

SOCIALLY RESPONSIBLE INVESTMENTS IN MUTUAL FUNDS

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Abstract: *This paper aims to add contribution to the socially responsible investments (from now on called “SRI”) research by examining the significance of this type of investment in terms of ethical or financial prior behaviour. Using the sample of European market of socially responsible investments funds, we first explore the SRI market dimension compared to the global data on SRI. We also investigate whether the ethical recognition is more important rather than the financial performance. Applied to the European social responsible investment fund market, the paper investigates the difference between these two aspects of behaviour and underlies the importance of socially responsible investments in promoting a sustainable development.*

Key words: *ethical consumerism, social responsible, sustainable development.*

1. Introduction

The generic term of “socially responsible investment” covers any type of investment process that combines investors’ financial objectives with their concerns about environmental, social and governance (ESG) issues (EUROSIF Report 2010). The terms “social”, “ethical”, “responsible”, “social responsible”, “sustainable” and others are often used in a multitude of overlapping and complementing ways to approach the SRI context.

Related to “responsible investment”, the area takes into consideration the long term influence of extra-financial factors such as environmental, social and governance (ESG) issues in the investment decision making.

In the same matter, the “socially responsible investment” area incorporates the ESG issues, as well as criteria linked to a value-based approach.

The effect of the social factor can be analyzed from different viewpoints, but investment is one of the most relevant insomuch as it may be the way this change is financed. In this respect, it is a question of discerning whether investment using ethical or social criteria really involves the acceptance on the part of the investor of a lower return.

Moreover, since ethical investment faces the saying “making money or making the difference” (Sandberg J. and co., 2009) the current paper sets its purpose on exploring the European market of socially responsible investment funds, also

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investigating whether for these SRI funds the ethical is prior to the financial performance.

The research is important and original insofar as the European socially responsible investment funds market has not been a widely set as a subject of investigation, despite its current development.

2. Socially responsible investments – Fundamental issues

The socially responsible investment also called ethical investment or sustainable investment has grown rapidly around the world, registering a “global revolution” (Sparkes R., 2002).

The global vision of responsibility has turned into an important philosophy, since more and more people are becoming increasingly aware that the future which includes social and economic welfare is uncertain, unless companies take into account the environmental, social and ethical issues in business decisions. Such concerns have created the need to take notice and try to influence every company in applying corporate actions. Consequently, responsible investment has developed into an economic mechanism for supervising corporate behaviour.

Different researchers at different points in time have emphasized the critical importance of the ethical strategies in promoting and creating a powerful market force for companies to be more aware of their significance to the environment and society in general.

The socially responsible investment issue has encouraged the academic field into various studies. Related to our theme, the most recent studies are the ones of: Statman M. (2000), Sparkes R. (2002), Shueth S. (2003), Sparkes R. and Cowton C. (2004), Bello (2005), Hellsten S. And

Mallin C. (2006), Lozano J., Albareda L. and Balauguer R. (2006), Bengtsson E. (2007), Cummings D. And Johan S (2007), Renneboog L. and co. (2008), Sandberg J. and co. (2009), Copp R., Kremmer M., and Roca E. (2010); we can also add the Reports on 2010 of EUROSIF (for the European SRI market) and Social Investment Forum (for the US SRI market).

Social responsible investments have been heard of since 1960s in US by the time of the civil rights campaign, the opposition to college endowments funds profiting from the controversial Vietnam War and so on. Moreover, the concerns about the Vietnam War led to the establishment of the “first modern SRI mutual fund” on 8 August 1971, the Pax World Fund (Sparkes R., 2002).

During the last 20 years, the research on SRI has been carried out into the financial effect of imposing social and environmental considerations. Many studies have shown the link between good environmental performance and high corporate profitability, but this matter still remains an interesting topic of discussion, since a closely correlation of this two considerations (environmental and financial performance) may ensure good improvement of every economic activity.

All these aspects have imposed a commonly accepted definition of socially responsible investments. Combining these facts (social, ethical, responsible, sustainable), Copp R., Kremmer M. and Roca E. (2010) have defined Socially Responsible Investment (SRI) as being the process of selecting or managing investments with the aim not to maximize investor returns for given risk *per se*, but to optimise these parameters subject to social, environmental and ethical constraints. Examples of social constraints on

investment include objectives of fostering education and training or worker rights; examples of environmental constraints include objectives of minimizing pollution or the carbon footprint from investment; and examples of ethical constraints on investment include refusing to invest in projects involving human rights abuses or animal cruelty.

