

**Socially Responsible Mutual Funds:
Recent Performance and Other Issues
Relating to Portfolio Choice**

by

**Kelly Young
and
Dennis Proffitt**

**College of Business and Professional Studies
Grand Canyon University**

This paper is based upon Kelly Young's undergraduate Honor's Thesis, Grand Canyon University, May, 2003.

corresponding author:

Dennis Proffitt
(602) 589-2822

dproffitt@grand-canyon.edu

Socially Responsible Mutual Funds: Recent Performance and Other Issues

Relating to Portfolio Choice

God has made man a sociable creature. We expect benefits from human society, it is but equal that human society should receive benefits from us. We are beneficial to human society by the works of that special occupation in which we are to be employed, according to the order of God.¹ (Cotton Mather, Unitarian Minister, 1701).

Puritan virtue is dead and there is nothing to replace it. (Gore Vidal, novelist)

In today's world of corporate scandals and multiple awareness campaigns, society is questioning its core values and standards. We hear about top leaders lying and acting fraudulently, the news media report on global warming, the deadly effects of tobacco, and the harm to families caused by addictive gambling. All these issues cause people to consider what they believe and how their actions affirm their beliefs. As unethical business practices make the headlines, investors grow more concerned about compromising their personal values for financial gain. Many investors do not want to have their retirement supported by acts they deem immoral or unethical. In response, the financial industry created "socially responsible" investing (SRI).

¹ "The Annals of America: 1493-1973" *Encyclopedia Britannica*, Volume 1, 1976, page 39.

A Brief Introduction to SRI

Since the beginning of investing, there have been individuals who have attempted to allocate their capital with an eye to their values. The advent of the temperance movement in the 19th century encouraged many churches and other religious institutions to avoid the so-called “sin stocks” of alcohol, tobacco, and gambling. During the 1960s, opponents of the war in Vietnam led boycotts against defense contractors and firms in weapons-related industries. They also sought to have pension funds and university endowment funds divest of such stocks. In 1971, two Methodist ministers founded the Pax World Fund, the first socially responsible mutual fund. Its portfolio avoided both the sin stocks and weapons manufacturers. SRI grew in the 1980s as the world focused its attention on the practice of apartheid in South Africa. Since then, the number of causes championed through SRI has continued to grow. In addition to those mentioned above, firms’ environmental record, their hiring practices, their support for (or opposition to) abortion, economic investment in the local community, corporate governance practices, and charitable giving have all become key SRI issues.

Some funds take a more pro-active position in SRI, implementing “positive screens” in their portfolios. Funds with positive screens seek to include companies with practices like good minority hiring records, environmental records, or community relations.

Shareholder activism has emerged as a third SRI strategy. Shareholder activism calls on investors to participate in discussions with management, exercising their proxies and voting shareholder resolutions in a manner consistent with their social values. If the company’s behavior does not change, shareholder activists sell their holdings.

The main goals of this research are to resolve the conflicting beliefs of investors about SRI and to examine the returns of SRI in the recent bear market. We find that many investor assumptions and public statements about SRI are inconsistent with established research findings in the financial literature. This could be in part because most of the return data on SRI comes from the 1980s and 1990s, a period of rapid growth in equity values. No systematic examination of returns from SRI during the recent bear market exists.

In addition, equity markets have changed dramatically during recent years. A few of the factors causing these changes include:

- The number of choices available to socially responsible investors is much greater today than 20 years ago.
- The economy has shifted from growth to recession.
- The profitable industries of today were not as profitable in past decades, and some did not even exist.
- As ethical issues push to the forefront in business, there are more investors seeking to match their personal values and their investment choices.

A Review of the Issues

Many people believe that SRI sacrifices returns and increases risk because it screens out some of the best-performing firms. Critics argue that investors would be better off to maximize their returns and donate the money to their favorite charities. A survey of investment professionals in central New York state indicated that “Few, if any of them, encourage SRI for one very simple reason – returns. And maximizing returns for clients, after all, is the chief

concern of any investment advisor or fund manager.”² Omaha financial planner Cella Quinn said she doesn’t recommend SRI funds because, “Traditionally, they have not had a good track record, and they’re so limited.”³ Some have put it even more bluntly, calling SRI a “dumb idea.”⁴

However, there is a host of research that contradicts these assertions. John B. Guerard developed a stock selection algorithm based on IBES earnings forecasts, and applied it to an unscreened universe and then to the screened, SRI universe. He found that the returns earned by the socially screened stocks were higher.⁵ D’Antonio, Johnsen, and Hutton tested the returns from socially screened investments against unscreened investments using three different strategies to allocate assets among stocks and bonds (buy and hold, constant mix, and constant proportions). They found that the socially screened investments outperformed the unscreened using all three asset allocation strategies.⁶ Dhrymes reviewed the impact of 17 different social screens on the returns of 464 stocks between 1991 and 1996 and found that there were “no perceptible and consistent differences” between the mean return of screened and unscreened investments.⁷

An important factor to keep in mind, though is that the list of SRI equities does not match the overall market in the important area of investment style. The two leading SRI indexes, the Domini Social Index and the Citizens Trust Index, contain more large-cap firms and more

² Apte, Vivek. “Socially Responsible Investing – Choices and Dilemmas” *Business Journal Serving the Southern Tier, CNY, Mohawk Valley, Finger Lakes North* (vol. 11, issue 9) April 28, 1997, page 9.

