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AfU *Investor Research*

ESG PERFORMANCE OF EUROPEAN INVESTMENT FUNDS

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Are SRI funds really more sustainable than their peers?

Using AfU Investor Research's investment fund holding data and the RepRisk Index (RRI), this report analyzes how SRI funds compare to their peers in regards to sustainability.

Abstract:

For the purposes of this report, a new method of evaluating investment funds on environmental, social and governance (ESG) performance was developed. This method takes into account each single holding in the fund's portfolio and the aggregation at the overall fund level by using the company's weight in the portfolio. In order to do this, detailed holdings for each investment were determined using the AfU fund data holding database. Secondly, an ESG performance evaluation was assigned to each company held by the fund using data from RepRisk. A total of 166 European equity investment funds, of which 13 explicitly claim the label SRI, were evaluated using this methodology. The result is an independent and reproducible evaluation of the funds' environmental and social performance.

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INTRODUCTION

Socially Responsible Investments (SRI) is a fast growing market segment for asset managers. While the term could be shortly described as covering any type of investment process that combines investors' financial objectives with their concerns about environmental, social and governance (ESG) issues (Eurosif 2010), its implementation into investment management strategies is not a clearly defined process. As a result, several different approaches for incorporating SRI criteria have been developed by fund managers. These range from ethical exclusions, norms-based screening, ESG thematic funds, and positive screening ('core' SRI interpretation according to Eurosif) to shareholder engagement and integration of ESG issues into investment decisions ('broad' SRI interpretation).

Given the variety of investment products available (according to Eurosif, the total SRI assets in Europe alone reached €5 trillion as of December 31, 2009) potential investors must face the overwhelming challenge of choosing the "right" SRI product. Unlike the majority of research in the field, which focuses on funds' financial performance and the SRI methodology, this report provides new insight by evaluating a fund holding's contribution to sustainability in terms of the ESG performance of the corresponding companies.

The advantage of this approach is that a fund can be judged based on the ESG performance of the assets it holds, as opposed to depending on the SRI label given by the fund management company- a label that has attracted skepticism in the past. The result is an independent and reproducible evaluation of the funds' environmental and social performance. To reach this, research combined two unique data sources: RepRisk's assessment of the environmental and social performance of a company and AfU Investor Research's investment fund holdings database. The remainder of this paper presents our approach, including an application to a sample of 166 investment funds.

RELATED LITERATURE

To date, research into socially responsible investment (SRI), and in particular into the business of socially responsible investment funds, has focused on whether investing in SRI assets has any differential impact on investor returns. Prior findings generally suggest that, on a risk-adjusted basis, there is no difference in performance between SRI and conventional funds. This result has led to questions about whether SRI funds perform differently in comparison to conventional funds when it comes to their actual ESG and financial performance.

Benson et al. (2006) examine whether the portfolio allocation across industry sectors and the stock-picking ability of SRI managers differ when compared to conventional fund managers. They find that SRI funds exhibit different industry betas consistent with different portfolio positions, but that these differences vary from year to year. They also find that there is little difference in stock-picking ability between the two groups of fund managers.

Kempf and Osthoff (2008) test the frequently made claim that SRI funds are conventional funds in disguise. For this purpose, they compare the portfolio holdings of SRI funds to conventional funds with respect to their social and environmental standards. Their empirical results for US equity funds show that SRI funds have a significantly higher ethical ranking than standard funds, suggesting that they are not, as some critics have suggested, simply conventional funds in disguise. This result holds for all ethical criteria studied. This conclusion is robust over time and holds after controlling for several fund characteristics. The authors also control their results for window dressing strategies of SRI funds and find no support for this proposition.

Rathner (2012) investigates with the help of meta-analysis how selected primary study characteristics influence the probability of a significant under- or outperformance of SRI funds compared with conventional funds. Twenty-five studies with more than 500 observations are included in this analysis. The results suggest that consideration of the survivorship bias in a study increases the probability of a significant outperformance of SRI funds relative to conventional funds, and vice versa, decreases the probability of a significant underperformance of SRI funds relative to conventional funds. The focus on United States SRI funds heightens (lowers) the probability of a significant outperformance (underperformance) too. The time period influences the probability of a significant under- and outperformance of SRI funds as well, although he does not draw a general conclusion on this variable.