Independently of the theoretical position, there are two facts that cannot be ignored: the growing implantation of socially responsible actions by firms and the greater availability of funds that, in some way, apply ethical, social and/or environmental criteria to their investment strategies, the so called socially responsible investment (SRI) funds (Sanchez J., Sottorrio L., 2004).

Also, the investors called ethical investors are interested in making a positive impact on society and the environment. They want to make a financial return on their investments and ease their consciousness, but they are not prepared to sacrifice their ethics for the sake of a profit.

Socially responsible investment spans a wide and growing range of products and investments, from stocks and bonds, to savings, checking and other banking accounts, to venture capital. Like all investors, socially responsible investors seek a competitive financial return on their investments, and the good news is that it is possible to consistently achieve this.

Socially responsible investment funds use a set of social, ethical and environmental criteria to select equities for their portfolio. These criteria are either used to choose specific stocks out of the investment universe (positive criteria) or to delete specific stocks (negative criteria). Positive criteria are for example low pollution emissions, equal employment opportunities and good workplace conditions. Usual negative criteria are the production of

alcohol, tobacco, nuclear power or military weapons. Several studies on the performance of SRI investments apply a so called matching approach. They compare the performance of SRI and non-SRI investment funds which otherwise have similar characteristics e.g. concerning investment universe, fund size or fund age. Consequently, the key distinguishing feature of socially responsible investment lies in the construction of equity portfolios whose investment objectives combine social, environmental and financial goals (Sparkes R., 2002).

The oldest and most basic SRI strategy is based on negative screening. These filters refer to the practice that specific stocks or industries are excluded from SRI portfolios based on social, environmental, and ethical criteria. A typical negative screen can be applied on an initial asset pool such as the S&P 500 stocks from which the alcohol, tobacco, gambling and defence industries, or companies with poor performance in labour relations or environmental protection, are excluded. Other negative screens may include irresponsible foreign operations, pornography, abortion, poor workplace conditions, violation of human rights, and animal testing. After performing a negative SRI screening, portfolios are created via a financial and quantitative selection. Some SRI funds only exclude companies from the investment universe when these firms' revenues derived from "asocial or unethical" sectors exceed a specific threshold, whereas other SRI funds also apply negative screens to a company's branches or suppliers. A small number of SRI funds use screens based on traditional ideological or religious convictions: for instance, they exclude investments in firms producing pork products, in financial institutions paying interest on savings, and

in insurance companies insuring unmarried people.

Nowadays, SRI portfolios are based on positive screens which in practice boils down to selecting shares that meet superior corporate social responsibility (CSR) standards. The most common positive screens focus on corporate governance, labour relations, the environment, sustainability of investments, and the stimulation of cultural diversity. Positive

screens are also frequently used to select companies with a good record concerning renewable energy usage or community involvement. The use of positive screens is often combined with a “best in class” approach. Firms are ranked within each industry or market sector according to CSR criteria. Subsequently, only those firms in each industry which pass a minimum threshold are selected.

