

The ethical and non ethical funds: an age-cohort analysis

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Abstract

The international financial systems have always based their funding and investment activities on the parameters as performance, capital and interest. However, the financial crisis that struck the United States and invested Europe has shifted the attention towards the theme of an ethically oriented finance. This one is based on the assumption that the operators of the financial sector use as benchmarks the capacity of producing social and environmental benefits, leading thus to greater corporate crisis prevention and development of a sustainable economy. The aim of this research is to analyze a data set of mutual funds under Italian and abroad law, collected on www.morningstar.com and based on 109 ethical funds and 110 non ethical funds. The aim is to highlight some funds characteristics such as performance, typology, geographical area of location, management fees, investments selecting criteria. Particularly the study is developed through a cohort analysis to put in evidence the performances of the cohort of funds in the period 1980-2008. The research highlights how some factors have a positive impact on the survival of mutual funds and that these award especially the ethical funds.

Keywords: ethical fund, non ethical fund, cohort analysis

Introduction

In the financial global current crisis, the concept of socially responsible can be a useful tool in support of finance and a basis for the investment choices. The ethical finance is created to support the activities and met the needs of the persons that carry out social investments for which the selection and management process is carried out according to not only economic criteria but also social and environmental criteria. It is known that an ethically-oriented finance is based on the assumption that operators of the financial sector use as a benchmark the ability of the investment to produce social and environmental benefits. The change of behavior in a more social sense should fund all those businesses that produce social and environmental benefits, leading thus to a greater corporate crisis prevention and to a development of a sustainable economy (Capriglione, 1997; Rothschild, 1993; Sen, 1986; Signori et al., 2005).

It is important review the international markets guidance: financial intermediaries, such as banks, the mutual funds and the financial institutions, promote the ethical portfolio selection through the ethical funds. The aim of this research is to analyze a data set of mutual funds under Italian and abroad law, collected on www.morningstar.com and based on 109 ethical funds and 110 non ethical funds. The aim is to highlight some funds characteristics such as performance, typology, geographical area of location, management fees, investments selecting criteria. Particularly the study is developed through a cohort analysis to put in evidence the performances of the cohort of funds in the period 1980-2008. The remainder of the paper is organized as follows. Section 2 discusses the ethical mutual funds market, sections 3 and 4 present the data and the methodology, section 5 describes the principal findings, while section 5 concludes the paper.

The ethical mutual funds market

The ethical investment has been defined as «a set of approaches which include social or ethical goals or constraints as well as more conventional financial criteria in decisions over whether to acquire, hold, or dispose of a particular investment (Cowton, 1999, p. 60). Social investment includes a number of activities, such as social screening (e.g., ethical mutual funds), community investment (e.g., investment in local development initiatives), and shareholder activism (e.g., shareholder resolutions or active dialogue with companies). The activity of social screening and particularly ethical mutual funds is the most popular of these categories of social investment, and appears to be drawing the greatest attention among investors.

The ethical mutual funds do not invest in companies that have a low rating or are considered not ethically-oriented by the fund managers (Beltratti & Miraglia, 2001). The ethical mutual funds are instruments similar to mutual funds of ordinary, not only for the management structure but also for the financial and regulatory aspects. In particular, the ethical funds can be distinguished according to the usual classifications applied to products of traditional asset management (securities and real estate, opened and closed, equities, balanced, liquid, flexible, etc.). However, they differ from the traditional mutual funds in the process of selecting investments to be included in the portfolio. All ethical mutual funds use a series of screens or filters to either intentionally avoid (i.e., exclusionary or negative screens) and/or intentionally select (i.e., qualitative or positive screens) certain companies as part of the fund's portfolio (Cory, 2001; Dal Maso & Bartolomeo, 2001; Lewis, 2002).

Particularly, there are ethical funds which:

1. avoid investing in companies involved in tobacco, alcohol, gambling, military, firearms, or nuclear weapons;

2. avoid companies connected with child labor or that fail to respect animal rights, gay and lesbian rights, diversity, or feminism;
3. include companies that best support the community, diversity, employee relations, the environment, or product quality and safety (Kinder and Domini, 1997).

