Chapter 9
The Impact of Social Screening on the Performance of US and European Funds

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ABSTRACT

This chapter investigates the relationship between the performance and the screening strategies of US and European socially responsible funds. For the full sample and, in particular, for US funds, the results show a curvilinear relationship between screening intensity and fund performance. Continental European funds exhibit a positive relationship between the number of screens and performance. Furthermore, for the full sample and US funds, screening on governance impacts performance positively. In turn, environment and products screens have a negative impact on US fund performance. Finally, funds certified with social labels tend to yield higher performance. Overall, the geographical differences in the impact of the screening process on SRI fund performance are consistent with the contextual nature of socially responsible investments.

INTRODUCTION

During the last decades, sustainable investments have experienced a substantial growth in financial markets.[1] The well-known corporate and environmental scandals of the beginning of the millennium and the events associated to the 2007-2008 international financial crisis have led to calls for reconsidering the role of finance in society, in particular the need to promote socially responsible corporate behavior and sustainable investments. Accompanying this trend, investors are increasingly willing to integrate non-financial criteria into their investment decisions to reflect their sensitivity to issues such as emissions control, global warming, human rights, labour relations and board diversity. Several recent papers

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investigating the drivers of sustainable investments confirm that social preferences are more important than financial motives in the decision to invest in socially responsible investment (SRI) funds (e.g., Riedl & Smeets, 2017). This evidence is consistent with a segment of values driven investors that wish to incorporate their social and personal values into their investment decisions (Derwall et al., 2011), even if it comes at the cost of lower returns. Nevertheless, the mainstreaming of sustainable investments is anchored with an approach that accommodates investors who wish to integrate Environmental, Social, and Governance (ESG) issues into traditional asset management as a strategy to generate profitability (Derwall et al., 2011; Revelli, 2017). The increasing growth of socially responsible investing around the world has led to an intense debate on whether there is a financial premium or penalty for holding SRI funds, with empirical evidence showing that, in general, investors do not sacrifice performance compared to conventional funds (Revelli & Viviani, 2015). Additionally, from the investor's point of view, selecting companies with high levels of CSR can be viewed as a useful risk management tool, as there is evidence documenting the portfolio risk mitigating effects of ESG integration (e.g., Maxfield & Wang, 2020). As such, managing ESG risks plays an important role in the investment process, regardless of the motivations underlying SRI.

Despite the profusion of funds with sustainability features, there is still ambiguity on what makes a mutual fund socially responsible. The answer to this question is not straightforward, as there is no single and universal definition of what criteria a mutual fund should follow to be considered an ethical or socially responsible fund (Dunfee, 2003). SRI funds can use several social screening strategies. Negative screening strategies exclude stocks that are associated with products or activities considered socially unacceptable, while positive screening strategies involve selecting stocks of firms meeting superior standards on several dimensions of corporate social responsibility. To avoid possible diversification biases, such as the exclusion of entire industries, a popular screening strategy is the best-in-class strategy, which involves selecting the companies with best social practices in each sector. Besides using different screening strategies, SRI funds can also vary on the type of screens used (e.g., of the environmental or social type) and the number of screens used (i.e., screening intensity). Combining different screening strategies, types of screens, and the number of screens used by mutual funds may result in different understandings of the objectives the screening process encompasses and leads to considerable heterogeneity in the SRI fund landscape (Sandberg et al., 2009). Ultimately, the degree of heterogeneity in the criteria used by SRI funds reflects the wide diversity of investors' values. Despite the heterogeneity of SRI funds, many studies treat them as being homogenous. According to Galema et al. (2008) and Derwall et al. (2011), among others, one of the reasons why the empirical literature finds scarce significant relations between socially responsible investments and returns is the aggregation of different social dimensions that may have confounding effects in financial performance. We argue that the heterogeneity within the SRI fund industry in terms of the screening processes used should be considered when investigating the impact of social criteria on mutual fund performance.

In this context, the main objective of this paper is to investigate how the screening process used by mutual funds affects risk-adjusted performance, and also if the impact of the screening processes differs geographically. Thus, the research question addressed in this investigation is: Do different screening strategies, types of screens and number of screens affect SRI funds' financial performance and does this impact vary in different regions worldwide? This study comprises data from socially responsible mutual funds domiciled in European countries and in the US. The analysis of whether there are geographical differences in the impact of the screening process on SRI fund performance is relevant, considering the