Key issues for SRI funds

Table 1

NEGATIVE CRITERION		POSITIVE CRITERION	
Tobacco	In the structure of SRI fund portfolio are avoided manufactures of tobacco products	Labor relations and workplace conditions	Seek firms with strong union relationships, employee empowerment, and/or employee profit sharing. Avoid firms exploiting their workforce and sweatshops
Alcohol	Avoid firms that produce market alcoholic beverages	Pollution control	Seek firms with proactive involvement in recycling, waste reduction and environmental cleanup. Avoid firms producing toxic products, and contributing to global warming
Gambling	Avoid casinos and suppliers of gambling equipment	Corporate governance	Seek companies demonstrating “best practices” related to board independence and elections, auditor independence, executive compensation, expensing of options, voting rights and/or other governance issues. Avoid firms with antitrust violations, consumer fraud, and marketing scandals
Military weapons	Avoid firms producing weapons	Business practice	Seek companies committed to sustainability through investments in research and development, quality assurance and product safety
Nuclear power	Avoid manufactures of nuclear reactors and firms operating nuclear power plants	Employment diversity	Seek firms pursuing an active policy related to the employment of minorities, women, gays/lesbians and/or disabled persons who ought to be represented amongst senior management
Irresponsible foreign operations	Avoid firms with investments in firms located in oppressive regimes such as Burma or China, or firms that mistreat the indigenous peoples of developing countries	Human Rights	Seek firms promoting human rights standards. Avoid firms which are complicit in human rights violations
Pornography /Adult entertainment	Avoid publishers of pornographic magazines, production studios that produce offensive video and audio tapes, companies that are major sponsors of graphic sex and violence on television	Renewable energy	Seek firms producing power derived from renewable energy sources
Abortion / Birth control	Avoid providers of abortion, manufactures of abortion drugs and birth control products; insurance companies that pay for elective abortions	Biotechnology	Seek firms that support sustainable agriculture, biodiversity, local farmers and industrial applications of biotechnology. Avoid firms involved in the promotion or development of genetic engineering for agricultural applications
Animal testing	Avoid firms with animal testing and firms producing hunting trapping equipment or using animals in end products. Seek firms promoting the respectful treatment of animals.	Community involvement	Seek firms with proactive investments in the local community by sponsoring charitable donations, employee volunteerism and/or housing and educational programs
Pork producers	Avoid companies that derive a significant portion of their income from the manufacturing or marketing of pork products (used by fund managed according to Islamic principles)	Shareholder activism	The SRI funds that attempt to influence company actions through direct dialogue with management and/or voting at Annual General Meetings.
Healthcare Pharmaceuticals	Avoid healthcare industries (used by funds targeting the Christian Scientist religious group)		

Source: Sparkes R. (2002), Renneboog L. (2008)

The negative and positive screens based on environmental, social or ethical criteria, defined by Renneboog L. and structured by

Sparker R. (2002) are the following, presented in Table 1, as follows:

The fact that SRI funds apply screens that limit the full diversification potential may shift the mean-variance frontier towards less favourable risk–return tradeoffs than those of conventional portfolios. For instance, excluding part of the stock market (firms producing alcohol, tobacco, pornography) may negatively influence the risk–return tradeoffs of SRI funds.

In these circumstances, SRI funds are expected to generate a weaker performance than conventional funds for two reasons. First, SRI funds under-invest in financially attractive investment opportunities, as some of these opportunities are excluded from the investment universe because they do not contribute sufficiently to the SRI objectives of the fund. Second, more intense screening intensity further reduces the investment universe, which may further weaken performance.

However, there are two arguments supporting the alternative hypothesis that states that SRI funds outperform conventional funds. First, sound social and environmental performance signals high managerial quality, which translates into favourable financial performance. Second, social, ethical and environmental screening may reduce the high costs that emerge during corporate social crises or environmental disasters. If financial markets tend to undervalue such costs, portfolios based on corporate governance, social or environmental criteria may outperform their benchmarks.

But socially responsible investment does not assume only benefits, because such activity involves time, effort and resources. Moreover, socially responsible mutual funds tend to have higher fees than regular funds since they hold securities in companies that adhere to high standards of good corporate citizenship. These higher

fees can be attributed to the additional ethical research that mutual funds managers must undertake. In addition, socially responsible funds tend to be managed by smaller mutual fund companies and the assets under management are relatively small. Under these circumstances, it is difficult for SRI funds to make use of the economies of scale available to their larger rivals.

In other words, we can say that funds are exposed to environmental costs (Rayment M. and co., 2009) through:

- *reduced future cash flows for companies held in portfolios and lower future dividends.* Some environmental costs externalized by companies will be incurred by other companies held in large portfolios. They can incur costs through decreases in productivity and increased input costs, including higher taxes, levies and insurance premiums. Falling revenues, unplanned capital investments and increased costs of capital driven by lower risk-weighted projected returns could increase operational costs.
- *rapidly changing conditions in capital markets.* Returns to institutional investors' portfolios are often closely related to capital market returns and value creation across economies, rather than particular companies or sectors. Rising externalities accumulate and can increase volatility in capital markets, which could become more vulnerable to sudden low-probability, high-impact environmental changes. This could undermine economic growth, reduce fund returns and create a diminished, lower-value investment universe.
- *depleted natural capital and reduced cash flows to the economy.* Allocating capital to environmentally damaging activities is

inefficient in the medium to long term and leads to a decline in the asset base.

