthicalDum_{i,t-1} + B_5EthicalDum + E$$

FLOW measures the quarterly percentage growth in a fund's total net assets (TNA) as a result of new money flowing into the fund (or existing money withdrawn), after controlling for growth due to the returns earned by each fund's beginning-of-period assets. We include the control variables *Expense* and *Size*. *Expense* includes the total

expenses including 12b1 and management fees and should be negatively related to *FLOW*. *Size*, measured as the log of the total net assets of the fund in the prior period, is included since similar absolute flows will have different percentage effects on funds of different size.

RawRet is the fund's return for the preceding quarter and tests investors' responsiveness to performance. A positive coefficient would indicate that investors chase positive returns and flee from negative fund returns. We include *EthicalDum*, a (0,1) binary variable (1 = ethical fund), to control for any increase in flow into social funds unrelated to financial performance. This variable is necessary because we know that, over our sample period, investment in socially responsible mutual funds became a much more accepted investment practice. An increase in social awareness by investors could create significant inflows to ethical funds unrelated to financial performance. We include the interaction term *RawRet*EthicalDum* to test for differential responses to financial performance by socially responsible investors. *RawRet*EthicalDum* is the focal point of the regressions because it most directly measures the commitment of ethical investors.

Table III provides the regression results. In Panel A, financial performance is measured by raw returns. We observe similar results to Sirri and Tufano (1998) in that investors, in general, appear sensitive to a fund's financial performance. This can be seen by the positive and significant coefficient for *RawRet*. Periods of superior performance lead to higher levels of new money flowing into the funds, while negative returns tend to reduce fund flows. As expected, *Size* lowers the flows when they are measured as a percentage change and ethical funds (*EthicalDum*) exhibit statistically significant growth over the study period independent of fund performance.

The negative and significant coefficient for *RawRet*EthicalDum* provides support for our hypothesis that investors in socially responsible mutual funds are less sensitive to financial performance than traditional fund investors. This result may be interpreted as ethical fund investors being committed to a socially responsible agenda in that they are willing to "stay the course" with little regard to fund returns. As shown in Panel B, where performance is measured by market-adjusted returns, these conclusion are robust with regard to the performance metric.

Table III. Past Performance and Fund Flows

This table reports the quarterly Fama and Macbeth (1973) cross-sectional estimation of fund flows on the fund's past performance. Fund flows is defined as

$$FLOW_{i,t} = \frac{TNA_{i,t} - TNA_{i,t-1} * (1 + R_{i,t})}{TNA_{i,t-1}}$$

where $TNA_{i,t}$ is fund i 's total net assets during the last quarter t ; $R_{i,t}$ is the fund's compounded return during last quarter. This flow measurement reflects the percentage growth of a fund in excess of the growth if there was no change in fund flows, after controlling for fund merging activities. Significance levels are noted at the .01 (***) and .05 (**) levels.

**A. Pooled Regressions:
Using Raw Returns as Control Variable**

Expense	3.23	
Tstat	1.17	
Size	-0.04	
Tstat	-3.82	***
RawRet	2.67	
Tstat	3.50	***
Ret*EthicalDum	-2.62	
Tttat	-2.78	***
EthicalDum	0.19	
Tstat	2.69	***
adjrsq	0.12	

**B. Pooled Regressions:
Using the Abnormal Returns (Raw Returns-Market Returns) as Control Variable**

Expense	10.92	
Tstat	4.74	***
Size	-0.02	
Tstat	-3.41	***
RawRet-Mkt	1.31	
Tstat	3.60	***
Ret*EthicalDum	-1.33	
Tstat	-2.19	**
EthicalDum	0.09	
Tstat	1.78	**
adjrsq	0.09	

IV. Conclusions

We examine the fee structures and turnover ratios of socially responsible mutual funds in order to determine the degree of management commitment to social responsibility. We find support for this in that a smaller percentage of ethical funds charge front-end or back-end loads, and turnover ratios and management fees are lower for ethical funds. However, 12b1 marketing fees are higher for ethical funds. This may indicate a lack of concern for ethics by these managers, or that ethical funds may require more marketing because of their newness or perceptions that they provide inferior performance.

In terms of investor response to financial performance, we find evidence to suggest that investors in socially responsible firms are not as concerned with financial performance as more traditional investors. While traditional investors chase positive performance, socially responsible investors do not seem to exhibit this behavior, or at least not to the degree that other investors do. We conclude, therefore, that these investors are committed to their social agendas.

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