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INVESTMENT PERFORMANCE OF ETHICAL AND CONVENTIONAL MUTUAL FUNDS: EMPIRICAL EVIDENCE FROM THE MALAYSIA

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Abstract

The main objective of this Paper is to investigate the performance of Ethical Mutual Funds (EMFs) in comparison with the conventional mutual funds (CMFs). The study has been conducted based on risk adjusted performance (sharp ratio) collecting regarding four conventional funds in Malaysia, four ethical funds in Malaysia and performance of FTSE Bursa KLCI. The results shows that ethical funds are performing poorly than conventional funds and local market portfolio (FTSE Bursa KLCI: IND). This indicates that ethical funds are sacrificing performance compared to conventional funds and other portfolios.

Keywords: Ethical Mutual Funds (EMFs), Conventional Mutual Funds (CMFs), Risk Adjusted performance

1. Introduction

1.1 Background of the Study

Ethical mutual funds or Socially responsible investing (SRI) is a steadily growing market segment. This growth is stimulated by investors who incorporate diverse social and environmental screens into their investment process. Almost one out of every ten dollars under professional management in the US today is invested according to socially responsible principles (SIF, 2005). The Social Investment Forum (SIF, 2006) reports that socially responsible mutual funds employ screens such as tobacco, alcohol, community, employee relations, environment and diversity. In Malaysia most of the ethical funds screenings are on Shariah-based so Islamic mutual funds are treated as ethical mutual funds or socially responsible mutual funds SRI. Malaysia is one of the countries in the emerging financial markets and a founding member of Asia-Pacific Economic Cooperation (APEC), which was established in 1989 to promote open trade and practical economic cooperation among the Asia-Pacific economies (Worthington and Higgs, 2004).

Kreander et al. (2005) stated that investment criteria can be divided into positive and negative criteria. Negative approach excludes companies which meet one or more negative screening criteria. On the other hand, positive screening approach includes companies which meet superior standards or ethical issues (Renneboog et al. 2008). The investment performance of ethical mutual funds or Socially responsible mutual funds (SRI) is an interesting issue to investigate as an alternative to conventional mutual funds (CMFs). Several studies (such as Abdullah et al. 2007; Elfakhani, M. K. Hassan, and Y. Sidani, 2005; Elfakhani and Hassan 2005; Hayat and Kraeussl, 2011; Hoepner, Rammal, and Rezec, 2011; Kraeussl and Hayat, 2008)

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have examined this issue. The major finding has been that ethical mutual funds perform better than CMFs only in a bearish market.

At this stage, the study will help us to understand the position of ethical investments funds or (SRI) in the Malaysia with compared to conventional mutual funds (CMFs) and local market portfolio.

1.2 Rationale of the Study

Socially responsible Investment (SRI) has become major concern of considerable research and debate over the few debates. Demand for this nature of fund has been increased rapidly especially over last few years, by 30% in USA and 40% in Europe. Over last few decades a phenomenal growth has been seen in SRI funds. In US SRI portfolios has been grown by 120% in 2005 compared to last year of 2004. At that time SRI portfolio was 10% of total portfolios (SIF, 2005). Eurosif (2006) stated that, European SRI Funds are in early stage but it is growing very rapidly. In 2005 SRI assets were around 1.4 trillion dollar which represents 10-15% of total market portfolios. SRI funds of Canada increased by $22 billion from the year 2002 to 2004 and in Australia SRI or ethical funds increased by almost 5 times from the period 2011 to 2005 (EIA, 2005). If we consider retail funds then the portion of SRI fund is very small but it is very rapid increase stage. SIF (2005) in their study concluded that in US SRI funds increased from 55 to 201 and in Europe 54 to 375 for the year 1995 to 2005.

Cummings (2000) stated that, ethical firms are expected to perform better in long horizon than that of conventional funds. Some other researchers conclude that screening process of ethical mutual funds has negative impact on the performance of ethical funds. Ethical funds exclude many investment opportunities considering ethical issues which make them less attractive. In this study, only Shahria-based screening process is considered to make ethical mutual funds in Malaysia.