³ Shim, Grace. “Investing With a Conscience Getting Easier” *Omaha World Herald* (May 29, 2001).

⁴ Rothchild, J. “Why I Invest With Sinners” *Fortune* (May, 1996).

⁵ Guerard, John B. Jr. “Is There a Cost to Being Socially Responsible in Investing?” *Journal of Investing* (vol. 6, issue 2), Summer, 1997.

⁶ D’Antonio, Louis, Tommi Johnson, and Bruce Hutton “Socially Responsible Investing and Asset Allocation” *Journal of Investing* (volume 9, issue 3) Fall, 2000.

⁷ Dhrymes, Phoebus J. “Socially Responsible Investment: Is it Profitable?” *The Investment Research on Socially Responsible Investing*, The Colloquium on Socially Responsible Investing, 1998.

growth firms than the standard market indexes. Large-cap stocks and growth stocks were precisely the sectors that led the market rally of the 1990s. Critics of SRI have asserted that its strong performance is due to its size and style. Abramson and Chung tested this assertion by rebalancing the stocks in the Domini Social Index and the Citizens Trust Index to match the size and investment style of the broader market. They found that the socially screened indexes, even when rebalanced, outperformed the broader market both on an unadjusted and a risk-adjusted basis.⁸

While the studies cited thus far establish the *potential* of SRI, none examine the performance of *actual* SRI portfolios. Hamilton, Jo, and Statman developed three hypotheses regarding the performance of SRI mutual funds:

H(1). SRI fund performance equals that of conventional funds. This hypothesis is consistent with a market that does not price the social responsibility feature.

H(2). SRI fund performance is lower than that of conventional funds. This hypothesis is consistent with a market that values the social responsibility feature, and bids up their prices accordingly.

H(3). SRI fund performance is higher than that of conventional funds. This hypothesis holds if a significantly large number of investors underestimate the probability that negative information will be released about non-SRI firms.

The authors tested the returns of SRI funds against an index of conventional funds and found that there was no significant difference in performance, consistent with H(1).⁹ In a follow-up study, Statman concluded that the performance of SRI funds is not significantly different from the performance of the Domini Social Index.¹⁰

⁸ Abramson, Lorne and Dan Chung "Socially Responsible Investing: Viable for Value Investors?" *Journal of Investing* (vol. 9, issue 3) Fall, 2000.

⁹ Hamilton, Sally, Hoje Jo, and Meir Statman, "Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds." *Financial Analysts Journal* (November-December, 1993).

Despite the large body of existing research, investors are left with differing opinions on at least three key questions relating to SRI:

1. Is it necessary to give up returns to invest in a socially responsible manner?
2. Does the screening process used by SRI funds cause investors to forgo valuable diversification benefits, thereby increasing their risk?
3. Does the screening process used by SRI funds generate higher management expenses for the funds, requiring the annual management fees charged by the funds to be larger than would otherwise be the case?

A Word of Caution

The financial community has embraced SRI in recent years, and there is an ever-growing number of mutual funds defining themselves as “socially-responsible” funds. Unfortunately, each of these funds defines socially responsible in a different manner. Just because an investor places money in one of the funds does not mean there will be a good match between that investor’s values and the practices of the fund.

For example, the Timothy Plan and the Meyers Pride Value Fund both define themselves as socially responsible. Art Ally, president of The Timothy Plan, calls himself “Planned Parenthood’s worst nightmare.” He does not invest in companies that he believes are “funding the downfall of America,” which includes firms supporting abortion rights or the “homosexual agenda.” The Meyers Pride Value Fund, in contrast, invests only in firms that have explicit anti-discrimination policies for gay and lesbian employees. “If a company doesn’t have protective

¹⁰ Statman, Meir “Socially Responsible Mutual Funds” *Financial Analysts Journal* (May/June, 2000).

policies for homosexuals” says Shelly Meyers, founder of the fund, “we have constructive dialogues with them about creating them.”¹¹

An even bigger absurdity is found in the case of Abbey Life, the British insurance firm that created a SRI fund in 1986. Abbey Life became a wholly-owned subsidiary of Lloyds of London in 1997 but, because of Lloyd’s much-criticized record on underdeveloped nation’s debt, the fund considers its own parent company too unethical to invest in.¹²

Research Design

The period covered by this study includes the most recent three years, during which time the U.S. stock markets have trended downward. Events like the Y2K bug, the terrorist attacks of September 11, 2001, and the recent war in Iraq have greatly affected the results of this study, as they should. By including these crisis moments in the U.S. economy, we will provide an initial look at how the performance of SRI funds holds up under adverse market conditions.

The first step in the analysis is to determine the elements that define a mutual fund as socially responsible. Dozens of mutual funds categorize themselves as socially responsible investments, but each applies different screens and levels of shareholder activism. A few funds are generally classified as SRI funds despite the fact that their management claims they are not.

An organization called Socially Responsible Investing hosts a web site listing a large number of SRI funds (www.socialfunds.com). This site provides a breakdown on the types of social screens and other policies employed by the funds. The resulting list, absent money market funds, is given in Table One.

¹¹ Whittelsey, Francis Cerra, “Mutual Funds That Match Your Beliefs” *Nation’s Business* (December, 1998), pages 23-24.