The ethical funds development is of interest for academic finance, particularly with respect to performance measurement. The empirical analysis of ethical funds dates back as early as 1972 (Moskowitz, 1972). Since then numerous studies have investigated the performance of these investments and compared the findings to the performance of conventional assets. The results of many of these studies show that the performance differential of ethical funds and traditionally managed funds does not deviate significantly from zero. Some studies (Derwall, Guenster, Bauer & Koedijk, 2005) even find an out-performance of ethical funds portfolios. This is a puzzling result because ethical funds are restricted to a subset of the total investment universe and should therefore exhibit – at best – the same performance as comparable conventional portfolios.

The ethical mutual funds have grown significantly over the past two decades. Despite the ethical funds are still a small segment of the international capital markets. In 2007, according to Eurosif research, the total asset under management in Europe has reached 2.665 trillion of euros. This total amount is made up of 511.7 billion of euro for Core SRI and 2.154 trillion of euros for Broad SRI. The European market of ethical funds has increased from 1.033 trillion of euros in 2005 to 2.665 trillion of euros at the end of 2007. On a like-for-like basis¹⁰, this represents a growth of 102% over two years (Eurosif, 2008).

In 2008, a new generation of ethical funds is emerging, the thematic funds, driven by investors' focus on specific sustainability themes in the market where they see strong growth potential. Technological innovations, the creation of new markets through government regulations that reward sustainable practices (such as carbon markets), and an increased spending on health, by both governments and consumers all present investment opportunities. Particularly, the funds focusing on themes such as water, climate change, renewable energy, eco-efficiency or health and nutrition, have multiplied since 2006.

In Italy, the ethical funds are still a small portion of total assets under management. In 2007, the Core SRI accounts for about 3.4 billion of euros, which means 0.32% of total assets under management to national level. The growth rate since the last survey in 2006 is 23% for Core SRI. The Broad SRI has increased remarkably: from 0.09 billion of euros in 2005 to 240 billion of euros in 2007.

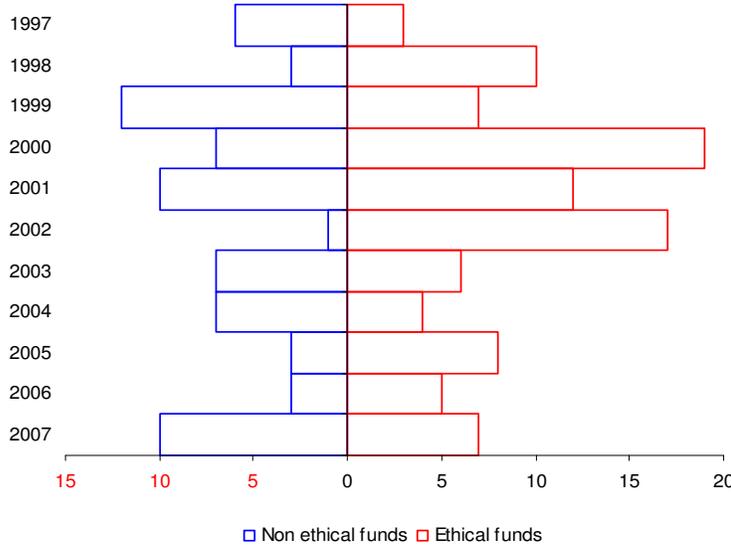
The prevalence of the retail component, as opposed to the institutional one, in the Italian SRI market still sets it apart from other markets. Unlike other European markets, the institutional investor market is still very small (6% of total Core SRI) due to the relatively recent start of the pension system (second and third pillars). Despite the current retail market crisis, investment funds are still the preferred investment vehicle for SRI investors. The market is very concentrated with the first three players accounting for more than 95% of total asset under management. The crisis of the Italian funds industry seems structural and only major changes in regulation, as well as the market forces, could adjust the situation. However, even in the most optimistic scenario, SRI in the retail sector is likely to remain a niche market.

Data

The data analyzed refer to the mutual funds under Italian and abroad law, representative of ethical and non ethical funds (Figure 1). The data are collected on www.morningstar.com and they are related to some funds characteristics such as

performance, typology, geographical area of membership, management fees, investment selecting criteria.