– *increased environmental costs for companies causing damage.* As governments increasingly apply the “polluter pays” principle, companies will have to meet the costs of reducing pollution and waste or pay compensation for the damage they cause. Abatement costs are usually lower than pollution damage costs.

SRI funds could perform better than conventional ones as SRI funds comprise more carefully and actively selected firms. However, SRI funds could perform worse as the screening reduces the diversification potential which comes at a cost.

3. Legal issues on socially responsible investments

From an international perspective, the social responsible investment issue has imposed shaping a legal framework as an imperative response to all the risks involved by a usage of unethical strategies or by noncompliance of the environmental, social and governance (ESG) issues.

The socially responsible investments received a public concern beginning with the 1980s and 1990s at the time of privatization and deregulation, when people’s lives were strongly influenced by the market forces.

Given rising public concern about corporate behaviour in areas like environmental damage, human rights etc., the politicians became aware that socially responsible investments were an available mechanism that could restrict the unregulated free-market forces in a social responsible and economic sustainable restraint.

The political support for environment and social campaigning such as Greenpeace, Friends of the Earth and

Amnesty International, empowered the growth of ERG concerns. Consequently, various international groups and institutions have been formed to sustain an ethical and responsible behaviour of corporations and of the consumer.

For example, in the US, socially responsible investments are promoted by the Social Investment Forum and the Coalition for Environmentally Responsible Economies (CERES), which emphasize principles on launching better environmental performance and better economic performance. In Europe, EUROSIF (the European Sustainable Investment Forum) acts as a partner of the national Sustainable Investment Forums within the EU, having the mission to develop sustainability through the European financial market.

The environmental issues, like the global warming threat, have raised the environmental problems to the international level since they involve a significant need for change to prevent the future consequences. For this reason, the United Nations has implemented the United Nations Environmental Program Financial Initiative (UNEP) which promotes the development closely related to ERG issues. In the recent years, UNEP and UN Global Compact backed the creation of the Principles for Responsible Investment Initiative (PRI), as a network of international investors working together to identify and to put into practice six Principles for Responsible Investment, which reflect the increasing relevance of environmental, social and corporate governance issues to investment practices.

The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The six Principles assumed by the former members were

guided by the following status: “As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, and asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society”.

The six Principles for Responsible Investment are:

1.to incorporate ESG issues into investment analysis and decision-making processes;

2.to be active in incorporating ESG issues into the ownership policies and practices;

3.to seek appropriate disclosure on ESG issues by the entities in which to invest;

4.to promote acceptance and implementation of the Principles within the investment industry;

5.to collaborate to enhance the effectiveness in implementing the Principles;

6.to report on the activities and progress towards implementing the Principles.

Today, the PRI has become a global standard of best practice within the investment industry, which encourages investors to maintain a collaborative engagement with the investment funds or investee companies (See Figure 1).