Finally, Boersch (2010) regards pension funds with their long-term horizon and asset size as one of the main drivers of socially responsible investment. A survey conducted by Allianz Global Investors and the Centre for European Economic Research (ZEW) among pension experts in France, Germany, Italy, the Netherlands, Switzerland and the United Kingdom on the future of socially responsible investment in pension fund portfolios showed the following results: On average, most of the pension experts surveyed believe that, in the future, SRI criteria will play an increasingly important role in how pension funds make investment decisions. While French and Dutch pension analysts were very optimistic, their British counterparts were quite pessimistic. The majority of experts surveyed believe the SRI approach will be extended to include asset classes other than equities. Again, the French and Dutch participants were the most optimistic. Apart from Germany, most experts are expecting pension funds to become more active owners. Environmental criteria are considered to be the most important element of the SRI concept. Respondents agreed that the growing SRI trend is being driven much less by the expectation of higher returns or lower risk than it is by public pressure.

Finally, an unpublished study by the University of Zurich reported on by the Financial Times (2010) uses the RepRisk Index (RRI) – the same indicator used in this study – to measure the sustainability of large sustainable funds and compares their RRI scores with those of regular equity funds. The results show that the RRI scores of both fund categories are almost identical.[1]

DATA

For our analysis we use two main data sources to fulfill the following needs: First we need to know the investment fund's detailed holdings. Second, we have to assign an ESG performance evaluation to every single company held by the fund. The remainder of this section provides a detailed description of these data sources.

The RepRisk Index

RepRisk's assessment of the environmental, social, and governance performance of a company is based on the company's activities in the field as observed by independent third parties, and is not derived from information provided by the company itself. The RepRisk Index (RRI) is a quantitative risk measure that captures criticism and quantifies a company's or project's exposure to controversial environmental and social issues. It does not measure a company's or project's overall reputation, but rather is an indicator of a company's or project's reputational risk. It facilitates an initial assessment of the risks associated with investments or business relationships, allows the comparison of a company's exposure with that of its peers, and helps track risk trends over time.

The RepRisk Index ranges from zero (lowest) to 100 (highest). It is calculated based on the influence of news sources, the frequency and timing of the news, as well as the news content, including the severity (harshness) and novelty (newness) of the issues addressed. In order to ensure a balanced and objective rating and weighting, news is only entered once into the database, unless it is escalated to a more influential source, appears again after six weeks or additional issues emerge. The current RRI value indicates the current level of criticism about a company or project while the peak RRI denotes the highest level of criticism in the past two years, and is an indicator of the environmental, social, reputational and investment risk associated with a company or project. The RRI change shows the increase or decrease of the RRI within the past 30 days.

The RRI can be interpreted as follows: low risk exposure (0-24), medium risk exposure (25-49), high risk exposure (50-74) and very high risk exposure (75-100). The RRI emphasizes companies which are newly criticized or have had less criticism in the past. Expressed differently, companies with a lot of criticism in the past are less sensitive to new allegations. If no new criticism is captured, the RRI of a company decays to zero over a period of two years. The RRI does not depend on the sequence of news.

Once negative news has been identified using advanced search algorithms and analyzed to ensure its relevance, it is entered into the RepRisk database and linked to the companies and related entities in question. This evaluation is performed by risk analysts in accordance with established international standards, such as the UN Global Compact Principles, the Universal Declaration of Human Rights, ILO Conventions, the UN Convention Against Corruption, the Equator Principles, World Bank Group Performance Standards and Environmental, Health and Safety Guidelines, and the OECD Guidelines for Multinational Enterprises.

[1] Financial Times, October 24, 2010.

The RepRisk scope includes comprehensive coverage of environmental, social and corporate governance (ESG) issues such as environmental footprint and climate change, human rights and community relations, labor conditions and employee relations as well as corruption and money-laundering. In particular, all principles of the UN Global Compact are addressed.

