

# ETHICAL FINANCE: TRENDS AND EMERGING ISSUES FOR RESEARCH

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**Abstract** *The objective of this paper is to understand the manner in which research in ethical finance has evolved and development of literature in the field of ethical/ socially responsible investing has taken place, which would provide us directions for future research work in the area. Contributions of 108 research studies published in the area of ethical finance, over a time span of 15 years were analyzed using a framework that classified research in the area of ethical finance according to research agenda and data analysis framework. This points to the areas which lack in – depth research and are worthy of being explored in future research.*

*The literature review reveals that research in ethical finance or socially responsible investment has been concentrated in a few areas. While some important areas like financial performance of ethical funds and indices have received adequate attention by researchers, there are several other areas which need focused research.*

*Measurement of ESG performance, ESG criteria for selection of stocks for an ESG/ ethical investment portfolio, process of integration of ESG criteria into investment decision making and regulatory mechanisms that need to be evolved to promote adoption of ethical finance are some of the areas worthy of being explored in future research. The study also suggests that models using multi–decision criteria for portfolio selection could greatly improve the performance of an ethical portfolio.*

**Keywords** *Ethical Finance, Socially Responsible Investing, Literature Review, Ethical Funds/ Indices.*

## INTRODUCTION

Ethical investment means integrating investment decisions with concerns for the environment and society. It is broadly about management of financial resources in a responsible way that maximizes financial returns together with social and environmental good. Interest in ethical finance has been growing in the investor community around the world. According to a recent study published by the Social Investment Forum, growth of ethical investment or socially responsible investment (SRI) continues to outpace that of traditional investment strategies. In the beginning of 2010, SRI assets had crossed \$3 trillion, an increase of about 34 percent in five years whereas traditionally managed assets increased only three percent in the same time. Even during the period of recession i.e. from 2007 – 2010 beginning, SRI assets recorded an increase of 13 percent as compared to one percent for traditional, professionally managed assets (SIF, 2010). Ethical or ESG issues are no longer the domain of a marginal group of investors in the financial community, disconnected from mainstream investment activity. If the general investment trends are observed on a global scale, it can be noticed that an increasing number of investment analysts and consultants are recognizing the importance

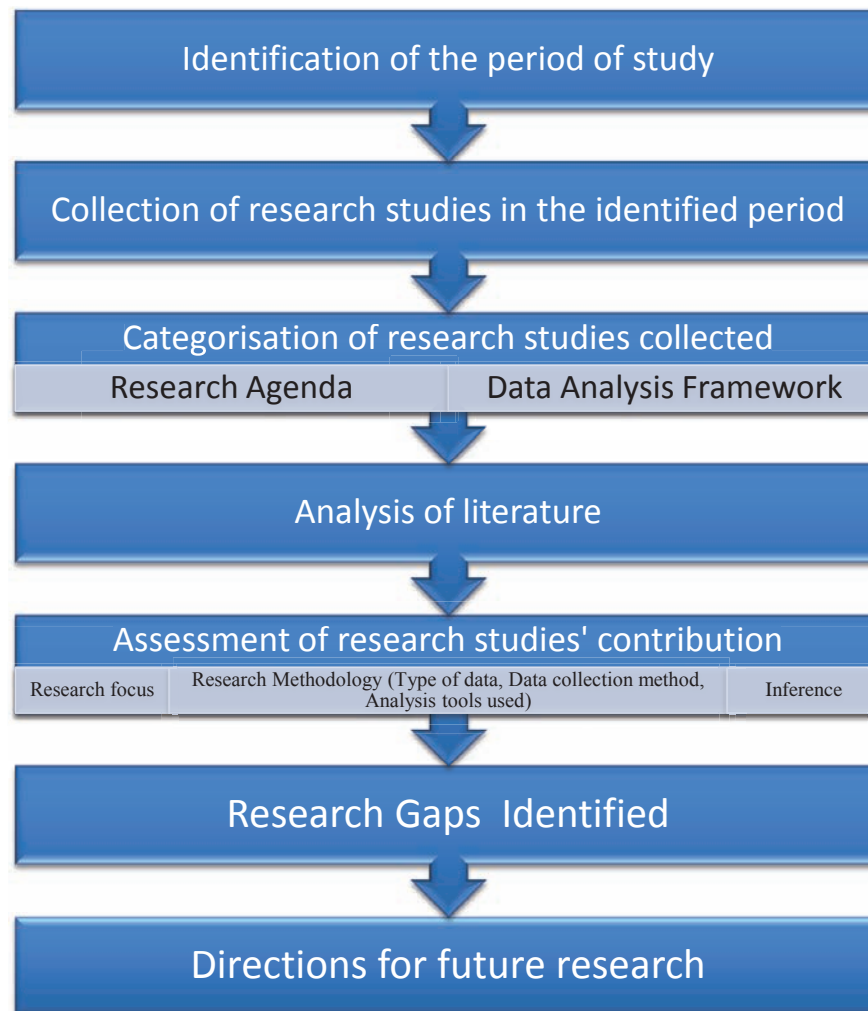
of these extra–financial criteria and integrating them into investment decision making.