¹² “Ethical? Well, sort of...” *The Times* (London), Saturday, May 3, 1997.

Seventy-nine funds are listed in Table One. The vast majority of these are domestic equity funds. Almost all of these employ negative screens against alcohol, tobacco, and gambling firms. A large majority of these also employ a shareholder activism policy. Almost all shareholder activism funds make their voting record public, either on their web sites or through their *Prospectus*. Of the remaining social issues, the environmental screen is the most popular, with slightly over half the funds employing it.

Table One - Investment Practices and Policies of SRI Funds (continued)

Key:

X = exclusionary screen, P= positive screen, "-" fund does not screen this criteria

Issues are defined differently by the various funds. Consult the fund's *Prospectus* for specifics.

Notes

	The Fund's Adviser uses stock ownership to initiate dialog with management of portfolio companies on critical social and environmental issues. The Adviser also believes that the proxy voting process is an important tool in advocating progressive social change. To help further its social goals, the Fund intends to publish its proxy voting record at least once each year.
Advocacy Fund	
Amana Growth Fund	"Invests according to Islamic principles, such as investors must share in profit or loss, receive no interest, and no investments in liquor, wine, casinos, pornography, gambling, and non-Islamic banks."
Amana Income Fund	"Invests according to Islamic principles, such as investors must share in profit or loss, receive no interest, and no investments in liquor, wine, casinos, pornography, gambling, and non-Islamic banks."
American Trust Allegiance	"Excludes companies involved in pharmaceuticals, biotechnology, and medical diagnostic services and products."
Citizens Value Fund (Formerly Meyers Pride Value)	Invests in companies identified as generally having progressive policies towards gays and lesbians.
Domini Social Equity Fund	Encourages shareholders to support community development through a bank deposit program called the Domini Money Market Account at South Shore Bank. The Fund invests in companies that (1) create products or provide services that offer solutions to environmental problems and promote a healthier environmental future (environmentally proactive companies) or (2) integrate the principles of waste management, pollution prevention, or efficient use of natural resources into its business practices (environmentally sensitive companies).
Winslow Green Growth Fund	

Some of the funds in Table One did not qualify for this study. With interest in SRI increasing rapidly in recent years, many of the funds were simply too new and were not in existence for the entire three-year run of the recent bear market. Performance data on other funds was unavailable, perhaps because the funds were too small to qualify for a *Morningstar* listing. A sample of 32 funds is what remained after we eliminated those with less than three years of performance data and those that were not included in *Morningstar*. This sample is listed in Table Two.

Of our sample funds, two are fixed income funds, 20 are equity funds, and 10 are a blend of bonds and stocks. Thus, 30 of the 32 funds in our sample include equities in their portfolios. Of these 30 funds, 23 invest in large-cap stocks, four invest in mid-caps, two funds invest in small-caps, and one fund invests in foreign stocks. Of the 20 equity-only funds in our sample, 15 invested in growth stocks, four invested in value stocks, and one fund invests in a mix of foreign stocks. Thus, our sample is composed predominately of large-cap growth funds, which is the same investment style identified as dominant in previous SRI research.

The funds in our sample have net assets significantly smaller than the typical, non-SRI fund. The impact of fund size on performance is an unsettled area in the financial literature, and its impact on our findings is uncertain.

Table Two - SRI Fund Sample			
<i>Fund</i>	<i>Ticker</i>	<i>Style Category</i>	<i>(\$Millions)</i> <i>Net Assets</i>
IPS Millennium	IPSMX	Large Growth	\$ 81.60
Noah Fund	NOAHX	Large Growth	\$ 8.40
USAA First Start Growth Fund	UFSGX	Large Growth	\$ 128.77
American Trust Allegiance	ATAFX	Large Growth	\$ 18.87
Stein Roe Young Investors Fund	SRYIX	Large Growth	\$ 601.51
Parnassus Fund	PARNX	Large Growth	\$ 294.20
Ariel Fund	APGFX	Large Growth	\$ 8.98
Dryefus Premier Third Century	DRTCX	Large Growth	\$ 22.82
Timothy Plan	TLGAX	Large Growth	\$ 12.31
Aquinas Growth Fund	AQEGX	Large Growth	\$ 47.62
Amana Growth Fund	AMAGX	Large Growth	\$ 20.21
<i>average for sample large growth</i>			\$ 113.21
<i>average for all large growth funds</i>			\$ 1,439.00
Pax World Growth	PXWGX	Mid-Cap Growth	\$ 22.59
IPS New Frontier Fund	IPSFY	Mid-Cap Growth	\$ 3.41
Bridgeway Aggressive Growth	BRAGX	Mid-Cap Growth	\$ 215.08
<i>average for sample mid-cap growth</i>			\$ 80.36
<i>average for all mid-cap growth</i>			\$ 496.00
Winslow Green Growth Fund	WGGFX	Small Growth	\$ 10.85
<i>average for all small growth funds</i>			\$ 404.00
Washington Mutual Investors	AWSHX	Large Value	\$ 42,440.00
American Mutual Fund	AMRMX	Large Value	\$ 8,030.00
Aquinas Value Fund	AQEIX	Large Value	\$ 32.77
<i>average for sample large value</i>			\$ 16,834.26
<i>average for all large value funds</i>			\$ 2,711.00
Stratton Growth Fund	STRGX	Mid-Cap Value	\$ 37.58
<i>average for all mid-cap value funds</i>			\$ 755.00
Green Century Equity	GCEQX	Large Blend	\$ 25.43
Devcap Shared Return Fund	DESRX	Large Blend	\$ 15.78
AHA Balanced Portfolio	AHDEX	Large Blend	\$ 67.77
MMA Praxis Core Stock	MMPGX	Large Blend	\$ 108.90
Lutheran Brotherhood	LUBRX	Large Blend	\$ 685.45
Domini Social Equity Fund	DIEQX	Large Blend	\$ 194.38
Advocacy Fund	ADVOX	Large Blend	\$ 1.34
Pioneer Fund	PIODX	Large Blend	\$ 4,370.00
<i>average for sample large blend</i>			\$ 683.63
<i>average for all large blend funds</i>			\$ 1,152.00
Fidelity Select - Environmental	FSLEX	Small Blend	\$ 10.60
<i>average for all small blend funds</i>			\$ 454.00
Pioneer America Income A	PBUSX	Fixed Income	\$ 68.76
Concert Investment Series	THIFX	Fixed Income	\$ 127.21
Concert Emerging Growth	CSQIX	Foreign Stock	\$ 2.70