It is known to all that ethical funds avoid investment in certain industries regardless of return from those industries. For this reason, investment from ethical funds seems riskier for than traditional investments (Michelson et al., 2004). It has been arguing that ethical funds charge higher management compared to conventional funds since ethical funds involves sophisticated screening process which makes SRI funds less effective than conventional funds (Michelson et al., 2004). So there is debate regarding performance of ethical funds and conventional funds which become problem of this research and researcher attempted to provide solution to the problem.

1.3 Research Objectives

Broadly, aim of the study is to evaluate the investment performance of ethical mutual funds and conventional mutual funds of Malaysia. The specific research objectives of the study are as follows-

- To determine whether the ethical mutual funds sacrifice or premium their performance over the conventional mutual funds in the Malaysia and
- To investigate the performance of the ethical mutual funds over the market portfolio (local equity index) in the Malaysia.

2. Literature Review

During 18th century due to influence of Catholic Church many individuals refused to do business with firms which are involved in alcohol, slave trade or gambling (Schwartz, 2003). From that the idea of ethical investment got new era. But we noticed peak growth of ethical investment after 1980. Schwartz (2003) and Climent & Soriano (2011) also stated that, corporate social responsibility (CSR) movements and business ethics are becoming important factors in investment and this is in increasing trend which indicates that ethical funds produce sufficient returns.

The market of ethical funds in UK was valued at around $59 billion in 2005 (Co-op, 2006). He also stated that value of Islamic mutual funds (IMFs) was 10 times in 2005 compared to that of 1995. This indicates the growth of ethical mutual funds. Various issue like environmental protection, human rights, labor relations and so on are considered as the screening criteria of ethical mutual funds. This is how SRI funds or ethical mutual funds are getting concentration by ethical or socially responsible investors. SRI funds or ethical mutual funds have seen rapid growth in US, Europe and rest of the world since early 1990s. Most important factor behind the growth of mutual funds is that consumers pay premium price for their desired products.

Criteria like transparency, governance, and sustainability have been emerged as essential SRI screens (Knoll, 2002). Knoll (2002) also stated various non-financial behaviors as the main concern of ethical investments and SRI for its growth. The study by Beal et al. (2005) concluded that screening funds on the basis of socially responsible criteria allows ethical funds to create market niche rather than anticipating positive changes in the society. Therefore, labeling companies as ethical company might be considered as new marketing technique of the mutual funds. Therefore, Enron or Chevron had to pay pollution charges but these companies might not be considered as ethical investment opportunities (Elena, 2009).

Mill (2006) conducted study on 4 SRI funds or ethical funds which switched from conventional funds and concluded that there is positive effect on performance over four years from date of conversion. Another study conducted by Mallin et al. (1995) concluded that there is no significant difference in performances of ethical mutual funds and conventional mutual funds. Kreander et al. (2005) performed similar test using regression analysis and this study also showed that there is no differences between performance of ethical mutual funds and conventional mutual funds in UK. Hasan (2014) studied on nine ethical mutual funds in the UK and nine ethical mutual fund in the Malaysia and found that the ethical mutual funds of Malaysia performing poorly in compare with the ethical mutual funds of the UK.

Gregory and Whittaker (2007) in their study found that 29.92% of conventional funds died before end period and 12.5% of the SRI fund did so. Then additional study conducted considering managements fees and other issues associated with the performance of the mutual funds' investment. Most of the study concluded that bias considerations, time period, fund domicile, management fees, evaluation measurement, number of investigated funds etc. may affect performance of SRI funds compared to conventional funds. On the other hand, shorter history SRI funds showed monthly alpha of -0.28% showing underperformance compared to no SRI funds with alpha -0.04%. Statman (2000) compared the performance between 31 SRI funds and 64 non-SRI funds matched by size of the funds. The performance was not significantly different. Bello (2005) concluded that there is advantage of selecting SRI funds over non-SRI funds as both the funds provided same alpha of approximately -.40% over the period. Studies in the UK (Gregory et al., 1997) also concluded that there is no significant difference between SRI funds and non-SRI funds.

