THE COST OF SOCIALLY RESPONSIBLE INVESTING

Windham Investment Review

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Socially responsible investors choose not to invest in companies whose behavior they judge to be at odds with the social good as they perceive it. Moreover, some proponents of socially responsible investing assert that "good" companies - those in harmony with the social good – perform as well or better than "bad companies" – those whose behavior is socially irresponsible. They conclude, therefore, that socially responsible investing is without cost and may even enhance performance. We withhold judgment about this assertion of market inefficiency, but we reject the claim that socially responsible investing is without cost for the following reasons. If investors are motivated to own good companies because they expect higher returns from them, they are not socially responsible investors. They are simply pursuing an active management strategy centered on the belief that good companies generate above average returns and bad companies generate below average returns.

Having argued that socially responsible investing is costly, we do not necessarily oppose it; rather, we argue that investors should be informed of its cost. Suppose, for example, that exclusion of tobacco companies reduces return. Some may argue that this cost is worth incurring because it focuses attention on the issue or because it may influence company behavior. Others might claim that it would be more effective to collect the incremental return and deploy it directly toward treatment of smoking related illnesses, or toward policies designed to curb smoking. Without knowledge of the expected cost, it would be difficult to evaluate this tradeoff.

01 Methodology

We employ a simulation technique known as Monte Carlo simulation to measure the cost of socially responsible investing. We use this technique to compare the performance of a skillful investor in an unrestricted investment universe with the performance of on investor in a restricted investment universe. We repeat this process for many thousands of hypothetical investors and summarize the results.

02 Results

We simulate the cost of socially responsible investing under a variety of scenarios. We vary the hypothetical investment universes to model four commonly used benchmarks: the Standard & Poors 500, the MSCI EAFE, the MSCI World, and the MSCI All Country World Index. We select portfolios of 100 and 250 securities, assuming a variety of skill levels ranging from unskilled (50%) to very skilled (60%). We estimate the costs associated with excluding 10%, 20%, and 30% of the securities due to not meeting socially responsibility criteria.

Exhibit 1 shows the cost of socially responsible investing for an investor who chooses 100 securities from a variety of equity indexes.

Exhibit 1: Cost of Socially Responsible Investing for 100 Stock Portfolios

S&P 500 Dispersion (35%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	0.02%	0.08%	0.17%	0.23%	0.32%	0.42%
20%	-0.03%	0.17%	0.37%	0.53%	0.71%	0.88%
30%	0.01%	0.31%	0.57%	0.88%	1.18%	1.50%
MSCI EAFE Dispersion (39%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	-0.02%	0.09%	0.15%	0.27%	0.38%	0.49%
20%	0.02%	0.18%	0.39%	0.60%	0.79%	1.02%
30%	-0.02%	0.36%	0.63%	0.98%	1.28%	1.60%
MSCI World Dispersion (44%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	-0.02%	0.12%	0.23%	0.29%	0.40%	0.51%
20%	-0.03%	0.21%	0.47%	0.65%	0.93%	1.15%
30%	-0.04%	0.35%	0.73%	1.07%	1.44%	1.86%
S&P 500 Dispersion (64%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	-0.01%	0.19%	0.28%	0.46%	0.61%	0.78%
20%	0.02%	0.31%	0.66%	1.00%	1.28%	1.62%
30%	-0.07%	0.58%	1.06%	1.63%	2.22%	2.71%

Exhibit 1 reveals that an investor with 52% skill who selects from a universe similar to that of the Standard & Poors 500 Index and who foregoes investment in 10% of the securities should expect to give up 0.08% annually to an investor of equal skill who selects securities from an unrestricted universe. This cost rises with the investor's skill level, the number of securities excluded from the universe, and the cross-sectional dispersion of the universe. For example, an investor with 60% skill who selects from a universe similar to that of the MSCI All Country World Index, and who foregoes investment in 30% of the securities, should expect to give up 2.71% annually to an unrestricted investor.

Exhibit 2 presents the same information for investors who select portfolios of 250 securities.