Returns

As mentioned earlier, many people assume that SRI investors must sacrifice returns in order to pursue their social goals. Our results, presented in Table 3, provide a mixed record with regard to this issue. The typical SRI fund had an average annual return of -16.02% for the three-year period, a slightly larger loss than the S&P 500 return of -12.69% . However, previous research in mutual fund performance indicates that mutual funds as a group typically do not match the performance of the overall market indexes, and our findings are no exception.

The downward slide in stock prices over the recent bear market was led by large-cap growth stocks. The performance of our sample funds followed this same trend. Returns from large-cap funds were worse than mid-caps and small-caps, and returns from growth funds were worse than value funds. The best performers were the fixed-income funds, which earned an average of 8.64% per year. The blend funds, with their mix of stocks and bonds, also had positive returns for the period.

It may be more useful to compare the performance of SRI funds against the performance of traditional funds. When doing so, it is important to match investment styles, especially because the various sectors of the stock market had such widely differing returns over the recent bear market. Data for this comparison is also provided in Table Three.

Table Three - Return Data

<i>Fund</i>	<i>3-yr return</i>	<i>Morningstar</i>		
		<i>Return Rating</i>	<i>Sharpe Ratio</i>	<i>Treynor Ratio</i>
IPS Millennium	-39.64%	average	-1.37	-36.49
Noah Fund	-27.56%	average	-1.42	-29.66
USAA First Start Growth Fund	-26.69%	below avg	-1.52	-29.27
American Trust Allegiance	-22.62%	above avg	-1.12	-23.85
Stein Roe Young Investors Fund	-21.20%	average	-1.15	-22.51
Parnassus Fund	-11.20%	high	-0.52	-11.83
Ariel Fund	-24.74%	not rated	not avail	not avail
Dryefus Premier Third Century	-21.73%	average	not avail	not avail
Timothy Plan	-27.30%	not rated	not avail	not avail
Aquinas Growth Fund (Small)	-14.39%	above avg	-1.06	-21.60
Amana Growth Fund	-20.36%	high	-0.98	-22.56
<i>average for sample large cap growth</i>	<i>-23.40%</i>			
<i>average for all large cap growth</i>	<i>-19.19%</i>			
Pax World Growth	-21.96%	below avg	-1.73	-40.90
IPS New Frontier Fund	-50.30%	low	-1.50	-40.65
Bridgeway Aggressive Growth	-12.93%	high	-0.30	-11.20
<i>average for sample mid-cap growth</i>	<i>-28.40%</i>			
<i>average for all mid-cap growth</i>	<i>-16.81%</i>			
Winslow Green Growth Fund	-30.52%	not rated	not avail	not avail
<i>average for all small-cap growth</i>	<i>-12.99%</i>			
Washington Mutual Investors	0.51%	above avg	-0.33	-8.23
American Mutual Fund	2.96%	above avg	-0.18	-4.65
Aquinas Value Fund	-7.36%	low	-0.87	-18.62
<i>average for sample large-cap value</i>	<i>-1.30%</i>			
<i>average for all large-cap value</i>	<i>-5.03%</i>			
Stratton Growth Fund	5.99%	average	0.04	1.14
<i>average for all mid-cap value</i>	<i>3.25%</i>			
Green Century Equity	-15.60%	average	-1.23	-21.61
Devcap Shared Return Fund	-14.24%	average	-1.21	-21.16
AHA Balanced Portfolio	-8.14%	above avg	-0.73	-14.38
MMA Praxis Core Stock	-9.32%	average	-1.00	-18.72
Lutheran Brotherhood	-16.54%	below avg	-1.31	-22.55
Domini Social Equity Fund	-14.68%	average	-1.16	-20.60
Advocacy Fund	-16.30%	not rated	not avail	not avail
Pioneer Fund	-10.41%	above avg	-0.99	-18.19
<i>average for sample large-cap blend</i>	<i>-13.15%</i>			
<i>average for all large-cap blend</i>	<i>-3.07%</i>			
Fidelity Select - Environmental	0.77%	below avg	-0.18	-5.53
<i>average for all small blend funds</i>	<i>1.63%</i>			
Pioneer America Income A	8.20%	low	1.26	4.75
Concert Investment Series	9.08%	average	1.57	6.04
<i>average for sample fixed inc funds</i>	<i>8.64%</i>			
Concert Emerging Growth	-38.49%	below avg	-1.73	-39.08
<i>average return for all SRI funds</i>	<i>-16.02%</i>			
<i>average return for S&P 500 Index</i>	<i>-12.69%</i>			

In general, the returns of the SRI funds held up relatively well compared with traditional funds of the same investment style. The notable exception to this is the growth funds. The growth funds of all three size categories (large-cap, mid-cap, and small-cap) all had significantly lower returns than their category averages. The reason for this is fairly straightforward.