Renneboog et al. (2008) in their study found that there are no significant performance differences between SRI funds and conventional funds on the basis of data collected from 13 different countries and but the report concluded that some countries France, Sweden, Ireland, and Japan seen significant underperformance of their conventional peers by 4-7% per annum during 1991-2003. Bauer et al. (2002) discussed about possible performance of Australian and SRI funds during 1992-2003. Their study concluded positives of SRI funds. They concluded that, SRI funds during that time seen new era and for that reason performance of ethical funds was better. One of first studies conducted on SRI funds is Hamilton et al. (1993) who investigated the performance of 320 randomly selected SRI funds and 32 SRI funds in US for the period 1981-1990. Using Jensen' Alpha the writer found that SRI funds with long history have higher average alpha compared to non SRI funds.

Beal et al. (2005) in their study concluded that, ethical investors invest for premium financial return, non-wealth return and most importantly for social returns. Again their study concluded that ethical investors are motivated by combination of financial returns and non-wealth factors. Many ethical funds provide slightly lower return (1%-1.5%) than that of conventional funds but investors are socially recognized (Beal et al., 2005). McLachlan and Gardner (2004) conducted survey using the sample of 55 conventional and 54 ethical investors showed no evidence that investors of conventional funds are more concerned with financial return than that of ethical investors. They also concluded that social considerations of SRI funds have become new marketing strategy of ethical funds.

This can be stated that, good past performance attracts higher investors over funds with poor past performance (Wie and Yan, 2007). Kempf and Ruenzi (2008) in their study concluded that mutual funds are strongly negatively related to fees. Investors in mutual funds are fee sensitive. Therefore, different fees, risk taking behavior and past performance of the funds are described the fund flow relationship in case of conventional funds. On the other hand, Rennebog et al. (2006) in their study conclude that ethical investors care more about social or ethical issue in their investment decisions rather than performance of the funds. Their study shows that around 75% of the ethical investors consider the ethical side of the funds and then consider past performance. This statement has been supported by other empirical researchers. Bollen and Cohen (2005) also stated that ethical investors are less sensitive to past negative return than they are to past positive return. Rennebog, Horst and Zhang (2006) in their study concluded that average ethical funds in most European and Asia-Pacific countries strongly underperform their benchmark portfolio. They also conclude that investors in those funds are investing not considering the performance rather than ethical issues associated with the funds.

Above mentioned discussion tried to evaluate the performance of ethical funds and conventional funds in the light of various empirical researches which is main concern of the present study. Therefore, it can be concluded here that there is no significant difference between performance of ethical funds and conventional funds. But some studies concluded that conventional mutual funds performed above ethical mutual funds. Now these studies can be used to test the present scenario of Malaysian ethical mutual funds and conventional mutual funds.

3. Research Methodology

Here researcher evaluate data through comparing risk adjusted performance of conventional mutual funds and Ethical mutual funds of Malaysia. William Sharpe devised the Sharpe ratio in 1966 to measure this risk/return relationship; indicating reward for an extra unit of risk. Investopedia (2015) stated Sharp Ratio as risk return trade off measurements which helps to estimate effectiveness of return. The higher the Sharp ratio, the higher the return from per unit of risk. This indicator is under the mean-variance approach (Bodie et al., 2005).

$$\text{Sharp Ratio} = \frac{(R_p - \text{Risk Free Rate of Return})}{\sigma}$$

Where, R_p = Return of the portfolio and σ = Square root of Variance

3.1 Data Collection

While carrying out a research study in structured way, its performance is largely dependent on the proper sources of collected data (Saunders, et al 2009). Two popular data collection sources are primary sources and secondary sources. As discussed above this study conducted on performance of market portfolio, ethical funds and conventional funds and therefore collected secondary data from the Bloomberg Terminal and Data Stream Terminal for the period of 2010 to 2015.