Ethical or socially responsible investment is a complex and ever – evolving concept. It has a long history but there has been a paradigm shift in its focus. It has evolved from an ethical movement in the 1960s and 70s, where religious and charitable trusts and organisations avoided investment in companies manufacturing tobacco, alcohol, arms and ammunitions, etc. to a mainstream financial strategy in the 1990s, where individual and institutional investors use environmental, social and governance or ESG criteria to screen firms for investment purposes. Since the concept evolved independently, at different time periods in different nations around the globe, it has been the subject of different terms and viewpoints; and no universal terminology and definition seemed to prevail over the years. It has been variedly described as ethical investment, responsible investment, socially responsible investment, screened investment, sustainable investment or environmental, social and governance i.e. ESG investment; according to the screening criteria used for portfolio selection and investment. As ethical finance evolved from a investment strategy used by a marginal group of ethical investors to become a mainstream finance strategy used by mainstream investors

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Figure 1: Analysis of Literature on Ethical Finance



and investment institutions the world over, its definition also evolved to include the more general and widely accepted environmental, social and governance criteria rather than the more constrictive and stringent ethical criteria. The ambiguity over definition and terminology carried on till institutional collaborative efforts, attempted to evolve a definition of the term. The United Nations Environment Programme Finance Initiative (UNEPFI) laid the Principles for Responsible Investment and encouraged adoption of ESG screening for all investment portfolios. These criteria were accepted by most of the investment organisations and consultants, which led to a major consensus regarding the concept of ethical investing. But, the various terms used interchangeably with ethical finance have been treated as signifying the same concept and have been equated in the literature on the subject.

Another major development in the field of ethical finance was that it no longer remained an ethical/ social activist movement but evolved into a commercial proposition. This was mainly

due to the realization among investment professionals that environmental, social and governance issues are not just reputational issues but can affect the performance of investment portfolios, due to the costs associated with poor governance and negative environmental and social externalities. There is a profusion of academic studies which have shown that superior environmental and social performance results in improved financial performance. This evidence fuelled the growth of ESG integration into investment decisions and encouraged research studies on legal measures that would promote adoption of ethical finance.

These developments in the ethical investment sector motivated us to understand the manner in which research into ethical finance has evolved and development of literature in the field of ethical/ socially responsible investing has taken place, which would serve as a beacon for research and further work in the area. This literature review analyzes 108 books and papers published during 1997 – 2013 in the area