SRI fund screens do not typically eliminate high-tech firms. Thus, the typical SRI fund is overinvested in the high tech industry. This is especially true for the SRI growth funds, which seek out companies with the kind of rapid growth that the high-tech industry enjoyed in the 1990s, and whose screens rarely eliminate companies in the high-tech industry. During the recent bear market, declines in the high-tech sector were even worse than the broader market, and SRI growth funds were especially vulnerable to these losses.

Overall, we conclude that the performance of SRI funds generally matches the performance of traditional funds. There are some exceptions though, particularly in the growth funds, where returns from SRI funds are significantly lower. We believe that these low returns are explained by the overweighting of technology in SRI growth portfolios rather than any systematic bias introduced by the social screening process itself. Consistent with the findings of Statman's H(1), we believe that the market neither penalizes nor rewards SRI investors for pursuing their social goals.

Fees and Expenses of SRI Funds

The fees and expenses charged by mutual funds should be a concern for all investors, but they are often overlooked. Consumer groups consistently advise investors to seek out funds with low fees, yet the annual fees charged by funds has been increasing rapidly in recent years.

To many people, the annual management fee charged by mutual funds just doesn't seem like a significant item. A typical range for annual management fees is 0.5% to 1.5%, and this amount sounds small. However, it is expressed as a percentage of the amount invested, not as a percentage of the profits, and it is assessed whether or not the fund earns a profit. Over time, differences in management fees can make a significant difference in the net return earned by the investor. The presence of management fees is a major reason why mutual funds do not typically outperform the broad market indexes.

The 12b-1 fee is another annual fee charged by mutual funds. It may receive even less attention from investors than the management fee. Many consumer groups publish guides to "low-fee" funds that do not even include information on the 12b-1 fee. The 12b-1 fee was originally authorized by the SEC as a means for funds to recoup their marketing expenses. Not all funds charge this fee. Like the annual management fee, the 12b-1 fee is assessed against the amount invested, not the profits, and is charged even in years when the fund experiences a loss.

Previous research shows that there is little correlation between the fees charged by mutual funds and their performance. It is important, therefore, that the managers of socially responsible funds act responsibly in the fees they charge.

Critics of SRI say that the cost of screening and monitoring corporate behavior by SRI fund managers imposes additional costs upon fund investors. For this to be the case, two criteria must be met; (1) the fund's screening and monitoring activities must be significant in scope, and (2) annual management fees and 12b-1 fees for SRI funds must be higher than for traditional funds.

The scope of screening and monitoring activities on the part of SRI funds is truly significant. Bill Thomason, Director of Portfolio Management for Parnassus Investments, says that the process of screening for socially responsible characteristics makes up perhaps 20% of the time that goes into managing his firm's socially responsible funds.¹³ The Calvert Asset Management Company describes their social screening activity as significant:¹⁴

Calvert typically first examines the company's published investor information such as annual and quarterly reports filed with the SEC. Next, the Fund checks each company's record of involvement before various federal agencies, including the Department of Defense, the Department of Labor, the Environmental Protection Agency, and the Occupational Safety and Health Administration. The fund also relies upon data from various special or general interest groups researching corporate activity, and it monitors relevant issues arising in the general media through regular on-line database searches. Finally, Calvert conducts personal interviews with corporate personnel and others with an interest in the activities of the corporations whose securities are being considered. After all of this research has been completed, Calvert's staff determines whether a particular organization's securities qualify for investment by the Fund from a social standpoint.

Table 4 lists the annual management fees charged by the funds in our sample, as well as the size of their 12b-1 fee, if any. Despite the scope of their social screening activity, the average management fee charged by the funds in our sample is actually *smaller* than the average fee charged by traditional funds. This is true despite the fact that SRI funds tend to be smaller in size and enjoy fewer economies of scale than the typical mutual fund.

We find that the managers of socially responsible funds act in a responsible manner. Even though they may incur higher expenses, they hold the annual management fees to a level below the average for all mutual funds.

¹³ Anderson, James A. "Doing Well by Doing Good" *Black Enterprise* (vol. 29, issue 12) July, 1999.

¹⁴ Djurasovic, George "The Regulation of Socially Responsible Mutual Funds" *Journal of Corporation Law* (vol. 22, issue 2), Winter, 1997.