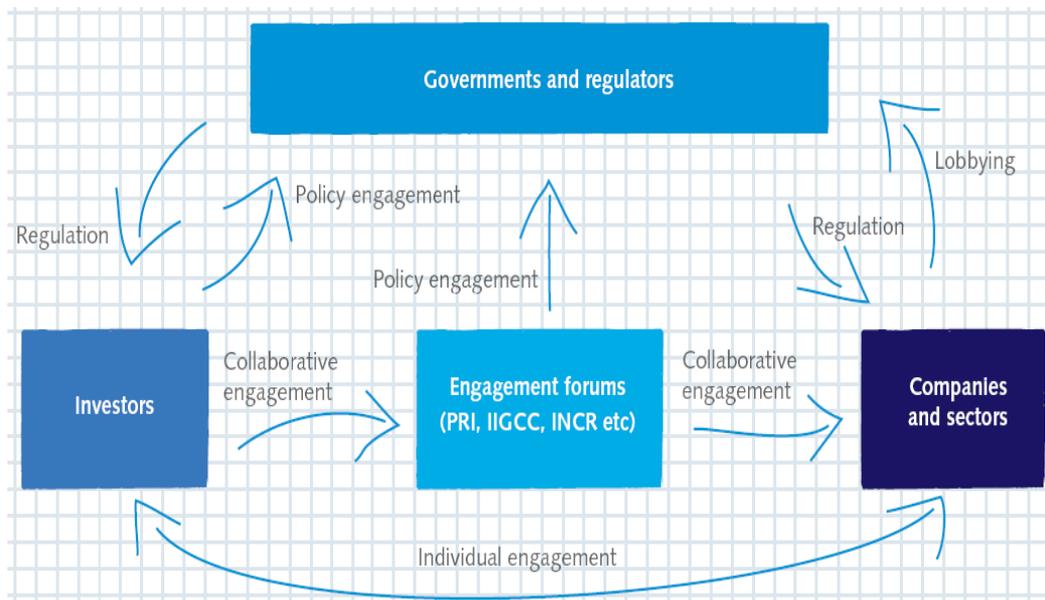


Fig. 1. Engagement mechanism set up by the Principles for Responsible Investment

Source: PRI Report on Universal Ownership.

Why environmental externalities matter to institutional investors p.11

The formulas will be numbered with Arabic figures, written within round brackets, to the right of the column (TNT

11, First line 0.3 cm, Tab stop position 6.75 cm, justified to the right or, in case of writing along the page, Tab stop position

14 cm). The measuring units will be framed within square parentheses and will be placed in the end of the relation. investee companies (See Figure 1).

Investors can encourage policy makers to:	Investors can encourage portfolio companies to:
1. provide long-term certainty on policy direction at national, regional and international levels that can help adjustment to a carbon-constrained and resource-scarce economy	1. measure impacts and dependence on natural resources and assess related business risks and opportunities
2. require companies to report systematically on environmental impacts	2. report on emissions and natural resource use connected with business activities and operations
3. incorporate valuations of natural capital assets into economic analysis and decision-making	3. establish targets to reduce emissions and use natural resources more efficiently. Review these measures on a periodic basis to assess progress.
4. implement incentives or regulation to correct market failures and encourage internalization of costs	4. develop mitigation policies and align environmental management systems with international standards
5. implement science based precautionary measures that aim to avoid sudden, high-impact changes from the use of ecosystem services	5. internally price natural resources and pollutants

Fig. 2. Investor necessary actions to ensure the Principle compliance

Source: PRI Report on Universal Ownership, p. 11

4. The SRI Fund Market

The rapid growth of global SRI in recent years is the best evidence that socially responsible investments yield competitive returns. Over the past 20 years, the total dollars invested in SRI has grown exponentially, as has the number of institutional, professional, and individual investors involved in the field. Between 1995 and 2010, total dollars under professional management in SRI grew from \$639 billion to \$3.07 trillion, outpacing the overall market (Social Invest Report, 2010)

The aggregate value of SRI internationally has grown considerably over the past 30 years, to the extent that SRI is now keenly encouraged by the

United Nations and other supra-national organisations.

The global SRI market can be estimated to reach approximately 7,6 trillion, with Europe holding the largest share, as illustrated below in Table 2. For instance, in the United States, SRI assets are worth US\$2.71 trillion (Social Investment Forum-United States (2007)); in Canada, they are worth some C\$503 billion or US\$471 billion (Canadian Social Investment Organisation, 2006); the UK market is valued at €781 billion or US\$1.17 trillion (European Social Investment Forum 2006); and Japan's SRI markets are worth up to ¥840 billion or US\$7.3 billion (Social Investment Forum-Japan, 2007).

Asset allocation in SRI funds 2010

Table 1

Region	Total SRI (bln. EUR)	% in global allocation
United States	2 141	28,21%
Canada	405	5,33%
Australia	58	0,76%
Japan	4	0,05%
Europe	4986	65,65%
World	7 594	100%

Source: *Eurosif Reseach, 2010*

SRI investing has become part of the mainstream and, as a result, a number of conventional companies now offer SRI products to their clients. The bottom line is that more and more investors adopt and use SRI strategies not only because such investments allow a focus beyond the bottom line, but also because returns are comparable to those of more conventional investments.

Ample evidence of the competitiveness of SRI is also found in the increasing investment in SRI by state pension funds, university endowments, and foundations.

