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### Socially Responsible Investing: It's a Sin

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By Charles L. Norton, RealMoney.com Contributor

*"There is one and only one social responsibility of business -- to use its resources and engage in activities designed to increase its profits, so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."*

-- Milton Friedman

Contrary to that statement by the Nobel Prize-winning economist, companies are increasingly being judged not on their fundamentals, but on the morality of their business practices.

In fact, investing based on the ethical merits of a company is arguably one of the fastest growing trends in the investment industry. So-called socially responsible investors put their hard-earned money to work only in a select group of companies that they deem morally worthy of their investment.

It's not a new phenomenon, but the numbers are startling. There's an estimated \$2 trillion currently invested in a so-called socially responsible manner. Heavyweights like Vanguard, Smith Barney, Neuberger Berman, and Dreyfus, among others, offer products aimed at the ethically charged, and more than 20 such funds have been around for over a decade. There's even talk of a socially responsible ETF coming out in the not-too-distant future.

But here's the real shocker: The owners of those \$2 trillion are wrong.

At least, if making money is the objective. While socially responsible investing is certainly a noble endeavor, the line between doing good and making money has been blurred -- to investors' own detriment. In fact, because of these funds' steep fees, do-gooder investors would be better served investing in an index fund and donating the difference in expenses to their favorite charity.

For an investment strategy to be successful, it has to meet at least two objectives. First, using an active process to select stocks should be more profitable than if no strategy were used and an investor passively put their money in an index product (which would come with much lower fees).

Second, the companies that meet a strategy's investment criteria should outperform those that don't. Otherwise, the very companies that a strategy screens out would be better investments than what's left in, which means that the investment process itself limits its performance.

Socially responsible investing fails on both counts.

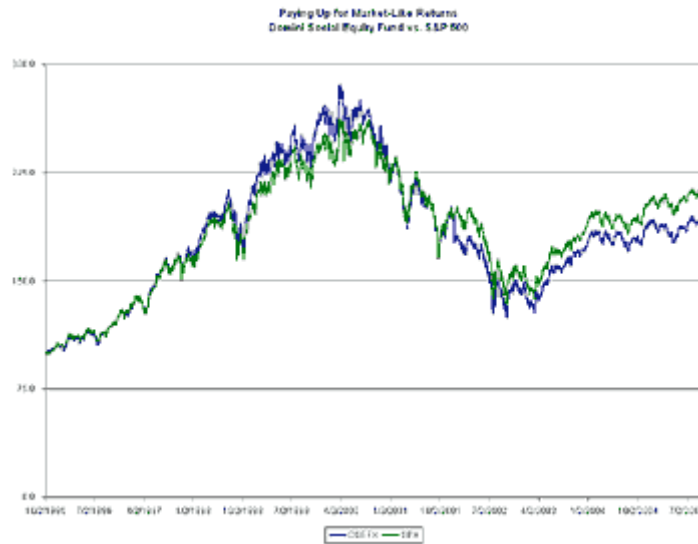
Last week, Vanguard announced that it was changing its benchmark to the FTSE4Good US Select Index from the Calvert Social Index for its Vanguard Calvert Social Index Fund (VCSIX). Both benchmarks are more than 98% correlated to the **S&P 500**, using weekly data from November 2001 through September 2005, implying that there's little value in using either one.

Academic research on the matter offers a similar conclusion. In one of the most cited studies, Meir Statman of Santa Clara University found that there was no statistically significant difference between the performance of social mutual funds and conventional funds.

Yet, despite the fact that these two social benchmarks are statistically the same as the S&P 500 Index, the expense ratio of the Vanguard Calvert Social Index Fund is nearly 40% greater than that of the Vanguard 500 Index Fund.

Granted, it's a small difference in absolute terms, but investors are paying a premium nonetheless.

Or consider the largest socially responsible fund, the \$1.3 billion Domini Social Equity Fund (DSEFX). The expense ratio of this fund is 0.94%, yet over the past decade the fund has virtually mirrored the S&P 500.



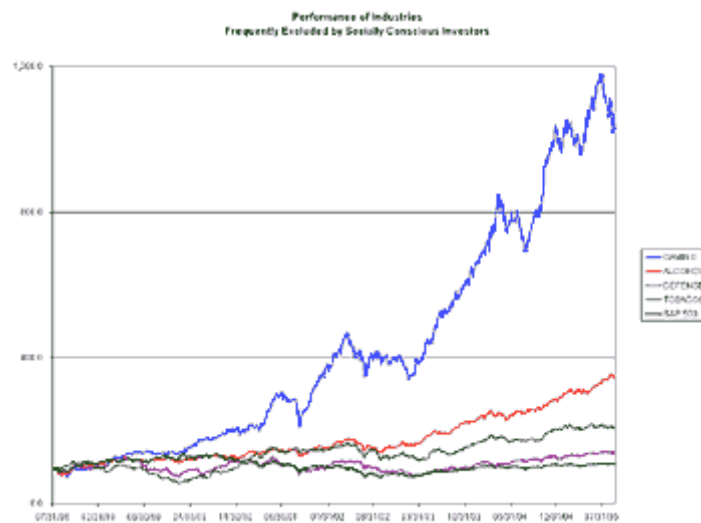
Then there's the more important issue of whether socially mindful money managers are doing their clients a service by excluding certain sectors -- or actually hindering their performance. In a paper published in the Fall 2005 issue of *The Journal of Investing*, David Hemley and two colleagues wrote, "By definition, any socially conscious fund that generates a poorer return than an excluded industry sector has been constrained by excluding that sector."

To find out whether the performance of those who invest with the heart is, in fact, being constrained, let's look at the how various sectors have done over the past few years.

Socially responsible investors have different parameters for what they outlaw. Ironically, what some consider acceptable others deem taboo. There are also discrepancies between the behavior of acclaimed and condemned companies. For example, monopolistic **Microsoft** (NasdaqNM:[MSFT](#) - [News](#)) is often included in socially-acceptable portfolios, while **Anheuser Busch** (NYSE:[BUD](#) - [News](#)) is almost always left out, despite the fact that it's the world's largest recycler of aluminum beverage containers.

Most, however, steer clear of investments in companies that derive significant revenues from the manufacture of tobacco or alcohol, or from the operation of gaming enterprises. Military contractors and firearms manufacturers are also typically no-no's.

The chart below shows the performance of the AMEX Tobacco Index, the S&P 1500 Aerospace & Defense Index, and indices of the gaming and alcoholic beverages industries that I had to create. The latter two are an equal-weighted basket of all companies in the respective industry groups with a market value greater than \$300 million, and that had data going back to 1998.



Source: GNI Capital

Every industry group excluded by do-gooder investors outperformed the S&P 500 from 1998 through 2005 -- in some cases, like gaming, by a large margin. So by narrowing the investable universe, these investors are doing a disservice to their wallets (or, even worse, their clients' wallets).

Finally, I took these four industry groups -- tobacco, alcohol, aerospace, and gaming -- and combined them into one index, with each group weighted equally. Below is a chart of how this index, comprised of stocks almost always shunned by moral investors, compared to both the S&P 500 and the Domini Social Equity Fund.



Source: GNI Capital

So it's clear that by limiting the universe of possible investments to only those that meet certain ethical guidelines, investors are constraining their performance. In portfolio theory jargon, this limitation results in a lower efficient frontier for social-based investors.

In other words, the \$2 trillion attempting to do well by doing good is, in reality, paying an ethical premium for average performance. In a world where money and returns matter, that seems criminal.

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