The AfU Fund Holdings Database

The AfU fund holdings database was initiated in1996 and contains the following information on investment funds: full holdings, number of securities for each fund, fund name, fund company/ asset manager, investment company, total net assets. The fund universe currently includes more than 33,000 mutual funds worldwide. The services and products offered are Shareholder-IDs and consolidated shareholder information from different sources, peer group analysis and investor targeting, individual analysis (e.g. SRI studies, umbrella fund analysis, fixed income fund analysis) or investment strategies (e.g. contrary opinion strategy).

The distinguishing features are a client-oriented concentration on the European market, a generic grown database structure (since 1996), the linkage of financial analysis with database know-how and the strategic distribution partnership with WPFC Consulting GmbH. References include a number of German small- and mid-caps, foreign companies (e.g. BP Plc. and CEMEX) and further companies like Bellevue Asset Management, Solventis, Bayerische Landesbank or Dow Jones Factiva.

We obtain sample funds by filtering the AfU database for equity funds with the geographic focus on Europe. We exclude sector funds because this may bias the analysis towards on average more or less responsible sectors. This yields 166 funds in the sample, whereof 13 funds are explicitly labeled as SRI funds.

Since asset managers publish their holdings using different reporting periods, we have to allow differences in this regard. For this study, only reporting dates from the year 2011 were taken into account. For fund assets under management denominated in other currencies than Euro conversion was made using FX rates from oanda.com.

METHODOLOGY

For our investment fund ESG performance evaluation we use the peak RRI for each company in the fund portfolio and combine it with the holding's weight relative to the portfolio's net assets. For example, if the company's stock is included in the portfolio with a weight of 5% and the RRI for the company is 50, then the weighted RRI for this single holding is 2.5.

All single weighted RRI's in the portfolio are then added up and result in the overall average evaluation score for the fund. For example, if all single holdings of a given fund have an RRI of 50, then the overall average RRI for the entire fund would be 50.

The advantages of this ESG performance evaluation methodology are that:

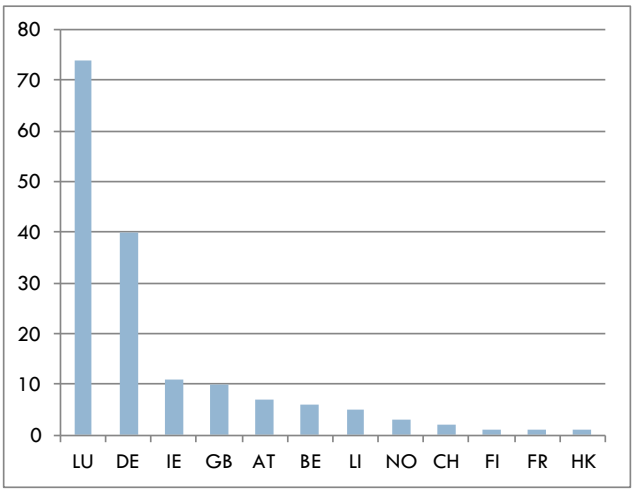
- the calculation methodology is straight forward;
- both the evaluation on single security level (RRI) as well as on fund level (weighted RRI) are the result of a clearly defined process and not affected by subjective opinion;
- the fund evaluation is possible for all funds where portfolio holdings are available and does not depend on an evaluation assignment by the asset manager;
- it offers insights into the tails of the holdings distribution (e.g. identifies extremely risky companies based on their environmental, social and governance performance);
- it is not derived from an evaluation provided by the asset management company itself;
- besides the equity funds in our sample this methodology is easily applicable to fixed income, balanced and umbrella funds.

RESULTS

Descriptive Statistics

The allocation of fund domiciles is shown in Figure 1. The main focus is on funds domiciled in Luxemburg and Germany. Please note, that the fund domicile is not necessarily equal to the domicile of the asset manager.

Figure 1: shows the number of funds clustered by fund domicile.



