On Course Financial Planning
Facing the Future with Optimism and Courage
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Socially Responsible Investing

Fund companies often create new funds in response to investor demand or to attract investor interest when accompanied by a persuasive story. In recent years, socially responsible investing (SRI) has fulfilled both criteria. SRI and ESG (environmental, social and corporate governance) funds invest in companies for non-economic reasons. Common themes for SRI funds include avoiding investments in alcohol, gambling, defense and tobacco companies. ESG funds seek to invest in companies engaged in social justice, environmental sustainability, alternative energy, human rights and firms considered to have good employee relations.

The persuasive story that accompanies these funds is that you can invest your capital for both financial gain and to support companies that do social good. Whose idea of social good or the precise definition of social good is never fully explained. Some proponents of SRI/ESG funds claim that these companies will produce better returns. But there is little or no evidence that "socially responsible" companies provide better returns than companies that don't make the grade. Most research on the performance of SRI/ESG funds suggests that, at best, they perform about as well as non-SRI/ESG funds in the same asset class.

Proponents of SRI/ESG investing hope that if enough people get on board, companies that harm society (no clear definition of harm) will find it harder to attract investor dollars; leading to higher capital costs and lower profits which could lead to a change in corporate behavior.

There are more than 150 SRI/ESG funds in the Morningstar mutual fund database. With such a limited investing criterion, most will hold similar portfolios unless fund managers are given broad latitude in defining "socially responsible". Most SRI/ESG funds are actively managed and charge relatively high management fees. Just like any actively managed fund, they will struggle to beat an index fund.

Q. If you invest in a SRI/ESG fund, how can you know if the fund manager shares your socially responsible values?

A. You can't because it is impossible to practice socially responsible investing on a collective basis. SRI/ESG fund managers must make "socially responsible" investment decisions for a pool of investors, each of whom likely defines morality and social responsibility differently. If someone created a list of activities that most Americans agree are socially irresponsible, we'd find that these activities are already (or used to be) illegal.

Mutual fund companies generate revenue from investment management fees. This creates a conflict of interest between producing profits for their corporate shareholders and generating superior, net-of-fee returns for their investors. Fund companies grow revenue by increasing assets under management; which creates an incentive to offer funds in a style or strategy that is currently popular.

"What's Trending? The Performance and Motivations for Mutual Fund Startups" is a 2016 study that examined the habit of mutual fund companies to cater to investor sentiment by launching "trendy" mutual funds to attract more assets. The authors divided new fund offerings into two categories –

- Skill motivated funds – fund companies launch new funds in a style or strategy that they believe their managers possess an expertise - which is the basis for their expectation of future outperformance.
- Demand motivated funds – fund companies launch new funds to profit from the current popularity of an asset class or investment strategy. They do so even if the company does not expect the fund to outperform or doesn't employ managers with expertise in managing the type of assets in the fund. Internet funds in the 1990s and commodity funds in the early 2000s are examples of demand motivated funds. Fund companies often charge higher fees for trendy funds than for their traditional funds.

The authors studied the monthly performance of more than 7,000 mutual funds from 1993 through 2014. They compared the difference in performance of trendy funds in the first five years of their existence to more traditional, non-trendy funds. The authors discovered that trendy funds attracted significant additional inflows in the first 12 months of their existence. However, these funds underperformed nontrendy funds over the five years after inception by an average of 1.0% annually. In conclusion the authors noted: "*Under the demand motivation, fund sponsors consider investor* *sentiment and market demand in their decisions regarding what funds to launch as they seek to attract assets under management to generate management fee revenues. This demand motivation exists regardless of whether the fund manager has skill…The implicit assumption of most studies of mutual fund performance is that funds are launched with an expectation of skill. In contrast, our results suggest that fund launches may be motivated by demand considerations, rather than skill expectations alone."*

Investors flock to funds with names that reflect current trends and investor preferences, so it's no surprise that mutual fund companies exploit investor sentiment when naming trendy funds. A 2018 Morningstar article on SRI/ESG funds noted: "*Funds launched in the past few years overwhelmingly use some term in their names to indicate their focus on what I call sustainable investing. Among funds launched or renamed since the beginning of 2015, 100 out of 111 use a reference word in their titles*."

There are several reasons why SRI/ESG funds are unlikely to enhance investor returns. First, there is no consensus on how to define corporate social responsibility. Every fund manager has the freedom to define SRI and ESG as he or she sees fit. It's hard to see why anyone would expect to receive superior returns when there is no agreement on what corporate social responsibility means or how to measure it. Instead of investing in SRI/ESG funds, investors seeking to do social good might be better served by investing in a globally diversified portfolio of index funds and donating the gains to non-profit agencies engaged in the socially responsible activities that they support.

Investing Is Hard

Defined benefit pension plans are disappearing; replaced with defined contribution plans that require an understanding of investing and the capital markets that most employees lack. I began On Course Financial Planning in 2004 thinking that perhaps one person in twenty has the knowledge, optimism, patience and emotional discipline to successfully manage their portfolio. Nothing I've seen in the past 14 years has caused me to change this opinion. This isn't a criticism, it's an observation. Few do-it-yourself investors will impoverish themselves but over the course of an investing lifetime, most will end up with a nest egg that is significantly smaller than what it could have been.

There's a well-earned distrust of Wall Street and its representatives throughout our fair land. Much of it is deserved but this leaves investors in a quandary. Those who believe that the system can't be trusted are likely to end up as do-it-yourself investors who seek and take advice from nearby amateurs - family and friends. No surprise then that we so often hear about people who have lost money in risky, obscure, speculative, complex investments or financial frauds.