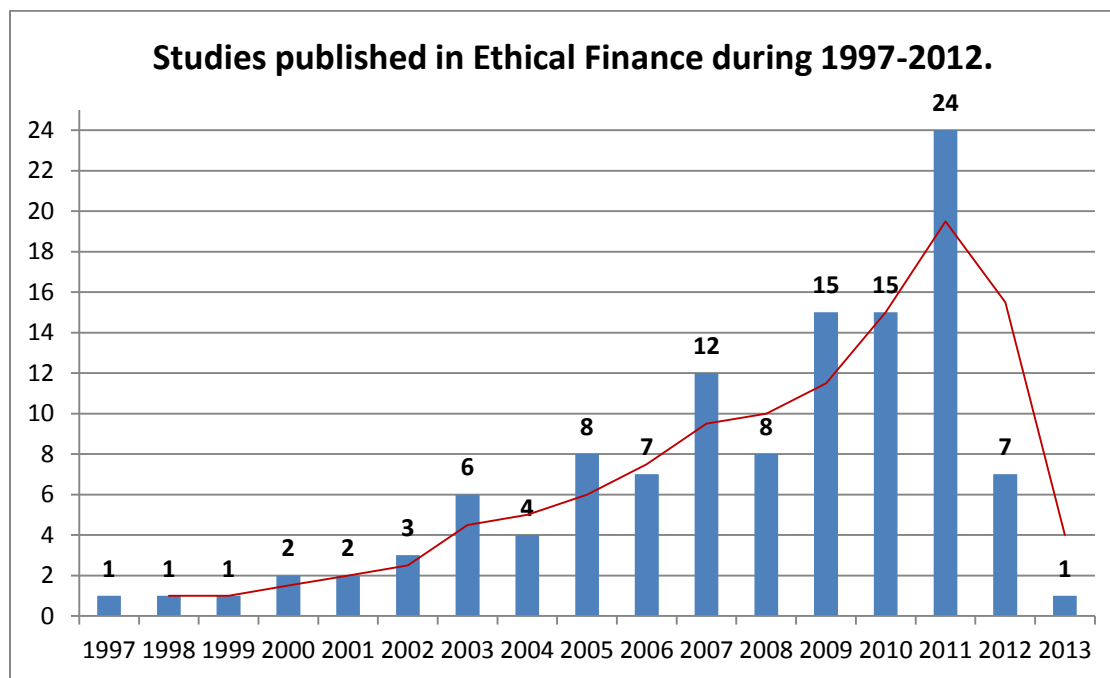
**Table 1: Details of Articles Selected for the Study**

<b>List of Journals Reviewed</b>	<b>No. of articles</b>
Harvard Business School Working Knowledge	5
Journal of Business Ethics	4
The Journal of Investing	3
IIMS Journal of Management Science	2
Business Ethics Quarterly	2
European Business Review	1
Journal of Business Finance and Accounting	1
German Law Journal	1
Financial Analysts Journal	1
Journal of Financial and Quantitative Analysis	1
Electronic Journal of Business Ethics and Organisation Studies	1
Ecological Indicators	1
Emerging Markets Review	1
Academic Journals	1
On Wall Street	1
<b>List of web sites and databases</b>	<b>No. of articles</b>
SSRN Social Science Research Network	17
Triple Pundit- People, Planet and Profits	7
Interscience Wiley	2
JSTOR	1
University of Liechester	2
University of Zurich – Centre for Corporate Responsibility	1
University of California	1
Copenhagen Business School	1
Standard & Poor's Indices	1
IIM Calcutta	1
New Economic Foundation	2
Others	20
<b>List of Reports Reviewed (Source)</b>	<b>No. of Reports</b>
EIRIS	7
UN Environment Programme Finance Initiative	5
Mercer Consulting	5
US Social Investment Forum	3
Ministry of Corporate Affairs, Govt. of India	1
Tata Energy Research Institute	2
World Resources Institute and International Finance Corporation	1
Institute of Economic Growth, Govt. of India	1
Deutsche Bank	1

of ethical finance. This analysis makes an attempt to classify the research studies in the area of ethical finance, which would help in the identification of specific areas which have been extensively researched and those areas which have either not been explored by research undertaken so far or where more focused research will lead to new insights into

the subject which would be useful for investors, researchers, and corporates.

The paper is organised as follows: the paper is divided into five sections. While this section provides the background and introduction; the next section aims at developing a framework for analyzing research in the area of ethical

**Figure 2: Studies Published in Ethical Finance During 1997 – 2013.**

Source: Graph Constructed using MS – Excel 2007

finance. The third and fourth sections use the developed framework to conduct an analysis of the literature reviewed. This provides basis for identification of directions and areas for further research in this area, in the fifth section. The last section contains the conclusions of the paper.

## METHODOLOGY

To conduct an analysis of literature, we attempt to develop a model encompassing the method and steps to be used.

Figure 1 depicts the steps involved in the process of analysis of literature on ethical finance.

The first step concerns identification of the period of study. Though some form of ethical finance has been in existence for long, ethical finance in its present form of Socially Responsible Investing, Responsible Investing and ESG Investing began to get popular only in the late 1990s. The research on ethical or ESG investing began to evolve around the start of the 21st century. In view of this, the period of study was chosen to be 1995 to 2012. Since significant studies were not available for the period 1995-96, the period of study was 1997-2013.