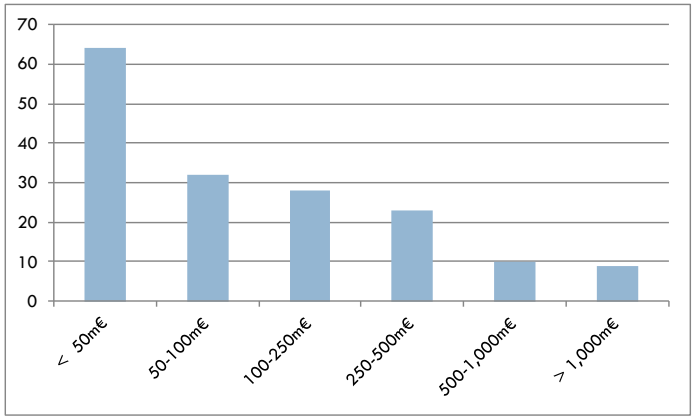
As can be seen in Table 2 the median fund size in both subsamples (conventional as well as SRI funds) is about €70m. The difference in the means is clearly more pronounced which has to do with the skew to bigger funds in the conventional fund subsample.

Table 2: shows fund size descriptive characteristics. Currency conversion for fund currencies other than Euro is made using FX rates from oanda.com. Correspondingly, all final fund assets are in Euro.

type	N	Mean	P50	Sd	Min	Max
conv	153	230,401,384	74,407,000	428,756,882	2,432,665	2,811,100,000
sri	13	92,869,714	70,572,892	127,292,883	5,590,000	486,983,621
Total	**166**	**219,630,831**	**73,664,750**	**414,609,081**	**2,432,665**	**2,811,100,000**

The distribution of fund size within the sample is shown in Figure 2. More than one third of sample funds have net assets below €50m.

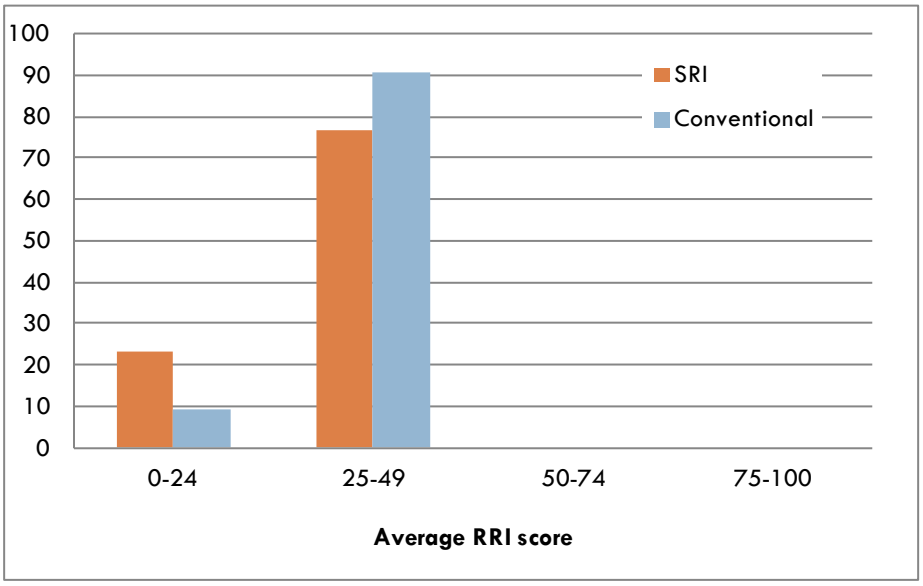
Figure 2: shows the number of funds clustered by different AuM ranges.



