

The Cost of Values

Ethical funds protect human rights and the environment. Do they protect your bottom line?

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IS YOUR RRSP MISBEHAVING WHEN YOU sleep? Is your money really green? These questions have taken centre stage with the emergence of ethical funds. To be honest, I've long thought that limiting your portfolio to only so-called ethical companies does yourself a financial disservice. It's akin to the arbitrariness of only investing in companies whose ticker symbols exclude the letter S. You might get lucky once or twice, but you've narrowed your financial choices — never a good strategy.

In practice, I've always tried to get the highest return on my investment portfolio — with no arbitrary constraints on what can be purchased — and then use my investment gains to give to charity, adopt a road or buy a forest. Financial economists call this kind of thinking a separation theorem; management should locate investments that generate the highest value for the company, while shareholders decide what to do with the dividends.

Others have taken the opposite view, arguing that ethical-friendly companies are likely to outperform their sinful colleagues by virtue of their long-term and global outlook. For example, a company that provides in-house day care to employees will boost morale

and might increase productivity. Or, companies that avoid any involvement with tobacco and firearms might save on crippling litigation costs.

Until recently, the debate centred on theoretical arguments with scant empirical evidence. But a new study by researchers in the Netherlands is shedding light on whether ethical investors are penalized by capital markets. The authors collected historical investment returns from more than 60 self-classified ethical funds from 10 countries. Unfortunately, their analysis did not include Canada, but I have tried to fill in some of the gaps.

The results are interesting. First, despite all the talk about ethical investing, the ethical (retail) mutual fund market is very small. In the U.S., which has the most ethical funds, only 2.26% of mutual fund assets are invested in ethical funds. The ethical market is smallest in France, with only 0.01% of assets, while Canada comes in a modest but respectable 1.0%.

Nevertheless, investors have over 500 ethical funds to choose from on a global scale. Some have been around for over 20 years, while most are Johnny-come-latelies.

The study examined ethical investment performance over time. As I said, it's always been my perception that ethical funds do worse on average than sinful funds, while ethical fund managers claim their performance is better since they keep out the sinners. In fact, it appears that ethical funds do neither better nor worse consistently.

A few anomalies are persistent, though. First, ethical funds in the U.K. perform better than those in the U.S. and the rest of Europe.



Second, newer funds tend to do worse than older funds. It seems to take time before ethical funds overcome the losses associated with their restricted investment opportunity set. Perhaps it's a lack of experience on the part of fund management, or too strict initial screening criteria, which limit the start-ups' performance. For example, at first, a fund may be committed to invest only in companies as pure as Mother Teresa, which obviously limits choices and performance. Over time, however, they may lower their standards and improve their returns.

But, once you take all the evidence, the authors' closing statement is telling: "We find no evidence that investors are penalized for selecting ethical funds ... they are no better, or worse, than any other mutual fund."

If ethical funds want to continue to attract our money, it's a finding they'd do well to promote. In the meantime, if you want to mix some profit with your investing peace of mind, you should wait for them to produce a reasonable track record before you open your wallet. **B**

DOING THE RIGHT THING At US\$170 billion in assets, ethical mutual funds are a small but growing market force

Country	# of ethical funds	Invested assets in millions US\$	% of all funds
Belgium	26	602	0.80%
France	14	371	0.01%
Germany	22	1,317	0.04%
Italy	5	2,077	0.45%
Sweden	42	1,190	1.46%
Switzerland	22	1,011	1.12%
Netherlands	11	1,309	1.20%
United Kingdom	55	6,390	1.35%
United States	230	153,000	2.26%
Canada	49	3,500	1.00%

Sources: "International Evidence on Ethical Mutual Fund Performance and Investment Style" by R. Bauer, K. Koedijk, and R. Otten; Morningstar and Globe HySales