Table Four - Fees and Expenses

<i>Fund</i>	<i>expense ratio (%)</i>	<i>12b-1 fee</i>
IPS Millennium	1.19%	0.00%
Noah Fund	2.20%	0.25%
USAA First Start Growth Fund	1.65%	0.00%
American Trust Allegiance	1.45%	0.00%
Stein Roe Young Investors Fund	0.58%	0.00%
Parnassus Fund	1.00%	0.00%
Ariel Fund	not avail	0.25%
Dryefus Premier Third Century	0.81%	0.00%
Timothy Plan	not avail	0.25%
Aquinas Growth Fund (Small	0.96%	0.00%
Amana Growth Fund	1.74%	0.00%
<i>average for sample large cap growth</i>	<i>1.29%</i>	
<i>average for all large cap growth</i>	<i>1.58%</i>	
Pax World Growth	0.92%	0.10%
IPS New Frontier Fund	1.40%	0.00%
Bridgeway Aggressive Growth	1.81%	0.00%
<i>average for sample mid cap growth</i>	<i>1.38%</i>	
<i>average for all mid cap growth</i>	<i>1.64%</i>	
Winslow Green Growth Fund	1.45%	0.00%
<i>average for all small cap growth</i>	<i>1.71%</i>	
Washington Mutual Investors	0.65%	0.00%
American Mutual Fund	0.59%	0.25%
Aquinas Value Fund	1.49%	0.00%
<i>average for sample large cap value</i>	<i>0.91%</i>	
<i>average for all large cap value</i>	<i>1.41%</i>	
Stratton Growth Fund	1.21%	0.00%
<i>average for all mid cap value</i>	<i>1.50%</i>	
Green Century Equity	1.50%	0.00%
Devcap Shared Return Fund	1.75%	0.25%
AHA Balanced Portfolio	0.16%	0.00%
MMA Praxis Core Stock	1.75%	0.75%
Lutheran Brotherhood	0.96%	0.00%
Domini Social Equity Fund	0.30%	0.00%
Advocacy Fund	1.50%	0.25%
Pioneer Fund	1.13%	0.00%
<i>average for sample large cap blend</i>	<i>1.13%</i>	
<i>average for all large cap blend</i>	<i>1.29%</i>	
Fidelity Select - Environmental	1.98%	0.00%
<i>average for all small blend funds</i>	<i>1.59%</i>	
Pioneer America Income A	1.93%	0.75%
Concert Investment Series	1.00%	0.00%
<i>average for SRI fixed income funds</i>	<i>1.47%</i>	
Concert Emerging Growth	1.54%	0.00%
<i>average for all sample funds</i>	<i>1.26%</i>	
<i>average for all funds</i>	<i>1.53%</i>	

Risk of SRI Funds

Critics say that the SRI fund's screening process results in a smaller universe of securities from which investors can choose, costing these investors valuable diversification benefits. Table 5 includes risk-related statistics for all funds in our sample.

The *Morningstar* risk rating evaluates a fund's volatility relative to that of other funds in its style category. As such, it is an index of total risk. The average risk score for a category is set to 1.0, and *Morningstar* evaluates all funds in that category against that average. The *Morningstar* risk ratings for our sample funds reveal a risk profile very close to the typical pattern for all funds, with approximately 1/3 of the sample rated higher than average risk, 1/3 of the sample rated at the average risk level, and approximately 1/3 of the sample rated below average risk.

Another important dimension of risk, especially relevant to diversified investors, is systematic risk. Both beta and the R-squared statistic provide insights into systematic risk. Betas for the funds in our sample were obtained from *Morningstar*. Their values varied with the style category of the funds, with the growth funds generally having betas larger than 1.0 and the value and blend funds generally having betas smaller than 1.0. *Morningstar* calculates betas of blend funds against a mix of 60% equity and 40% bonds, with the bond portion represented by the Lehman Brothers Corporate Bond Index. Overall, the average beta for all funds in our sample is slightly less than 1.0.

Table Five - Risk Measures			
<i>Fund</i>	<i>Morningstar Risk Rating</i>	<i>beta</i>	<i>R2</i>
IPS Millennium	high	1.16	0.36
Noah Fund	above average	1.10	0.61
USAA First Start Growth Fund	average	1.15	0.70
American Trust Allegiance	average	1.08	0.64
Stein Roe Young Investors Fund	average	1.13	0.76
Parnassus Fund	above average	1.16	0.68
Ariel Fund	not rated	n/a	n/a
Dryefus Premier Third Century Timothy Plan	below average not rated	n/a n/a	n/a n/a
Aquinas Growth Fund	below average	0.84	0.75
Amana Growth Fund	above average	0.99	0.58
<i>average for sample large-cap growth</i>		<i>1.08</i>	
Pax World Growth	low	0.64	0.50
IPS New Frontier Fund	high	1.67	0.36
Bridgeway Aggressive Growth	above average	0.91	0.28
<i>average for sample mid-cap growth</i>		<i>1.07</i>	
Winslow Green Growth Fund	not rated	n/a	n/a
Washington Mutual Investors American Mutual Fund	below average low	0.69 0.59	0.62 0.60
Aquinas Value Fund	average	0.79	0.72
<i>average for sample large-cap value</i>		<i>0.69</i>	
Stratton Growth Fund	average	0.68	0.48
Green Century Equity	above average	1.01	0.96
Devcap Shared Return Fund	average	0.96	0.99
AHA Balanced Portfolio	average	0.86	0.87
MMA Praxis Core Stock	below average	0.78	0.93
Lutheran Brotherhood	above average	1.01	0.98
Domini Social Equity Fund	above average	1.01	0.96
Advocacy Fund	not rated	n/a	n/a
Pioneer Fund	below average	0.88	0.95
<i>average for sample large-cap blend</i>		<i>0.93</i>	
Fidelity Select Environmental	average	0.70	0.43
Pioneer America Income A Concert Investment Series	average below average	1.03 0.92	0.93 0.91
<i>average for sample fixed income</i>		<i>0.98</i>	
Concert Emerging Growth	high	1.14	0.46
<i>average for all sample funds</i>		<i>0.96</i>	