Fund Sustainability Evaluation

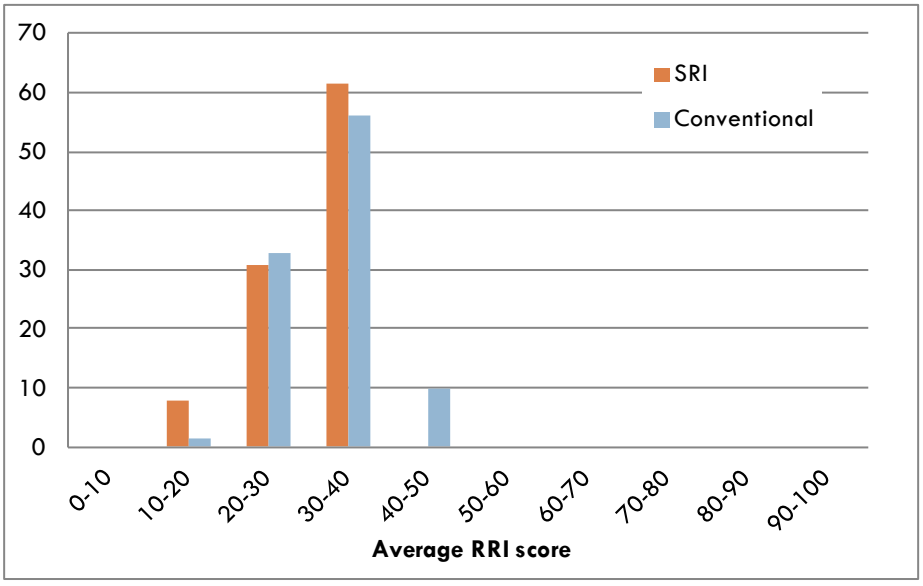
Now we take a look at the fund ESG performance evaluation. In Figure 3 the funds average RRI scores are clustered according to the four main risk categories described in the Data section of this study. The results show that all funds fall either into the 'low risk' or 'medium risk' category, but the 'low risk' category is dominated by SRI funds (23.1 vs. 9.2 %).

Figure 3: shows the percentage of funds in different ESG risk exposure ranges.



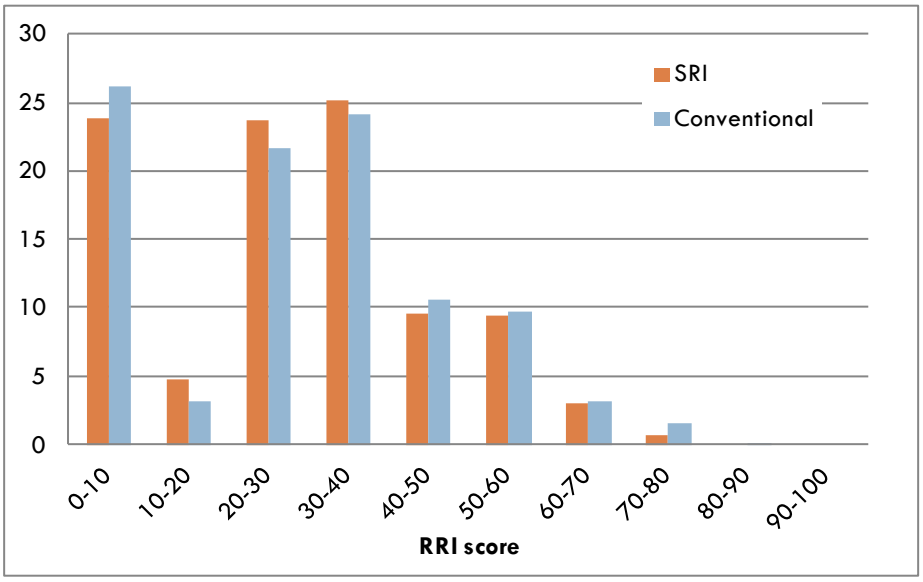
If we take a closer look at the average RRI score distribution clustered by subsamples and more narrow RRI ranges, we can see that indeed SRI funds are slightly tilted towards lower risk companies. The average for the SRI subsample is 30.76 and 32.58 for the conventional fund subsample.

Figure 4: shows the percentage of funds in different ESG risk exposure categories.



The most controversial company held by a sample fund is Transocean (peak RRI of 82), the world's largest offshore drilling contractor which was involved in the Deepwater Horizon accident. This company was only held by conventional funds. Other highly exposed companies include BP, UBS and Deutsche Bank. The latter is the highest risk position of the SRI fund sample (peak RRI of 71). Figure 5 shows the distribution of peak RRI's for all companies held by the sample funds. The nonzero share of companies in the range from 80 to 90 for the conventional funds is due to Transocean. Also, in the range from 70 to 80 the share of companies held by conventional funds is significantly higher than for SRI funds.