Figure 1: The pyramid of the mutual funds classified by date of inception



As regards the ethical sector, it is represented by 109 funds and it is divided in the different categories indicated by Assogestioni: equity (76), balanced (13) and fixed income (20). As regards the non ethical sector, it is representative by 110 funds and it is based on the following categories: equity (37), balanced (34) and fixed income (39) (Figure 2).

Figure 2: The categories of mutual funds



The asset of the ethical funds is in media equal to 275,96 million of euros, while the asset of the non ethical funds is on average equal to 156,04 million of euros. Furthermore, the data are analyzed by analysis of the performance recorded from the ethical funds and non ethical on 30 December 2008 to 10 years. Particularly, it is noted that the performance on average registered by the traditional funds is better than that registered by the ethical funds and that the minimum and maximum values are registered on a 1 year (Table 1).

Table 1: The ethical and non ethical funds performances

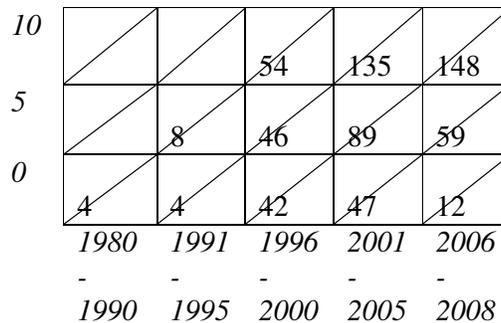
| | Ethical funds | | | | | | |
|----------------|----------------------|-------|----------|--------|---------|---------|----------|
| | 3 months | | 6 months | 1 year | 3 years | 5 years | 10 years |
| <i>Average</i> | -6.54 | -3.18 | -14.82 | -19.50 | 0.32 | 4.87 | 0.64 |

| | | | | | | | |
|--------------------------|----------------|---------------|---------------|---------------|----------------|----------------|-----------------|
| <i>Dev_st</i> | 4.16 | 3.14 | 7.36 | 11.87 | 3.47 | 3.66 | 2.15 |
| <i>Min</i> | -16.72 | -13.55 | -28.52 | -44.54 | -9.77 | -2.54 | -3.29 |
| <i>Max</i> | 12.49 | 4.59 | 0.39 | 24.52 | 9.51 | 14.04 | 3.81 |
| <i>Asimmetry</i> | 0.80 | -0.77 | 0.76 | 0.87 | -0.22 | 0.44 | -0.42 |
| Non ethical funds | | | | | | | |
| | | 3 | 6 | | | | |
| | <i>1 month</i> | <i>months</i> | <i>months</i> | <i>1 year</i> | <i>3 years</i> | <i>5 years</i> | <i>10 years</i> |
| <i>Average</i> | -0.87 | -8.13 | -11.76 | -18.20 | -5.38 | -0.27 | 0.12 |
| <i>Dev_st</i> | 2.23 | 10.72 | 16.28 | 20.83 | 6.87 | 2.64 | 3.05 |
| <i>Min</i> | -8.18 | -33.43 | -49.02 | -53.60 | -20.66 | -6.85 | -5.85 |
| <i>Max</i> | 2.50 | 6.92 | 15.16 | 11.33 | 3.70 | 6.85 | 3.52 |
| <i>Asimmetry</i> | -0.78 | -0.38 | -0.23 | -0.19 | -0.27 | -0.02 | -0.77 |

The age-cohort analysis

The study is developed through a cohort analysis to put in evidence the performances of the cohort of funds in the period 1980-2008. The funds of the sample were grouped into five cohorts with five years amplitude except of the first that is broader and of the last that is less broad. Each cohort was analyzed highlighting the performance registered in the different periods and comparing the performance of each cohort with that recorded by generations of non ethical funds. The age-cohort of the ethical funds is represented in the Figure 3.

Figure 3: The age-cohort of the ethical funds



The first generation includes the funds born between 1986 and 1990 that are equal to 4 in the first year of life, to 8 after five years and to 54 after ten years. The second generation is based on 4 funds in the first year, too. However it became more consistent during the years with 46 funds after five years and 135 funds after ten years. The third and fourth generations are similar in the first year with respectively 42 and 47 funds, but we can observe as the third cohort is wider than all the cohorts analyzed. Interesting observations may be comparing these age-cohorts with that based on non ethical funds (Figure 4).

