The Cost of Socially Responsible Investing

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Socially responsible investing can be costly. The cost depends on manager skill, how stringently the manager defines socially responsible investments, the portfolio size, and the base investable universe. The authors quantify the cost of socially responsible investing by using several variables. They find that the cost is highest for the most highly skilled managers with the most stringent limitations on their investable universes. The authors do not argue against socially responsible investment but, rather, assert that investors should be fully informed of the cost.

The authors seek to quantify the cost that socially responsible investors incur as a result of limiting their investment universe to those companies they deem socially responsible. Some proponents of socially responsible investment claim that responsible companies perform as well or better than others and, thus, socially responsible investing is without cost. The authors define socially responsible investors as those who exclude from their portfolios the securities of otherwise attractive companies deemed as acting in socially irresponsible ways in favor of less attractive companies judged as behaving in more socially beneficial ways. Therefore, they assert, some cost must be associated with socially responsible investments.

The authors use Monte Carlo simulation to estimate the cost of socially responsible investing. They first draw a random sample of 500 returns from a normal distribution with a mean of 0 percent and a standard deviation representative of various indices' dispersion. The returns are ranked from highest to lowest. To simulate various skill levels, random pairs of returns are switched. The authors select a subsample of the returns and calculate its arithmetic average. That average represents the performance of an investor with imperfect foresight who selects an equally weighted portfolio from an unrestricted universe. Next, the authors randomly delete a fraction of the

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original universe to simulate the effect of restricting the universe for purposes independent of expected performance. The authors again select a subsample from the culled universe and calculate its arithmetic average. The culled average is then subtracted from the whole universe average to solve for the cost of socially responsible investing. The steps are repeated 10,000 times to arrive at an average cost.

Cross-sectional standard deviations are used to represent actual 2007 deviations for the following indices: S&P 500, MSCI EAFE, MSCI World, and MSCI All Country World (ACWI). The authors select portfolios of 100 and 250 securities. An investor's skill at ranking returns is varied from 50 to 60 percent, in 2 percentage point increments. They estimate costs associated with excluding 10 percent, 20 percent, and 30 percent of securities from investment.

Results show that an investor who correctly ranks 52 percent of securities in the S&P 500 Index and builds a portfolio of 100 stocks while eliminating 20 percent from consideration gives up about 0.17 percent annually. At the other extreme is an investor who correctly ranks 60 percent of securities in the MSCI ACWI, builds a 250-stock portfolio, and reduces his or her investable universe by 20 percent. This investor cedes about 2.4 percent of performance per annum as a result of his or her imposed restriction on investable securities. Considered from another angle, if the first investor manages a $1.0 billion account for 20 years and assumes an average market return of 8 percent, the investor will sacrifice about $153 million in performance. If the second investor manages the same-sized portfolio but excludes 20 percent from the MSCI ACWI universe, the act of limiting the investable universe will cost about $421 million over 20 years.

The authors do not make a case against socially responsible investing. They simply assert that investors should be informed of its associated cost. Alternate ways exist for influencing the behavior of companies. Investors can choose to eschew investment in irresponsible companies and bear those costs. Or, they can invest in those companies but redirect the excess gains toward alleviating the social harm the companies are deemed to cause. The authors conclude that only by clearly understanding the cost of socially responsible investing can investors make an informed choice.

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