Figure 5: shows the distribution of single company peak RRI's clustered by fund groups.



These results suggest that the differences in terms of the environmental, social and governance performance of SRI funds and conventional funds is not significant.

Fund Performance

The general distribution of monthly fund returns in the sample is characterized by Table 2. Using a two-sample test with equal variances, this research does not contradict the hypotheses that the group's mean returns of SRI and conventional funds are equal.

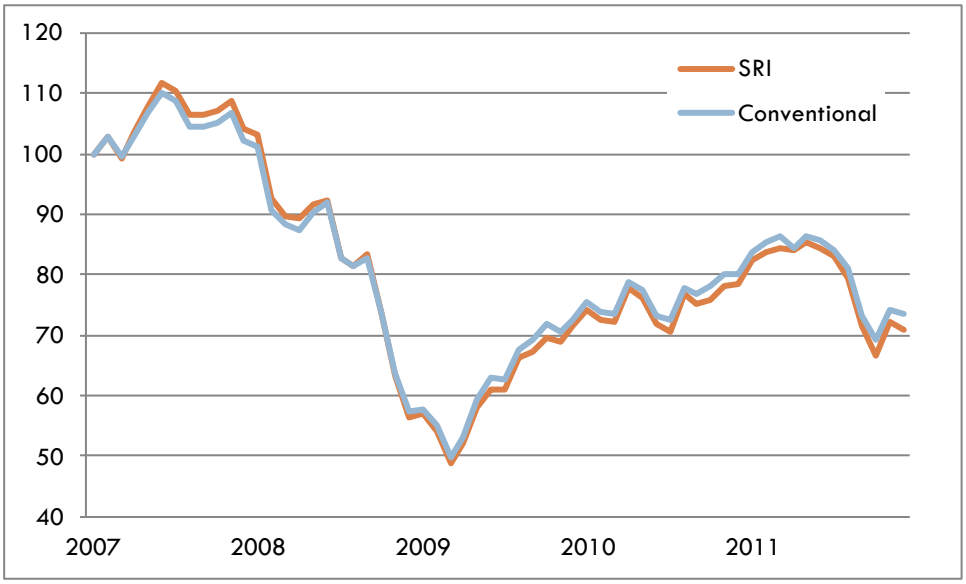
Table 2: characterizes the distribution of monthly fund returns (in Euro) from 2007 to 2011 for investment fund sample.

SRI funds						
year	**N**	**Mean**	**P50**	**Sd**	**Min**	**Max**
2007	96	0.26%	0.72%	3.31%	-6.18%	6.26%
2008	124	-4.92%	-2.57%	6.29%	-18.49%	5.58%
2009	144	2.18%	2.92%	6.00%	-12.99%	15.15%
2010	147	0.87%	0.12%	4.23%	-7.51%	11.46%
2011	156	-0.73%	-0.75%	5.02%	-11.61%	12.12%
Total	**667**	**-0.39%**	**-0.17%**	**5.66%**	**-18.49%**	**15.15%**

Conventional funds						
year	**N**	**Mean**	**P50**	**Sd**	**Min**	**Max**
2007	1,403	0.23%	0.67%	3.13%	-9.22%	6.48%
2008	1,583	-4.60%	-2.59%	6.21%	-30.83%	9.18%
2009	1,636	2.12%	2.60%	6.00%	-20.34%	22.76%
2010	1,718	0.90%	0.25%	4.09%	-9.89%	13.94%
2011	1,749	-0.63%	-0.41%	4.80%	-21.11%	17.76%
Total	**8,089**	**-0.38%**	**0.02%**	**5.50%**	**-30.83%**	**22.76%**

Also, the cumulative fund performance for the two subgroups through time does not reveal great differences as shown in Figure 6.