Investor behavior, not investment performance, is the prime determinant of success or failure in long term wealth accumulation. Studies in behavioral finance reveal that investors do not learn from the past (their own experience or that of others) so they keep making the same predictable mistakes. Perhaps this is because it's so easy to fool ourselves into thinking that we are older and wiser than our "past selves" so we won't repeat our past mistakes.

The financial media highlights the stock market's short-term performance. This emphasis harms investors who inevitably react to opinions and recommendations that might not reflect the market's long-term fundamentals. Every day, investors are bombarded with endless information and often find themselves asking, "What do I do now?" When faced with information that is too overwhelming to absorb or comprehend, we tend to use decision-making shortcuts called "heuristics". One of the most common decision heuristics is using past performance when choosing mutual funds.

Most investors don't understand the part that luck plays in short-term returns. I'll define luck as an invisible force that yields results greater than what effort alone is likely to produce. Over the short-term, an excellent strategy might yield subpar results while a "stab in the dark" strategy can produce phenomenal results. Luck is never mentioned when the financial media interviews successful fund managers. The article "Chasing Performance and Identifying Talented Investment Managers" appeared in the Spring 2018 issue of *The Journal of Investing*. The paper provides new insight into why performance chasers are so often disappointed by the subsequent performance of their investments. The authors acknowledge that investing in funds with excellent past performance makes intuitive sense but *"it takes an impractically long time to differentiate talented from untalented managers – far longer than the five years or so that many investors believe is sufficient."*

They give the example of a group of 21 fund managers – 20 of whom are unskilled. From a purely mathematical standpoint, there is only a one in seven chance that the skilled manager will outperform the other 20 managers over a five-year period. In other words, in six out of seven years we expect that at least one unskilled manager will be lucky enough to outperform the skilled manager. Over ten-year periods the odds are just one out of three that the skilled manager will outperform the other 20 managers. Even after 15 years, the odds that the skilled manager will outperform all other managers is only 50-50. In their summary the authors noted: *"the probability that a talented manager's performance will exceed the best in a pool of untalented managers can be surprisingly small, even for long time periods;*

hence, chasing performance is unlikely to result in choosing the best managers." I have always assumed that performance data over time periods of less than five years is random; useless for determining if luck or skill produced the returns. It seems that I should increase this to at least ten years - a time frame that is a multiple of what most investors use in analyzing past performance data when trying to find skilled fund managers.

All investors are subject to "recency bias", the term that describes our tendency to assume that the future will look like the recent past. The most recent example of this phenomenon came in the first quarter of this year when, in response to a sharp, but not uncommon, 10% decline in stocks, investors withdrew $53 billion from domestic stock funds. Looking at investment returns on an annual basis reinforces our susceptibility to recency bias because annual return data tends to overstate the volatility of returns. Over five or ten-year time horizons, annualized returns tend to fall within a smaller range of outcomes as compared to one-year time horizons.

Another behavioral mistake that investors make is called "hindsight bias". This is the inclination, after an event has occurred, to see the event as having been predictable, even though there is little or no objective basis for this inclination. This is also known as the "I knew-it-all-along" effect. It explains the almost universal belief among investors today that they knew the housing bubble was sure to burst. Hindsight bias gives investors the illusion that they can see what the future holds; often leading them to take more speculative risk with their investments than is prudent.

Can the performance of individual investors be improved by providing feedback that shows them the mistakes they are making? "Does Feedback on Personal Investment Success Help?" is a paper by Sustainable Architecture for Finance in Europe (SAFE) that provided more than 1,500 customers of a German online broker (which does not offer advisory service to clients) with ongoing monthly feedback on their investment activity. The authors attempted to discover if feedback on risk, return, costs and portfolio diversification can improve the investment decisions of investors.

The authors focused on two mistakes which have been shown to be most detrimental to individual investors – under-diversification and frequent trading. Studies have shown that investors who trade the most tend to underperform by the largest amount. All 1,500 investors were frequent traders, with an average annual portfolio turnover well above 100%. Surprisingly, only 3% of investors in the study said that they had a short-term investment horizon. Perhaps they felt that their short-term trading would enhance their long-term performance.

The authors found that after receiving monthly reports over an 18-month period, investors tended to trade less, diversify more and have higher risk-adjusted performance relative to a control group of 35,000 customers of the firm whose aggregate data was used for computing peer group performance. They also found that these improvements became stronger over time. The authors stated their belief that investor behavior is not etched in stone and may be improved by training or ongoing feedback: "*making relevant information salient to them improves outcomes in terms of lower costs and better diversification resulting in higher risk-adjusted returns*."

Brokerage firms, both brick-and-mortar and online, have little incentive to provide feedback to clients that will likely lead to lower trading revenue. As the authors noted in their summary: "*There is no incentive in the market to overcome shrouding and our results suggest that it may not be in the brokers' interest to provide feedback to investors as they ultimately start trading less."*

The rules of successful investing are simple — keep your costs low, diversify and sit still for a long time. Create a financial plan that has a portfolio allocation among stocks, bonds and cash that is appropriate for your goals, time horizon and risk tolerance and rebalance it annually. Maintain a rational expectation for the future returns of your portfolio. Continue to fund your portfolio regardless of what's happening in the market in the short-term. Few investors follow this advice – which helps explain why there are so few successful do-it-yourself investors.

The best financial plan will be of no value if you put it in the shredder. Surprisingly, when the stock market is marching higher some investors will do just that. Through overconfidence – and maybe a little greed – they believe that their portfolio isn't yielding a high enough return. At other times, when stocks are declining, some will panic, under the assumption that the world is about to end because, "it's different this time!". An essential part of any financial advisor's value proposition is keeping clients out of self-induced trouble by providing prudent advice that discourages otherwise smart people from doing dumb things with their money.