Unit trusts and pension funds have been the main drivers behind the growth of socially responsible investment in Anglo-Saxon countries; and in Europe they have been lacking until recently.

Until recently there was little information available on socially responsible investment across Europe. In the summer of 2000, the Italian sustainable development research agency Avanzi made one of the first systematic calculations of how big the European market for SRI might actually be. Thus, the market for funds of this nature has grown spectacularly in the last five years, by 40% in Europe and 30% in the United States.

Since Europe had the largest holding market in SRI funds in 2010, it is

important to expand the analysis to observe its development.

5. European SRI Market

The European SRI market has grown over the last 20 years, i.e. in countries like the United Kingdom, this growth is such that SRI is expanding from a niche market to the main stream financial market (Sparkes and Cowton, 2004).

Sparkes R. (2002) treats UK SRI market separately from Continental Europe, as two distinct areas in terms of their development of socially responsible investments. The UK has always been one of the leaders in SRI, and is second only to the US in terms of socially responsible assets under management. Although some Nordic countries were early pioneers of SRI mutual funds, these have operated on a small scale. SRI in Europe has therefore been relatively small and low profile, at least until recently. Since the 1950s, most continental European countries have experienced low inflation, which has limited investor interest in equities as an inflation hedge. Investment in mutual funds/unit trusts has therefore been slow to develop, and has remained relatively small compared to Anglo-Saxon levels.

In the late 1990s, the European Market had experienced 'exponential growth'. For example, the number of Belgian socially

responsible mutual funds more than doubled over the course of 2000 from 10 to 24, while their total investment assets increased from €500 million to €1000 million. The German market experienced a similar development. The number of German SRI funds increased from 10 to 18 in 1998-2000 with their assets under management rising from DM 600 million to reach DM 3 billion (€1.5 billion).

The Netherlands' largest banks and insurance companies such as ABN AMRO and Aegon have discovered the potential of SRI. ABN's Groen Fond has become the largest single SRI fund in the Dutch market, with assets under management of €300 million at the end of 2001. In 1999 the University of Amsterdam created its own SRI index for the Dutch stock market in response to requests from the Wereld Natuur Fonds, the Dutch arm of the World Wide Fund for Nature, with €80 million of assets. Aegon Asset Management runs the €50 million AEAM Sustainable World Fund for institutional investors based on the DGSi index.

Socially responsible investing has been relatively slow to take off in the southern half of Europe. For example, the Swiss market for socially responsible investment has little public information available. At the end of 2001, UBS reports that the total value of its in-house SRI assets (including individual portfolios of private and institutional investors) broke through the SFr 1 billion (€680 million) barrier for the first time. The pillars of Swiss market development are Zurich based funds and Geneva based ones.

Spain, also, is one of the last European countries to develop SRI strategies. SRI first developed in Spain through the creation of SRI mutual funds for the retail market.

The most dynamic market for socially responsible investment in southern Europe has undoubtedly been France, a fact reflected in the rapid growth of research providers meeting the demand for SRI information. AReSE was created in July 1997 as the first specialist French environmental and social rating agency. Its objective is to provide institutional investors with specific social analysis and research tools. AReSE currently dominates the market, as 15 French SRI funds use its sector-based social and environmental ratings. Nineteen new funds were launched in 2000 alone, and the amount invested in French SRI mutual funds more than doubled from €325 million in 1998 to €777 million. There are three types of SRI fund in France: funds carrying out the value systems of their investors, often churches; funds with specific objectives such as creating employment; and sustainable development funds investing in businesses respecting financial, environmental and social criteria.

For example, two of the big French savings banks, the Caisse des Dépôts and the Caisse d'Épargne, tried out a similar idea in 1994 via the launch of the Insertion-Emplois fund. By 2000, the total assets had risen to over €50 million, making it one of the larger SRI mutual funds in France. Its prospectus states: 10% of your savings will be invested in businesses that create employment for the excluded (i.e. the unemployed). As a consequence, this socially responsible investment example has combined financial performance and the growth of employment, complying both financial and social criteria.

6. Conclusions

Reviewing the recent development of socially responsible investment (SRI), the paper argues that not only has it grown significantly but it has also matured, in the sense that it has become more complex and begun to enter the mainstream of investment practice.

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