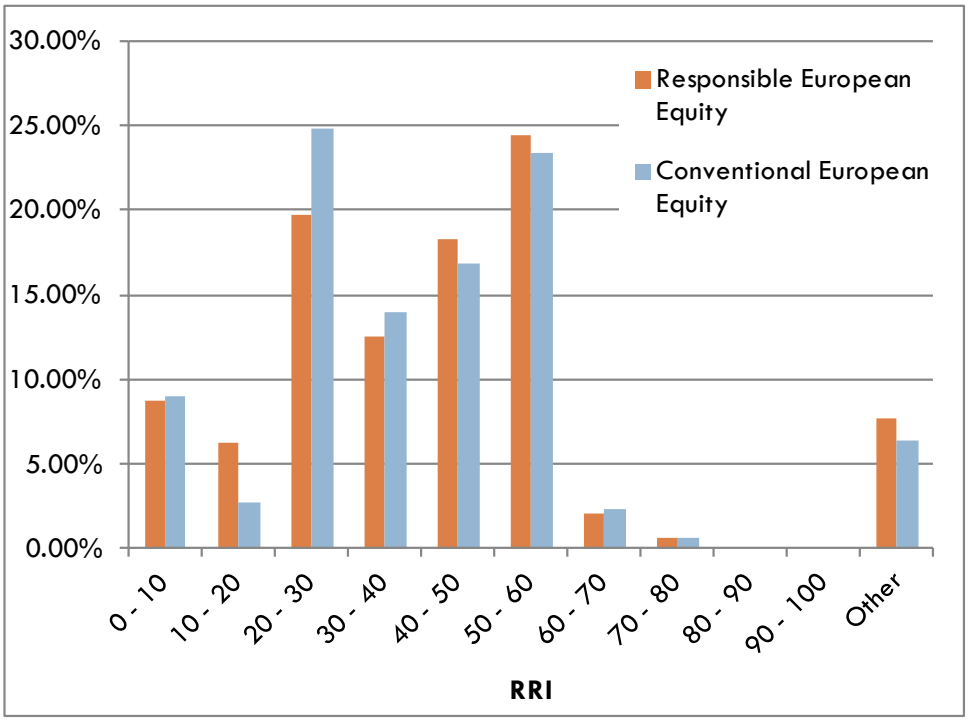
Figure 6: shows cumulative financial performance for SRI and conventional fund groups.



Case study based on two specific funds in the sample

Finally, the proposed method of ESG analysis can be demonstrated using two specific funds in the sample. Both funds have the same Morningstar benchmark (MSCI Europe NR USD) and investment universe (European large cap equities), but one fund explicitly uses the term 'responsibility' in its name and claims SRI compliance in the factsheet. Both are managed by the same fund company. The key findings for these two funds are that the non-SRI fund's value-weighted average RRI is only slightly higher compared to the SRI fund (34.8 vs. 34.4). Also, the distributions of value-weighted RRI values are quite similar (see Figure 7). While the cost for the SRI fund is significantly more than for the non-SRI fund (TER of 2.08 vs. 1.67%) the SRI fund's performance for the years 2009 to 2011 is inferior. A closer look at the funds' portfolio holdings reveals that 41 out of 47 different portfolio companies overlap, e.g. are included in both funds.

Figure 7: shows the distribution of single company peak RRI's clustered by the two funds in the case study (other refers to non-equity instruments).



CONCLUSIONS

This report has outlined a new methodology for evaluating investment funds in accordance with environmental, social and governance standards. This method is based on the evaluation of each single holding in the fund's portfolio and the aggregation at the overall fund level by using the company's weight in the portfolio. A sample of 166 European equity investment funds, of which 13 explicitly claim the label 'SRI', was evaluated using this methodology.

The advantages of this ESG performance evaluation are that our quantitative calculation methodology is straight forward and is not derived from an evaluation provided by the asset management company itself. It also offers insights into the tails of the holdings distribution, e.g. identifies extremely risky companies.

Our empirical findings suggest that although SRI funds are not conventional funds in disguise, the difference regarding their ESG performance is very small. Financial performance analysis shows that there is no statistical significant difference in the monthly return regarding the mean of the distribution. Both results are in line with previous research on this topic.

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