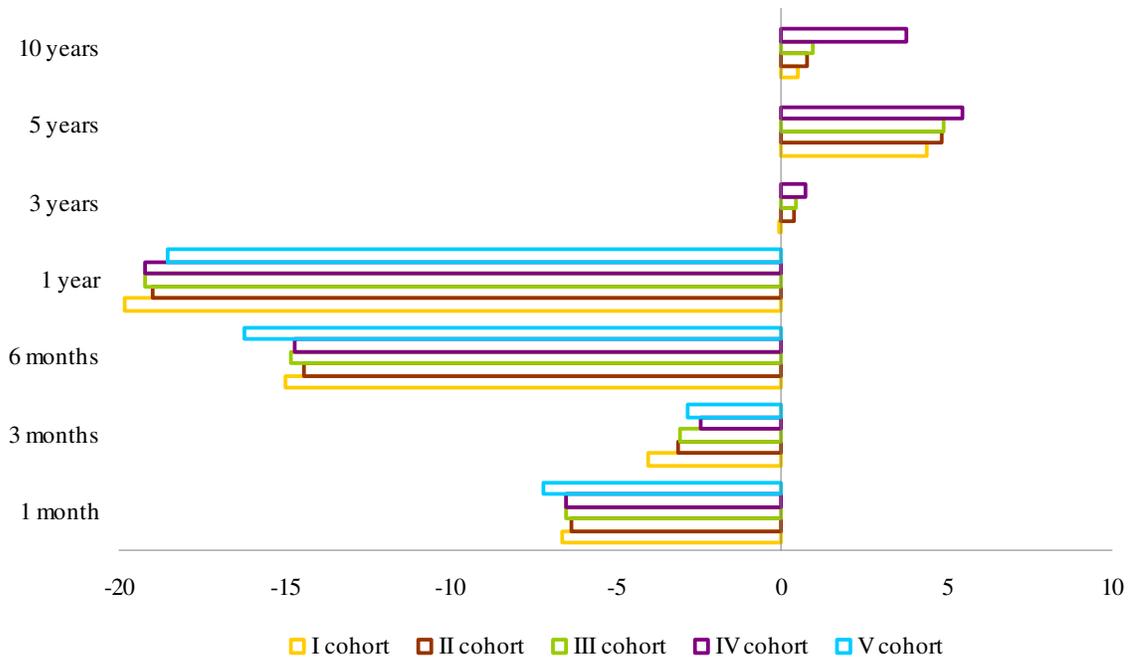
Figure 4: The age-cohort of the non ethical funds

| | | | | | |
|----|------|------|------|------|------|
| 10 | | | 84 | 142 | 119 |
| 5 | | 20 | 64 | 78 | 41 |
| 0 | 6 | 14 | 50 | 28 | 25 |
| | 1980 | 1991 | 1996 | 2001 | 2006 |
| | - | - | - | - | - |
| | 1990 | 1995 | 2000 | 2005 | 2008 |

The empirical results

From the analysis of the performance of each cohorts we can observe as the ethical funds are characterized by a negative value respects to the non ethical funds. As regards the first generation, the yield up to three years is positive, while that in one year is very negative and tended to decrease in recent months. The other four generations have positive returns for up to three years and have negative values for a year although in decreasing order. Particularly, values are in sharp decline are recorded in the second and fourth cohort of funds (Figure 5).