Exhibit 2: Cost of Socially Responsible Investing for 250 Stock Portfolios

S&P 500 Dispersion (35%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	0.00%	0.12%	0.22%	0.37%	0.48%	0.60%
20%	-0.02%	0.25%	0.53%	0.79%	1.05%	1.32%
30%	-0.02%	0.47%	0.87%	1.36%	1.78%	2.24%
MSCI EAFE Dispersion (39%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	-0.01%	0.12%	0.29%	0.39%	0.53%	0.66%
20%	0.01%	0.27%	0.58%	0.87%	1.19%	1.47%
30%	-0.03%	0.49%	0.99%	1.48%	2.00%	2.49%
MSCI World Dispersion (44%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	0.00%	0.13%	0.30%	0.43%	0.60%	0.76%
20%	-0.02%	0.33%	0.66%	1.01%	1.34%	1.70%
30%	-0.04%	0.57%	1.08%	1.68%	2.24%	2.82%
S&P 500 Dispersion (64%)						
Fraction of Excluded Securities	Fraction of Correct Choices					
	50%	52%	54%	56%	58%	60%
10%	0.01%	0.21%	0.46%	0.66%	0.86%	1.09%
20%	-0.02%	0.51%	0.94%	1.44%	1.94%	2.44%
30%	-0.01%	0.75%	1.64%	2.41%	3.28%	4.13%

Exhibit 2 reveals that the cost of socially responsible investing rises as the number of securities in the portfolio grows. An investor with 54% skill who selects 100 securities from a universe similar to that of the Standard & Poors 500 incurs a cost of 0.37% by foregoing investment in 20% of the securities. If this investor were to increase the number of securities to 250, her cost would rise to 0.53%. The cost rises because the investor must substitute progressively lower ranked securities as she expands the number of securities in the portfolio.

Our estimates of the cost of socially responsible investing are expressed as percentages of portfolio value for a single year. Exhibit 3 converts these percentage costs into their cumulative dollar values assuming portfolios of 100 securities, 52% skill, 20% exclusion, an initial portfolio value of $1 billion, and an underlying market return of 8.0% for periods of five, 10 and 20 years. Exhibit 4 presents the same information under the same assumptions with the sole exception that the portfolios contain 250 securities.

Exhibit 3: Multi-Year Cost of Socially Responsible Investing for 100 Stock Portfolios, 52% Correct Choices, 20% Excluded

Years	SP500	MSCI EAFE	MSCI World	MSCI ACWI
5	$11,598,976.22	$12,203,492.52	$14,447,678.02	$20,727,416.49
10	$33,950,866.59	$35,712,943.15	$42,248,022.51	$60,481,124.22
20	$145,442,087.77	$152,927,717.10	$180,635,728.36	$257,490,455.50

Exhibit 4: Multi-Year Cost of Socially Responsible Investing for 100 Stock Portfolios, 52% Correct Choices, 20% Excluded

Years	SP500	MSCI EAFE	MSCI World	MSCI ACWI
5	$16,943,637.34	$18,545,523.08	$21,985,289.85	$34,326,624.85
10	$49,504,437.29	$54,154,979.08	$64,123,854.33	$99,695,830.18
20	$211,302,044.97	$230,900,314.37	$272,765,315.39	$420,532,381.25

Exhibits 3 and 4 inject a harsh reality into the debate about socially responsible investing. A socially motivated investor can either exclude bad companies from her portfolio and thereby sacrifice vast sums of wealth through time or invest in an unrestricted fashion and deploy some or all of these funds directly toward reforming those who behave badly or mitigating the consequences of their bad behavior.

03 Summary

- We argue that investors should estimate the cost of socially responsible investing in order to ascertain whether it is preferable to invest without restriction and deploy the savings directly toward social improvement.
- We make no assumption about the relative performance of "good" companies and "bad" companies. We argue, though, that investors who select good companies because they expect them to outperform bad companies engage not in socially responsible investing but rather in active management. Socially responsible investing, by definition, requires investors to avoid bad companies even if they expect them to outperform good companies. The good news in this otherwise bleak story is that turbulence is both persistent and correlated with asset and strategy performance.
- The cost of socially responsible investing increases with the investor's skill, the cross-sectional dispersion of the universe, the fraction of the universe that is restricted, and the number of securities in the portfolio.
- Our simulations show that the cost of socially responsible investing is substantial for even moderately skilled investors. For example, an investor with 52% skill choosing 250 securities from a universe similar to that of the MSCI World Index and for which 20% of the securities are restricted should expect to sacrifice nearly $273 million over a 20-year period assuming an initial portfolio value of $1 billion and a market return of 8.0%.

References

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