The R-squared statistic ranges from 0 to 1.0. It reflects the percentage of the fund's volatility that is associated with fluctuations in the return of its associated market index. An R-squared of 1.0 means that all the volatility in the fund's returns is associated with fluctuations in the returns of the market index, and thus the fund takes on the risk characteristics of the overall market. Most funds have R-squared statistics far lower than this value. Low R-squared statistics indicate that variation in the fund's returns is generally not associated with variation in the market index. A standard interpretation of low R-squared values is that the fund is poorly diversified. Also, R-squared values can be used to ascertain the significance of a particular fund's beta. Generally, higher R-squared values indicate a more reliable beta figure. If R-squared is low, then beta is less relevant to the fund's actual risk.

From these statistics, we conclude that there is no evidence supporting the charge that SRI funds are riskier than normal. The total risk profile, as measured by Morningstar, generally matches the risk profile for all funds. The average beta of the funds in our sample is slightly below 1.0. The screening activity of SRI funds does not subject investors to higher risk levels.

A Biblical Basis for SRI

For Christians, all this is moot unless there is a moral basis for SRI. As followers of Christ, we look to the Scriptures to develop this moral basis.

Fundamentally, the moral dimension of investing decisions can be viewed as an attempt to strike a balance between two conflicting priorities:

1. God wants us to be good stewards of all our resources, including money. Among the Scriptural evidence supporting this is the Parable of the Talents in Matthew 25: 14-30.

2. God does not want us to be greedy in the process of doing so. “For the love of money is the root of all sorts of evil...” (1 Timothy 6:10). The prophet Isaiah writes:

Woe to those who add house to house and join field to field,
Until there is no more room,
So that you have to live alone in the midst of the land!
In my ears the Lord of hosts has sworn, ‘Surely, many houses shall become desolate,
even great and fine ones, without occupants.
(Isaiah 5:8-9)

In view of God’s admonition, Larry Burkett goes so far as to say, “The most crucial thing to remember about investing is that it is wrong to invest just for the sake of making money. Making money should be a byproduct of God’s direction ... It is not how much someone can accumulate that is significant, but *how the resources are used*.¹⁵ (Italics added.)

Why we do what we do is often as important to God as *what* we do. Even the very act of worship can be scorned by God if done for the wrong motives. In Amos, God tells Israel, whose worship was motivated for personal gain:

I hate, I reject your festivals,
Nor do I delight in your solemn assemblies.
Even though you offer up to Me burnt offerings and your grain offerings,
I will not accept them;
And I will not even look at the peace offerings of your fatlings.
Take away from Me the noise of your songs;
I will not even listen to the sound of your harps.
But let justice roll down like waters
and righteousness like an everflowing stream.
(Amos 5:21-24)

How can we make investment decisions that are pleasing to God? By setting our hearts straight before we make them. Realize that, as stewards, we are not managing what is ours, but

only what God has given us to use while on this earth. “But godliness actually is a means of great gain, when accompanied by contentment. For we have brought nothing into this world, so we cannot take anything out of it either.” (1 Timothy 6:6-7).

Realize that, until we set our priorities straight, we are probably doomed to pursue empty self-gratification and personal gain. “Beware, and be on your guard against every form of greed, for not even when one has an abundance does his life consist of his possessions.” (Jesus, speaking in Luke 12:15.) This is especially important for modern Americans, who have been given more material wealth than any other people who have ever lived. George Monsma says, “Regarding the purposes for which we are to use our material resources, the Bible consistently calls us to use them to provide justice (or equity). On the other hand, I see no call in the Bible to use resources in order to continually increase the overall level of production, or to meet the desires of those with economic or political power, whatever those desires may be. (These, of course, are two commonly stressed uses of our day.)”¹⁶ As the U.S. Conference of Catholic Bishops stated,

“(T)he ways resources are invested and managed must be scrutinized in light of their effects on non-monetary values. Investment and management decisions have crucial moral dimensions: They create jobs or eliminate them; they can push vulnerable families over the edge of poverty or give them new hope for the future; they help or hinder the building of a more just society.¹⁷

The central point is that our lives, including our business decisions, our careers, and our investment decisions, are to be carried out in view of the larger and deeper meaning provided in

¹⁵ Burkett, Larry. “Biblical Principles Governing Personal Investing” *Biblical Principles and Business: The Practice*, Richard Chewning, Editor. (Navipress, Colorado Springs, Colorado, 1990), Chapter 12, pages 237-238.

¹⁶ Monsma, George N. “Biblical Principles Important for Economic Theory and Practice” *On Moral Business: Classical and Contemporary Resources for Ethics in Economic Life*, edited by Max Stackhouse, Dennis McCann, Shirley Roels, and Preston Williams, Eerdmans Publishing Company, 1989. Page 38.