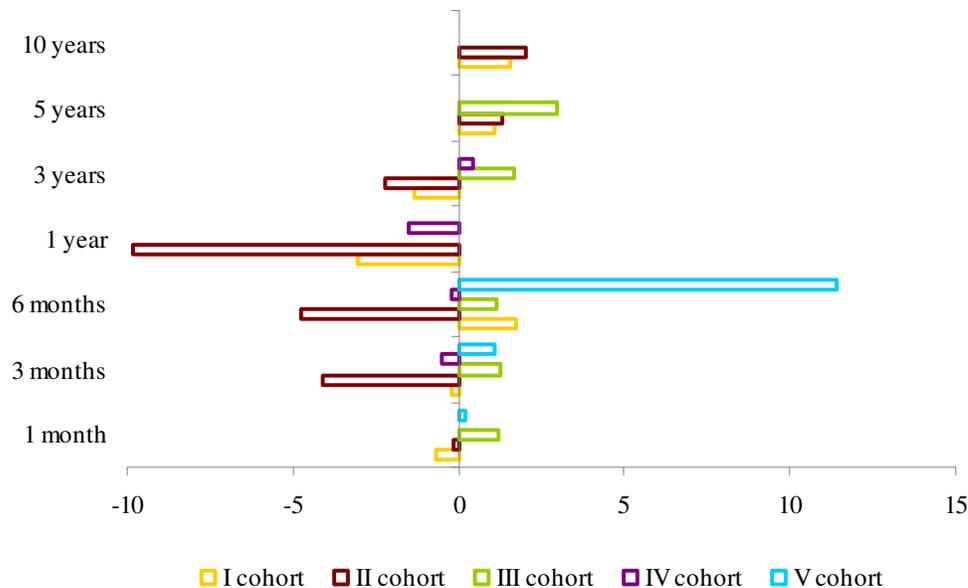
Figure 5: The performance of the ethical funds cohorts



Instead of the non ethical funds we can observe different values. Specifically all the cohorts have an alternative performance trend. In fact the first and the second generations have a performance that worsens in the last months, while the fifth generation is characterized by a high performance (Figure 6). The high performance on 1 year of the fifth generation is

due to mostly presence of the balanced and bond funds that have governed better signals to the financial crisis of last year.

Figure 6: The performance of the non ethical funds cohorts



The comparison between the two figures shows that before of the financial crisis the generations of ethical funds showed significantly higher performance compared to the generations of non ethical funds. This indicates that the inclusion of ethical criteria in portfolio choice improves the performance of funds.

During the financial markets crisis both categories of funds showed negative signals. However, the generations of ethical funds are most affected because our sample is composed predominantly of Italian equity funds that use an outdated approach. Particularly, many Italian funds focus only on negative criteria to avoid investing in companies involved in tobacco, alcohol, gambling, military, firearms or nuclear weapons; they do not use positive criteria to select companies that best support the community, diversity, employee relations, the environment, or product quality and safety.

Indeed, a company listed on the Stock Market that is able to offer guarantees about the environment protection and respect for human rights and workers, or to adopt transparency standards in business management and managers remuneration, and to maintain a relationship of dialogue constructively with shareholders, denotes a state of good health. All these characteristics show that, in the long period, the company will reach a more stability; it will be able to improve its ability to create value, and thus get a better financial performance.

However, in Italy, the complex and rigorous analysis that allows identifying the socially responsible companies is often lacking; in fact:

1. on 16 ethical funds located in Italy, only three (Credit Suisse Equity Fund Future Energy, Valori Responsabili Azionario and Dexia Eqs Sustainable Green Planet) invest on financial securities;
2. of these three funds, only two (Credit Suisse Equity Fund Future Energy and Valori Responsabili Azionario) recorded a performance at one year significantly higher than the industry average and respectively equal to -3.92% and -15.90%;

3. all other ethical funds available for the Italian saver displayed on financial securities in high percentages.

Conclusions

The devastating effects produced by the latest crisis of the markets have shown, clearly, the need not to continue to assert the uniqueness of the rules that underlie the financial assets. For example, after the mortgage crisis the most important rating agencies have been accused of failure and have been subject to strong criticism for not being able to promptly assess the risk of structured products.

The ethical funds should, therefore, represent an attempt to replace the use of money to the social relations. In this sense, the owners and managers of financial assets begin to integrate the risk and return analysis with environmental and social considerations. Consequently, issuers are also measured according to their level of social responsibility.

The creation of socially responsible securities portfolios implies recognition of the efforts deployed by the best companies in terms of human rights respect and total lack of involvement in illegal activities.

The socially responsible finance could then activate a virtuous cycle that can produce benefits for individual stakeholders and for society suggesting, moreover, a particular pattern of behavior that precludes the easy profit and the absence of values. It is necessary to recover the moral aspect also and especially in the selection of investments. The data collected and processed confirm this recovery: if the ethical funds continue to outperform the traditional investment instruments in the future years, showing an increase in the number and underwriters of socially responsible, then you can say that the ethical finance won partially his bet.

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