U.S. News & World Report
August 19, 2014

Are Socially Responsible Funds a Smart Way to Invest?

These funds may make you feel good, but do your homework before investing.

Some mutual fund companies are tapping into growing interest among millennials and women to invest in funds that account for environmental and social issues. But are so-called "socially responsible" funds simply a way for investment companies to cash in on good intentions, or are they a smart way to invest?

Sixty-five percent of women versus 51 percent of men say they think it's important to consider the impact of investment decisions on society and the environment, according to a 2013 U.S. Trust Insights on Wealth and Worth survey of 711 adults with at least $3 million in investable assets. In the same survey, 67 percent of investors under age 49 felt the same.

Meanwhile, a TIAA-CREF Asset Management survey taken in January asked 1,000 plan participants about their interest in socially responsible investments. Among survey respondents under age 35, 76 percent said they were interested or very interested in SRI options versus 64 percent of all survey takers. Seventy percent of women surveyed were also interested in SRI strategies, which take social, environmental and corporate governance factors into account, compared with 55 percent of men.

Millennials' interest in these funds is indicative of their pushback against the kind of short-term thinking that spurred the financial crisis, says Joseph Keefe, CEO of Pax World Management LLC and Pax Ellevate Management, which offer socially responsible funds.

“A lot of millennials grew up in a time when the market was broken and there were corporate governance meltdowns. They have a sense of how excessively short-term thinking got us into trouble,” Keefe says. “Transitioning into a sustainable economy will require a longer-term focus.”

The longest-running index for socially responsible investing – the Domini 400, now known as the MSCI KLD 400 – was created in 1990. Since then, the meaning of "socially responsible" has shifted from simply excluding vice industries such as guns, pornography, cigarettes and gambling to consider factors including unfair labor practices, environmental concerns and company diversity.

The number of socially responsible funds has held steady in recent years, from 182 funds in 2012 to 183 in 2013 and 181 today, according to Morningstar data.

How socially responsible are these funds? Determining which companies are socially responsible is not as simple as it seems. For example, investors may not realize that a manufacturing company with green facilities may also dispose of unused parts and other trash in an environmentally irresponsible way.

Some funds are becoming increasingly focused on issues of diversity as well as environmental and labor issues. For example, Pax Ellevate Global Women's Index Fund was recently relaunched to invest in more than 400 companies with the highest rankings in women's leadership determined by Pax World's gender analytics. Representation of women on the board of directors and in the C-suite is weighted the heaviest. But how well does the fund represent women on the lower echelons of a company? Keefe says the fund also weights factors such as whether the company has endorsed the United Nations' women's empowerment principles.

Since the funds differ widely in their approaches, investors should do their homework to understand if a fund meets their criteria for sustainability and social responsibility, says Amy O'Brien, managing director and head of global social and community investing at TIAA-CREF. "There is an increasing trend toward more comprehensive evaluations. In our approach, we have to look at things on an industry basis. You don't evaluate a tech company in the same way you'd evaluate a financial company," O'Brien says.

Dan McElwee, a wealth manager and executive vice president of Ventura Wealth Management, says investors have to set their priorities, such as expected return or how well a fund measures companies' adherence to certain values. For example, a technology company may have a stringent emissions limit for its factories, but it doesn't pay its workers a fair wage.

"Look at international solar companies. When you look at the pollution that comes from creating [solar panels], especially in China, it's not as cut and dry as it seems," McElwee says. "Life is about choices, and so is investing. Do you plan for your child's college education or for your retirement? The same applies here. Do you care more about return than exposure to certain stocks?"

McElwee says some investors may want to consider building their own portfolio instead of investing in a socially responsible mutual fund.

Should you invest in these funds? Assuming a fund meets your standards for social responsibility, the next question is whether it provides decent returns.

Keefe argues that stocks of companies with women on their boards perform better than stocks of companies without women on the board. “It’s not a niche strategy … A significant body of research shows that where women are better represented in management, those companies do better over time. This isn’t a nice thing. This is about making money,” Keefe says.

Michael DiNuzzo, vice president and wealth advisor at DiNuzzo Index Advisors, Inc. and a millennial who invests in socially responsible funds, says one drawback of sustainable investing is that you limit your exposure to some emerging markets since environmental standards differ throughout the world.

“For sustainability, if you look at emerging markets countries, some Eastern European countries and South American countries may [have good environmental standards], but it’s not the same as it would be in more developed countries,” DiNuzzo says.

Investing in some socially responsible funds could also limit your exposure to entire sectors, says Clint Haynes, a financial advisor and founding partner of Axius Financial. "The cons are that you’re limiting yourself too because you don’t have as many options to invest in. Sometimes you’re not investing in pharmaceuticals or defense," Haynes says.

Investors also need to research funds to find out what company sizes are represented in the portfolio and other details about their screening process. “People are sometimes hesitant to put their money in these funds … You apply a screen, and based on those parameters, that’s what’s allowed,” DiNuzzo says.

He favors funds that track MSCI SRI indexes because there is more historical data on which to base investment decisions. “There’s at least something to compare it to. You’re able to find more historical data. You can have some idea of how it will perform in the future and how much risk you’re taking on,” DiNuzzo says. “My investments are pretty close to the benchmarks I thought they would be close to, and that gives me a good feeling.”

Funds that provide broad exposure to a variety of large-cap companies may be a better bet for socially responsible investors who want steadier returns. The iShares MSCI KLD 400 Social ETF, which provides exposure to U.S. stocks screened for environmental, social and corporate governance standards, has performed similarly to the Standard & Poor’s 500 index over the past few years. It returned an annualized 65.4 percent over the past three years and has gained 18.6 percent over the past year. In comparison, the S&P 500 rose an annualized 63.7 percent over the past three years and gained 18.7 percent in the past year. The ETF's top holdings are Procter & Gamble, Verizon Communications, IBM, Intel and Merck.