Financial Analysts Journal ›
Volume 56, 2000 - Issue 3

PERFORMANCE

Socially Responsible Mutual Funds (corrected)

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Pages 30-39 | Published online: 02 Jan 2019

Cite this article https://doi.org/10.2469/faj.v56.n3.2358

Abstract

Conversations about socially responsible investing are difficult because they combine facts with beliefs. Proponents of socially responsible investing believe that combining social goals with investments does good; opponents believe that such combinations are unwise or even illegitimate. In this article, I try to separate facts from beliefs. I report that the Domini Social Index, an index of socially responsible stocks, did better than the S&P 500 Index and that socially responsible mutual funds did better than conventional mutual funds over the 1990–98 period but the differences between their risk-adjusted returns are not statistically significant. Both groups of mutual funds trailed the S&P 500 Index.

Errata

Socially responsible mutual funds performed as well as conventional mutual funds in the period May 1990 through September 1998, and the Domini Social Index (DSI), an index of stocks of socially responsible companies, performed as well as the S&P 500 Index.

The DSI is a capitalization-weighted index modeled on the S&P 500 but with a combination of exclusionary and qualitative screens used in its construction. The screens eliminate from the DSI companies that derive 2 percent or more of sales from military weapons systems, derive any revenues from the manufacture of alcohol or tobacco products, or derive any revenues from the provision of gaming products or services. The qualitative screens reflect the entire company record on diversity, employee relations, the environment, and similar issues.

For the May 1990 to September 1998 period, the DSI beat the S&P 500 by a small margin when performance was measured by raw returns. The mean arithmetic annualized return of the DSI in the study period was 17.31 percent, which exceeded the 16.95 percent mean return of the S&P 500. Beta and standard deviation both indicated that the DSI is somewhat riskier than the S&P 500. When risk-adjusted returns were measured, the S&P 500 beat the DSI by a small, statistically insignificant, margin.

The Domini Social Equity Fund, a mutual fund indexed to the DSI, uses the DSI social screens. Some other socially responsible mutual funds, however, do not use the DSI screens. For example, the Amana Fund screens reflect Islamic principles, and the Meyers Pride Fund screens in companies that support gay rights. The screens do share some common themes: 84 percent of socially screened portfolios exclude tobacco, 72 percent exclude gambling, 69 percent exclude weapons, and 68 percent exclude alcohol.

The risk-adjusted performance of the study's 31 socially responsible mutual funds lagged the S&P 500 by an average of 5.02 percentage points a year when risk was measured by beta. The average performance of a matching sample of 62 conventional mutual funds was worse, lagging the S&P 500 by an average of 7.45 percentage points. The difference between the performance of the socially responsible and the conventional funds was not, however, statistically significant. The poor performance of both socially responsible and conventional mutual funds reflects, in part, the general tilt of mutual funds toward small-cap stocks and the poor performance of such stocks in the period studied.

Socially responsible investors may use their investment activities as banners or as swords in the battle to affect the behavior of companies. Socially responsible funds act as swords when their withdrawal of money from the stocks of companies raises those companies' costs of capital and reduces the availability of the product. Socially responsible investing acts as a banner when it rallies the public to use political action as swords. For example, the social responsibility movement played a role in the battle that led to the imposition of high taxes and settlement costs on tobacco companies.

Socially responsible investments provide insights into the general demand for securities that meet investors' search for value-expressive as well as utilitarian features in their investing. In the future, a comprehensive model of asset pricing will need to describe how both utilitarian and value-expressive features determine the demand for investments and their expected returns.

I thank Jennifer Clayton, Ramie Fernandez, Tom Kuh, Lloyd Kurtz, John Rekenthaler, and Jonathan Scheid and acknowledge financial support from the Dean Witter Foundation. I also thank Sheridan Pauker and Jonathan Scheid for their help with the corrections.