The second step involved collection of research studies for the period under study. To accomplish this end, a common descriptor term was defined as the keyword – a term which has one of the words - ethical, responsible, sustainable and ESG followed by any of the words like investing, investors, screening, selection, portfolio, funds, mutual funds and

indices. A search is then made in electronic databases for each study which included the above listed words in their title, abstract, keywords, etc. From the fairly large universe of potentially eligible studies for literature review, identified by the above method, 108 studies were chosen after analysis from content perspective and their relevance for the study. The descriptive statistics of the literature reviewed is as follows: Figure 2 graphically depicts the distribution of the articles/ papers published over the study period 1997 – 2013. Table 1 shows the distribution of papers/ articles according to the journals/ publications in which they were published.

Hence, the next step was to identify categories for classification of the selected articles to further analyze the selected studies, using the classification scheme. The classification of studies into conceptual, exploratory, empirical, analytical, and review based on the type of research framework alone was not considered appropriate as many studies in ethical finance literature were composite studies – qualifying for classification under more than one head. Also, such a classification would not provide any useful information regarding the aspects of ethical finance which need to be researched further and on which future research propositions should be developed. Hence, a method is chosen which classifies studies on the basis of critical analysis of the contributions made by them to the respective fields. These contributions pointed to the research agenda i.e. focus area of research of each study.

This was considered as the most appropriate and relevant method of classification of literature in the field of ethical

**Table 2: Focus Areas of Research and Topics Under Each Focus Area\***

Focus Area	Topics	No. of papers
Concept and history	• Definition and Explanation	5
	• Approaches and process	3
	• Evolution and Development	2
	• Significance and Reasons for growth	6
	• Implementation guidelines and best practices	5
Current Status	• Awareness and Interest	7
	• Adoption and growth	10
	• Future Implications	5
	• Recommendations	1
Ethical Screening criteria	• Choice of most important and universally acceptable ESG issues	3
	• Development of ESG rating system to screen funds/companies	2
	• Index construction using ESG criteria	3
Motivations and Barriers	• Motivating factors	2
	• Dissuading factors / Barriers	7
Evaluation and Comparison of Financial performance	• Ethical (ESG) funds / indices vs. non-ethical funds / indices / benchmarks	12
	• ESG portfolios	4
	• ESG stocks and non- ESG stocks / companies	10
	• Relation between E /S/G or ESG performance and business performance	7
Regulatory Measures to promote adoption	• Role of national govt.- legal measures	3
	• Standardised Reporting framework	1
Others	• Impact of ethical screening on firms	4
	• Consequences of ESG performance disclosures for stakeholders	1
	• Impact of ESG investment strategy on security analysts' recommendations	1
	• Reasons for impact of ESG disclosure on stock value	1
	• Decision making behaviour of ethical investors	2
	• Sources of standardised ESG data to aid investor decision making	1

\*Based on the researcher's understanding of the papers reviewed

finance due to the reason that there are a number of topics/sub-areas under the broad area of ethical finance. Analysis of contributions made by research studies to various sub-areas would help us to correctly position the research efforts in their respective sub-areas and identify under-researched areas of work which would benefit from more focused future research. Further, since the field of ethical finance is constantly evolving with newer issues and new players coming to light, and involvement of international organisations and regulatory bodies, such a categorisation could be immensely helpful in developing better research propositions for future research.

Data and analysis framework used constitute another important dimension for classifying research studies. The type of data used helps define the tools and types of analyses to be done, helps identify the difficulties in data availability and collection, and the limitations of the analysis and the

study. It also avoids duplication of research and points to the evolution of the tools and techniques as research in the field progressed. It helps in improvement of tools and techniques and in adoption of newer/ improved tools and techniques, keeping in mind the limitations of the previous ones.

Therefore, we adopt research agenda and data analysis framework as our classification framework to assess contributions to existing literature and identify niche areas which lack influential research and must be chosen for further work.

## DATA ANALYSIS FRAMEWORK USED

### Focus Areas of Research

Table 2 shows the focus areas of research and topics under each focus area along with number of research studies in each.