¹⁷ JA, paragraph 92, 1986 letter of U.S. Catholic Bishops quoted in Dennis P. McCann, “The Church and Wall Street” *America* 158, no. 4 (January 30, 1988),85-94.

God's instructions. Our decisions should look beyond the latest movements of the company's stock price, quarterly earnings announcement, or rumors of an impending merger. Jesus' instructions are clear, "Let your light shine before men in such a way that they may see your good works, and glorify your Father who is in heaven." (Matthew 5:16).

Summary

Socially responsible investors want portfolios that are consistent with their values and their beliefs. In this paper, we have examined the choices open to socially responsible investors, and we have found that they are growing in number and in variety. We have tested the widely held assertion that the returns of SRI are not as high as those of traditional, economics-based investing. While SRI returns have suffered during the recent bear market, we believe that this is due more to portfolio composition and style than to the process of screening investments for social criteria.

SRI critics have asserted that the process of screening investments generates high costs for mutual funds and that these costs are passed on to the fund's customers, harming their net returns. While the screening process does consume significant time and resources, we find that the fees charged by the SRI funds in our sample are actually below the average charged by all mutual funds.

We also examine the assertion that the screening process harms investors by denying them valuable diversification benefits available in unscreened portfolios. We find that the total risk profile of SRI funds matches the universe of funds generally, and that the systematic risk (beta) of SRI mutual funds is slightly lower than average.

In his recent article, Statman brings up the case of an unnamed Quaker college pursuing SRI in its endowment portfolio by screening out the stocks of weapons manufacturers. Did the Board think it was going to eliminate the world armament buildup by pursuing such a policy, the Provost was asked? “No,” he replied, “our Board isn’t out to change the world. We’re just seeking a oneness between ourselves and our Lord.”¹⁸

This is good advice for us all.

¹⁸ Statman, Meir. “Socially Responsible Mutual Funds” *Financial Analysts Journal* (May-June, 2000), page 34.

References

- 2001 Report on Socially Responsible Investing Trends in the United States* (Social Investment Forum, November, 2001).
- Abramson, Lorne, and Dan Chung. "Socially Responsible Investing: Viable for Value Investors?" *Journal of Investing* (vol. 9, issue 3, Fall, 2000).
- Anderson, James A. "Doing Well by Doing Good" *Black Enterprise* (vol. 29, issue 12, July, 1999).
- Angel, James, and Pietra Rivoli. "Does Ethical Investing Impose a Cost Upon the Firm? A Theoretical Examination" *Journal of Investing* (Winter, 1997).
- Brill, Marla. "Holy Growth Fund!" *Mutual Funds* (June, 1999).
- Chewning, Richard. (ed.) *Biblical Principles and Business: The Practice* (Navipress, 1990).
- D'Antonio, Louis, Tommi Johnson, and Bruce Hutton. "Socially Responsible Investing and Asset Allocation" *Journal of Investing* (vol. 9, issue 3, Fall, 2000).
- Dhrymes, Phoebus J. "Socially Responsible Investment: Is It Profitable?" *The Investment Research Review on Socially Responsible Investing*, The Colloquium on Socially Responsible Investing, 1998.
- Djurasovic, George. "The Regulation of Socially Responsible Mutual Funds" *Journal of Corporation Law* (vol. 22, issue 2, Winter, 1997).
- Gasparino, Charles, and Pui-Wing Tam. "Feel-Good Mutual Funds Haven't Yet Found Favor" *Wall Street Journal* (February 12, 1998), page C1.
- Guerard, John B. Jr. "Is There a Cost to Being Socially Responsible in Investing?" *Journal of Investing* (vol. 6, issue 2, Summer, 1997).
- Hamilton, Sally, Hoje Jo, and Meir Statman. "Doing Well While Doing Good? The Investment Performance of Socially Responsible Mutual Funds" *Financial Analysts Journal* (November-December, 1993).
- Melton, James, and Matthew Keenan. *The Socially Responsible Portfolio: Balancing Politics and Profits in Institutional Money Management* (Probus Publishing Company, 1994.)
- Scherreik, Susan. "A Conscience Doesn't Have to Make You Poor" *Business Week* (issue 3679, May 1, 2000).

Stackhouse, Max, Dennis McCann, Shirley Roels, and Preston Williams (eds.) *On Moral Business: Classical and Contemporary Resources for Ethics in Economic Life* (Eerdmans Publishing Co., 1989).

Stone, Brett A. "Social Responsibility and Institutional Investment: An Empirical Analysis of the Environmental Screen" *Journal of Investing* (vol. 9, issue 3, Fall, 2000).

_____. "A Special-Purpose Taxonomy of Corporate Social Performance Concepts" *Accounting and the Public Interest* (vol. 1, 2001).

Statman, Meir. "Behaviorial Finance: Past Battles and Future Engagements" *Financial Analysts Journal* (November/December, 1999).

_____. "Socially Responsible Mutual Funds" *Financial Analysts Journal* (May/June, 2000).

Tech, Siew Hong, Ivo Welch, and C. Paul Wazzan. "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence From the South African Boycott" *Journal of Business* (1999, vol. 72, no.1).

Whittelsey, Frances Cerra. "Mutual Funds That Match Your Beliefs" *Nation's Business* (December, 1998).