4. Data Analysis and Findings

4.1 Performance of Market portfolio of Malaysia

To measure the performance of Malaysian Capital Market, FBMKLCI was considered. The FBMKLCI stands for FTSE Bursa Malaysia Kuala Lumpur Composite Index where 30 largest companies are included. Therefore, the risk adjusted performance are shown in the following table-

FTSE Bursa Malaysia Kuala Lumpur Composite Index: FBMKLCI	
Mean	0.107428
Standard Deviation	0.101584
Average Risk-Free Rate of Return of Malaysia (Source: MA3MAY Index, Bloomberg)	.030536
Sharp Ratio	0.756925

Source: The table made by the author based on the data collected from Bloomberg and DataStream.

From the table, it is seen that the average annual return of the market was 10.74% and variation of the return for those periods was 10.16%. However, the risk-adjusted return i.e., sharp ratio, of the market portfolio was 0.77 which means that for taking one extra unit of risk market portfolio provide 0.76 times of return.

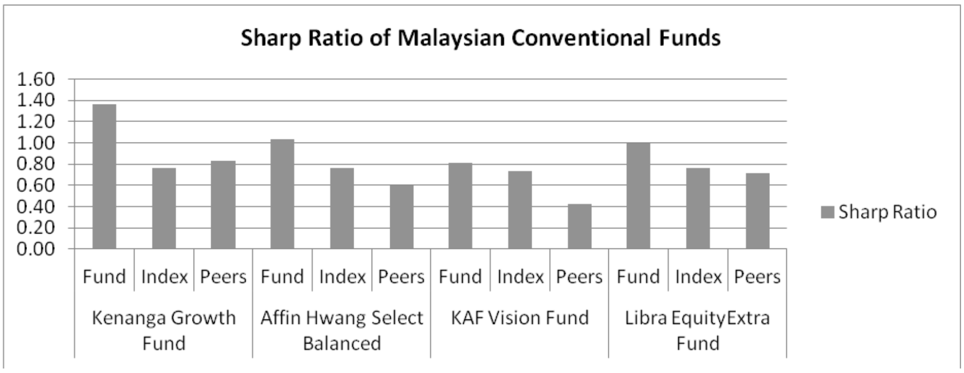
4.2 Performance of Conventional Mutual Funds of Malaysia

To measure the performance of the conventional funds of Malaysia, four (4) CMFs were selected on random basis. The data of their benchmarks and peers funds have also been collected to compare the performance of those CMFs. The risk adjusted performance of the sample CMFs are as follows-

	Kenanga Growth Fund			Affin Hwang Select Balanced			KAF Vision Fund			Libra Equity Extra Fund		
	Fund	Index	Peers	Fund	Index	Peers	Fund	Index	Peers	Fund	Index	Peers
Mean (%)	20.47	10.71	10.11	10.44	10.71	6.34	15.47	11.19	6.52	10.80	10.71	30.26
Standard Deviation (%)	12.75	10.02	8.48	7.16	10.02	5.46	15.38	11.14	8.11	7.77	10.02	37.98
Sharp Ratio	1.37	0.76	0.83	1.03	0.76	0.60	0.81	0.73	0.43	1.00	0.76	0.72

Source: The table made by the author based on the data collected from Bloomberg and DataStream.

From the above table, it is seen that the average return of all the funds were higher than their benchmarks except Affin Hwang Select Balanced Fund's return is slightly lower than the benchmark. On the other hand, in compare to peers return all the funds average return were higher except the Libra Equity Expert fund. That means, in compare to average return most of the CMFs are performing better than their benchmarks and peers' average return. Again, the risk-adjusted performance i.e., sharp ratio of the sample CMFs were more than their benchmarks and their peers. This means that from the perspective of risk-return trade off CMFs of Malaysia providing better return than its benchmarks and peers of the same risk level. The comparative sharp ratio of the above four funds are shown in the following chart-



Source: Graph made by the author which shows the sharp ratios of 4 (four) sample Malaysian CMFs, corresponding benchmark and their peers based on the data collected from Bloomberg and DataStream.