**Table 3: Focus Areas of Research and Data Analysis Tools Used\***

Focus Area Data Analysis Tools	Concept and History (Reasons for growth)	Current Status	Ethical Screening criteria, ESG index construction, stock selection	Motivations and Barriers	Evaluation and Comparison of Financial performance	Others (Impact of ESG screen- ing on firm)
<b>Statistical</b> <ul style="list-style-type: none"> <li>• Ranks and Percentiles</li> <li>• Trend Analysis</li> <li>• Correlation</li> <li>• Panel Regression</li> <li>• T- test for testing equality of returns</li> <li>• Factor Analysis</li> </ul>	1	10 1	1    1	1    1	4 1 1	
<b>Accounting Measures</b> (Tobin's Q, ROE, ROA, EBDIT, etc.)			1		3	
<b>Financial / Portfolio Models and Market measures</b> <ul style="list-style-type: none"> <li>• Single factor</li> <li>• Multi – factor</li> <li>• Scenario Analysis</li> <li>• Dynamic Filtering Analysis</li> <li>• Multi criteria decision making</li> </ul>			2   1		17 3 1 1	2
Total	1	11	6	2	31	2

\*Based on the researcher's understanding of the papers reviewed

On the basis of analysis of papers selected for review, six major sub-areas of ethical finance research emerged. They included -

- i. definition, terminology and strategies of ethical finance and ethical investment; its evolution and development over the years into its present form;
- ii. the current status of ethical investment, its awareness, understanding and extent of adoption in a particular geographical area;
- iii. the ethical issues of concern to investors, the issues they would like to prioritize (and hence, must be included in ethical screens used);
- iv. the motivations that cause ethical investors to support ESG causes and the barriers to investing that have impeded its widespread adoption in any particular area;
- v. whether ethical investment places a cost upon the investor or does ethical investment pay i.e. analysis of financial performance and returns of ethical funds in comparison to conventional funds and benchmarks;
- vi. analysis of environmental and/ or social performance of ethical funds; and whether existing legal/ regulatory measures impede or promote adoption of ethical

finance thereby, providing guidance as to the future direction the domestic law and international guidelines should take to promote ethical finance.

### Data Analysis tools used

Table 3 shows the focus areas of research and data analysis tools used.

Both primary and secondary (published) data have been used in ethical finance research. The type of data used and the analysis framework used have been primarily been governed by the research agenda.

Studies investigating the current status of ethical investment, its awareness, and extent of adoption in a particular geographical area; those aimed at identifying the ethical issues of concern which investors would like to prioritize (and hence, must be included in ethical screens used); studies that analyze the motivations that cause ethical investors to support ESG causes; and those aimed at finding out the barriers to investing that impede its widespread adoption in any particular area; have been based on primary data. Study by EIRIS (Ethical Investment Research and Information Service) (2009) titled 'What's needed to mainstream green

and ethical finance?'; EMDP (Emerging Markets Disclosure Project) and EIRIS (2009) titled 'Emerging Markets Investor Survey Report: An analysis of responsible investment in emerging markets'; EIRIS (2010) titled 'Socially Responsible Investment: Are the French public interested?' used primary data obtained from investors through online survey questionnaire. SIF (Social Investment Forum) (2009) study titled 'Investment Consultants and Responsible Investing' and Social Investment Organisation's March (2009) report titled 'Canadian Socially Responsible Investment Review 2008' used primary data collected through survey of money managers, investment consultants, and finance providers in combination with published data on pension funds, mutual funds, and investment trusts. The majority of these surveys have been conducted by NGOs/ non-profit organisations, investment analysts, and consultant houses or have been commissioned by the government agencies. Primary data obtained from these exploratory surveys have generally been subject to percentile and rank analysis to draw meaningful inferences.

Studies that have analyzed the link between ESG performance and financial performance; and those analyzing financial performance and returns of ethical funds and indices in comparison to non-ethical (non-SRI) funds, conventional funds, and benchmarks have been based on secondary data obtained from stock exchanges, brokerage house reports, corporate reports, databases, and consultancy organisations viz., EIRIS, SIF, Innovest, CRSP (Centre for Research in Security Prices), IRRC (Investor Responsibility Research Centre) and Compustat, Morningstar, KLD, Domini, and Thomson Financial Datastream Database. There is a profusion of academic studies in this sub-area of ethical finance though there are some studies by investment analysts and consultants too. This is the most researched area of ethical finance and researchers have used various tools to analyze the financial performance. Orlitzky, Schmidt, and Rynes (2003) examined the link between corporate social and financial performance, by reviewing 52 studies that used accounting performance measures like Tobin's Q, ROE, ROA, etc. and investment performance measures like stock market returns, P/E ratio, etc. Barnett and Salomon (2006) and Brammer, Brooks and Pavelin (2006) analyzed the correlation between corporate social and corporate financial performance or stock returns. Most of the studies including Abramson and Chung (2000); Statman (2000); Bauer, Otten, and Rad (2004); Bello (2005); Kreander, Gray, Power, and Sinclair (2005); analyzed index performance/ investment and portfolio performance using market-based measures like stock returns, risk-adjusted returns, t-tests and non-parametric tests for comparing performance of ethical and non-ethical funds and indices. Single factor models like Sharpe Ratio, Jensen's alpha, and Treynor ratio were also used to analyze portfolio performance. Statman (2005), Renneboog, Horst, and Zhang (2007); Norup and Gottlieb