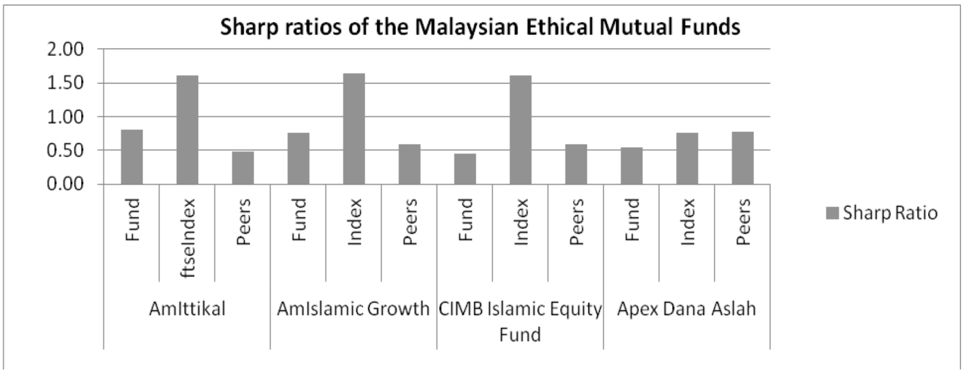
4.3 Performance of Ethical Mutual Fund of Malaysia

In this section, four ethical mutual funds of Malaysia has been selected on random basis to find out the position of the ethical fund in comparison to the peers and the corresponding index performance. The average return, riskiness and risk-adjusted performance (sharp ratio) are shown in the following table-

	AmIttikal			AmIslamic Growth			CIMB Islamic Equity Fund			Apex Dana Aslah		
	Fund	Index	Peers	Fund	Index	Peers	Fund	Index	Peers	Fund	Index	Peers
Mean (%)	10.01	12.86	7.14	9.65	10.71	13.95	6.94	12.86	8.79	9.65	10.71	13.95
Standard Deviation (%)	8.57	6.06	8.49	12.26	10.02	13.97	8.49	6.06	9.71	12.26	10.02	13.97
Sharp Ratio	0.81	1.62	0.48	0.54	0.76	0.78	0.46	1.62	0.59	0.54	0.76	0.78

Source: The table made by the author based on the data collected from Bloomberg.

From the above table, it is seen that the average return of the sample ethical mutual funds of Malaysia were below than the corresponding benchmarks and most of the case from its peers. On the other hand, risk adjusted return of all the sample ethical mutual funds are lower than their corresponding index and peers which means that the ethical mutual funds of Malaysia are performing lower than the benchmarks and peers. This is shown in the following chart-



Source: Graph made by the author which shows the sharp ratio of the Malaysian ethical mutual funds, corresponding benchmark, and their peers based on the data collected from Bloomberg and DataStream.

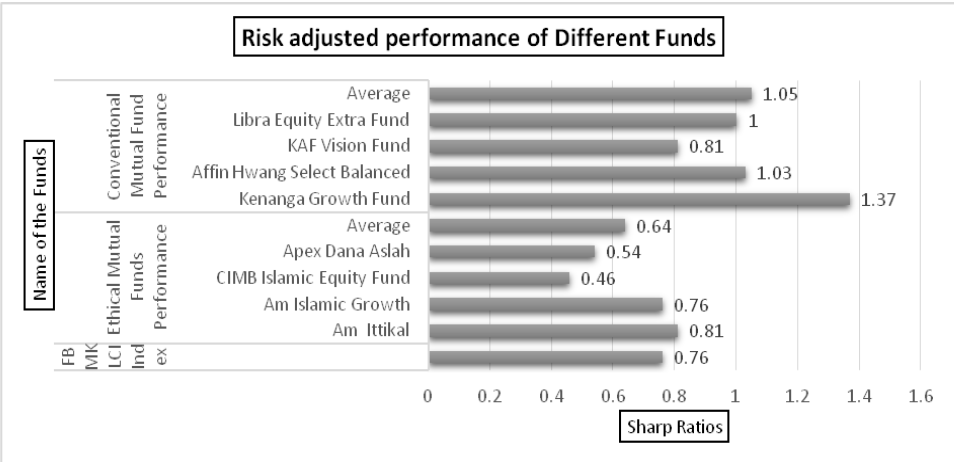
4.4 Position of Ethical Funds Performance among other funds in Malaysia

At this stage, the researcher tries to find out the position of the ethical mutual funds by comparing with the conventional mutual funds and market portfolio performance. To do this, average performance of the sample ethical mutual funds and conventional mutual funds are calculated. Moreover, the market overall performance was measured from the average performance of FBMKLCI. The summary of all these are shown in the following table-

	FBMKLCI Index	Ethical Mutual Funds Performance					Conventional Mutual Fund Performance				
		Am Ittikal	Am Islamic Growth	CIMB Islamic Equity Fund	Apex Dana Aslah	Ave-rage	Kenanga Growth Fund	Affin Hwang Select Balanced	KAF Vision Fund	Libra Equity Extra Fund	Ave-rage
Mean (%)	10.74	10.01	11.62	6.94	9.65	9.56	20.47	10.44	15.47	10.80	14.30
Standard Deviation (%)	10.16	8.57	11.20	8.49	12.26	10.13	12.75	7.16	15.38	7.77	10.77
Sharp Ratio	0.76	0.81	0.76	0.46	0.54	0.64	1.37	1.03	0.81	1.00	1.05

Source: The table made by the author based on the data collected from Bloomberg and DataStream.

It is seen that the average risk adjusted return of the ethical mutual funds are around 40% lower than the conventional mutual funds and around 16% lower than the market portfolio return. This means that on average the ethical mutual funds of Malaysia are performing poorly than the conventional mutual funds and market portfolio. This is shown in the following graps-



Source: Graph made by the author which shows the risk adjusted performance of ethical mutual funds, conventional mutual funds of Malaysia and Malaysian market index (FBMKLCI Index) based on data collected from Bloomberg and DataStream.

From the above all discussion the major findings are as below-

- The ethical mutual funds performance in Malaysia is poor than the conventional mutual funds performance. So, ethical funds sacrifice their performance in Malaysia in compared to conventional funds.
- Ethical funds performing below the Market Portfolio. In this situation, ethical funds again sacrifice their performance over the market portfolio.

Finally, it can be said that ethical mutual funds sacrifice their performance over other investment options in Malaysia. Therefore, the only reason is to invest in the ethical/Shariah funds in Malaysia are the ethical, social, environmental and Shariah issues rather than the consideration of return from the investment. Therefore, ethical mutual funds sacrifice their performance compared to conventional mutual funds and market portfolio in Malaysia.

5. Conclusion

In the Malaysia only Sariah-based selection criteria is followed to select the ethical/social responsible companies. Therefore, large number of financially sound companies are screened out from ethical mutual funds' portfolio. The risk adjusted performance of the ethical mutual funds in Malaysia is poor than the conventional mutual funds' performance. Finally, it is said that ethical mutual funds sacrifice their performance in compared to conventional mutual funds in Malaysia. Ethical mutual funds performing below the Market Portfolio. In this situation, ethical mutual funds again sacrifice their performance over the market portfolio. Kreander et al. (2005) stated that, information asymmetry may make investors not concerned about fees and actual return from the investments. Malaysian investors of ethical mutual fund may suffer from similar situation. Beside these, the economic growth is the main concern of developing countries irrespective of ethical issue whereas the ethical, social and environmental (ESG) issues were come forward for developed countries as they already reach the peak of economic growth.

Lastly, there is a huge opportunity for the introduction of ethical mutual funds in the capital market of Bangladesh as currently there is no such types of ethical mutual funds in our capital market. If we can introduce the ethical mutual funds or Shahriah based mutual funds in our capital market, then a new product will be added in our capital market which will strengthen the economy of Bangladesh in the long run. As most of the people in our country are from Muslim community so this types of ethical mutual funds will be highly accepted by the general investors of the country as like as Shahriah based banking system.

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