(2011) performed multiple regressions using Fama-French three factor and Carhart four factor models with greater explanatory power to ascertain the contribution of each factor in determining return and risk of SRI funds. UNEPFI's Asset Management Working Group (2006) report examined the link between ESG issues and share pricing using published research reports that used a range of valuation tools like benchmarking, scenario analysis, proprietary valuation methodologies, etc. UNEPFI Asset Management Working Group and Mercer's 2007 report used review of academic and broker research studies to analyze whether integration of ESG factors into investment decision making leads to portfolio underperformance.

## DIRECTIONS FOR FUTURE RESEARCH

The classification framework we adopted in this study analyzed the literature in ethical finance on the basis of research agenda and data analysis framework. This provides us the basis for identifying the potential direction and tools for future research.

Our literature analysis points that research in ethical investment or socially responsible investment has been concentrated in a few areas viz., definition and concept of ethical finance, its evolution and development; the current status of ethical investment, its awareness, and extent of adoption in a particular geographical area; the ethical screening criteria that investors consider important; and the challenges to the growth of ethical finance. Analysis of financial performance and returns of ethical funds in comparison to conventional funds and benchmarks i.e. whether investing ethically leads to financial underperformance is the most researched area in ethical finance. This is also the most important issue of concern to investors as growth of ethical finance to become a mainstream investment strategy is feasible and in fact, desirable only if it does not result in financial underperformance. But, there are some other aspects of ethical finance that need to be researched and are worthwhile areas for future research. Ethical investment and its impact on financial performance may reduce investment in companies that score low on ESG criteria and make finance costlier for them, as ethical investment gets popular. Relation between ESG performance or corporate social performance and access to finance is likely to be an interesting area for future research which has not been addressed in the literature. Research on motivations for ethical finance; and research on regulators' actions – whether they promote or impede ethical finance, are important issues that need focused research.

Our literature study also points to the need for some uniformity in selection of stocks of ethical or socially responsible funds. Hence, research on ethical screening criteria and the process or manner of their integration into investment decision making is required to remove ambiguity

in this area and promote better understanding of investors, researchers and practitioners. Further, analysis of ethical or ESG funds' social and environmental performance is an important issue that needs consideration. Although a range of measures have been used to measure financial performance, objective measures of ESG performance need to be developed. Objective ESG ratings of companies and funds would also help in clearly establishing the relation between ESG performance and financial performance.

The data analysis framework suggested that the analysis tools were selected based on the research agenda. Hence, studies analyzing the awareness and current status of ethical finance relied on surveys and simple category percentage analysis of thus collected data. The primary data collection for such purpose could be improved through use of schedules or interviews and secondary data like trading volumes of ethical indices, amount of money invested in ethical funds, etc. could also be used to assess the current status of ethical investment. Literature analysis reveals that selection of stocks for an ethical investment portfolio is done on the basis of positive or negative screening, etc. whereas the traditional portfolio theory uses risk – return analysis for the purpose. A hybrid method using multi–decision criteria like risk and return along with ESG performance score could greatly improve portfolio selection and performance. These analysis methods can be explored in future research.

## CONCLUSIONS

This study has analyzed the development of literature in the field of ethical finance, based on the literature review of 108 studies over a period of 15 years and revealed which issues or sub–areas of ethical finance have been addressed in the research. This also points to the areas which would benefit from future research.

Measurement of ESG performance is an important aspect which should be addressed in future research. Also, ESG criteria for selection of stocks for an ESG/ ethical investment portfolio, process of integration of ESG criteria into investment decision making, and regulatory mechanisms that need to be evolved to promote adoption of ethical finance are some of the areas worthy of being explored in future research. The study also suggests that models using multi–decision criteria for portfolio selection could greatly improve the performance of an ethical portfolio.

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