Research Proposal:

Returns to Socially Responsible Investing: A Clinical Study

Authors:

Elroy Dimson, Professor of Finance, London Business School
Oğuzhan Karakaş, PhD Student in Finance, London Business School

Contact details:

Address: London Business School, Regents Park, London NW1 4SA, UK
Telephone: +44 (0)20 7000 7000
Email: edimson@london.edu, okarakas.phd2005@london.edu

Executive Summary

This study will examine the linkages between responsible investment strategies and stock market performance. While there is a substantial body of previous research in this area, empirical findings have often been confusing.

One might expect that "ethical" investment could generate superior returns. But if so, all investors—not just responsible ones—would initiate ethical programmes, and superior returns could not be expected to persist. On the other hand, if some assets are abhorred by a subset of investors, their prices will fall. Abhorrent strategies would then be expected to achieve superior long-run returns. Responsible strategies would, in turn, be expected to underperform.

Comparison of the long-term performance from responsible and "sinful" strategies is a blunt instrument, however, and cannot indicate whether adoption of a responsible strategy is rewarded with superior or inferior performance. Moreover, existing studies that examine interventionist strategies are often uninformative because it is not clear when the engagement took place, what form it took, and how it was delivered – through written documents, conversations, and so on.

In this research, we examine a manager who engages with investee companies, to persuade them to pursue more responsible approaches to investment. By exploiting a complete dataset of extensive engagements with target companies, the study aims to identify the causal relationship, if it exists, between the corporate social responsibility activities of a company and its performance.

We expect our findings will enhance understanding of the returns to socially responsible investment strategies.

Research objectives

In this paper we plan to address the relationship between the Corporate Social Responsibility (CSR) practices of a firm and the firm's value/performance.

Within this broad research interest we would like to give answers to the following questions:

- If there is a correlation between CSR and value/performance, and which way does the causality run?
- Are there certain CSR activities that influence value and performance more than others?
- What are the returns to Socially Responsible Investing (SRI)?
- How do the CSR engagements compare to the engagements of activist funds; for example, in terms of style, intensity and performance?

Previous research in the area

Overview of the literature

The relation between CSR and firm performance has been discussed extensively. Margolis and Walsh (2003) compile 127 empirical studies on this issue published between 1972 and 2002 with a summary of the measures used for CSR and for financial performance. Among the 127 studies, 109 treat performance as a dependent variable. Of these 109 studies, 54 imply a positive relation, seven find a negative relation, 28 report non-significant results, and the rest report mixed results. In 22 of the 127 studies, performance is treated as an independent variable and 16 find a positive relation. Overall, "there are more results than studies" especially due to possible endogeneity (e.g. reverse causality) and other methodological and data issues which will be mentioned in more detail below. However the literature suggests that there is a positive relation between CSR and company performance.

Fisman, Heal and Nair (2005) provide a framework viewing social responsibility as actions that improve the welfare of interest groups who can affect firm value. This framework allows them to separate CSR activities into the ones that are profit motivated and those that are driven by non-financial motives. Using a database covering approximately 650 companies listed on the S&P 500 or Domini 400 Social Indexes for the years between 1991 and 2002 they create a "visible" CSR index focusing on the consumer-oriented CSR activities. Overall, they find very little correlation between CSR and profitability. However, focusing on visible activities, they find that CSR is more prevalent in advertising intensive (consumer-oriented) industries, and CSR is more positively related to profitability in these industries. Further, the effect of CSR on profits is stronger in competitive industries, especially when few other firms undertake such actions, suggesting that CSR may be used as a means of differentiation in otherwise competitive environments.

Recently, Edmans (2007) analyzes the relationship between employee satisfaction and long-run stock price performance. He studies a portfolio of stocks selected as the

"Best Companies to Work for in America" by Forbes in January 1998 and finds that these companies would earn a monthly four-factor alpha of 0.7%. This result suggests a positive relationship between employee satisfaction (might be considered under SRI) and firm performance which, however, is not priced correctly in the market.

Problems in previous literature

The following is a concise list of main problems observed among the papers in the literature which we plan to address in our work:

- **Causality.** The literature mostly examines the correlation between the CSR activities of a firm and its performance. The main reason for this is lack of good quality data and correct methodological approach. However it is quite important to know whether CSR activities causes a better firm performance or not. Note that the positive correlation between CSR activities and performance does not necessarily imply this causality, as one can easily come up with other reverse causality stories. For instance, it might be the case that the firms with good performance prefer getting involved in CSR activities to enhance the firm's image in society.

- **Public vs private data.** Studies in the previous literature mostly exploit public data on CSR activities and their measurement. However, the public announcements might be delayed and/or be very generic. This impedes precise performance measurement. By exploiting detailed data on both public and private engagements, and their follow-up event data, we hope to overcome this difficulty.

- **Methodology.** Some studies on CSR and firm performance lack proper control variables. Moreover, especially for the long-run performance analysis, the benchmarks and the way the portfolios are formed are quite crucial, and this issue is not tackled properly in the literature. Because our study will use a very rich database, it is possible to evaluate performance in calendar time, event time, and across CSR classifications, using a carefully constructed approach to performance measurement that builds on Ibbotson's (1975) "RATS" experimental design.

- **Cross-CSR activities and cross–country effects.** Previous work usually aggregates different types of CSR activities. However, as Fisman, Heal and Nair (2005) show, certain types of CSR activities may lead to superior or inferior performance. In addition to cross-activity analysis, we will be able to analyze the impact of CSR engagement across countries. CSR activities on emerging markets may have different effects from those we observe in developed markets.

Research design and methods

Data

The dataset has been compiled by the UK's largest investor with a major commitment to engaging in responsible investment strategies. The data provider has a long heritage of CSR investing, extending back to the UK's first ethical fund, launched 24 years ago, and uses its influence as one of Europe's largest shareholders to promote the adoption of social, governance and environmental practices. In recent years, the firm's engagements have been compiled as a detailed electronic file, and the complete dataset is being made available for the purposes of this study.

Table 1 demonstrates an overview of the sample over recent years. The figures are the number of companies engaged by the investor in that particular year. Over the course of a year, it is not uncommon for the firm to engage a specific company at least a couple of times. Therefore the total number of engagements is on average about 2-3 times of the numbers given at the table. There is not any backfilling in the dataset.

Table 1: Overview of sample (number of companies engaged) in recent years

Year	# of Companies
2002	775
2003	500
2004	944
2005	834
2006	640
2007	762

As for sample composition, more recent years in the sample provide good coverage of Asia and Emerging Markets, while there is consistent coverage of US and UK, companies in all years. The dataset includes companies where the investor or its clients have holdings or are interested in gaining exposure in the near future. The data provider manages over GBP 100 billion with more than 3 million customers. This ensures it addresses stocks from all over the world. For the companies that are monitored by the firm, even if it stops having holdings for a short while, the coverage continues.

Each of the engagements is recorded in a centralized database, and we are therefore able to construct a comprehensive dataset of all the engagements through the media used for communicating with the target company. These media include letters, memos, e-mails, telephone conversations, face-to-face meetings, and so on. This rich database will also facilitate comparing the CSR engagements with the private engagement by an activist fund, namely Hermes, studied by Becht, Franks, Mayer and Rossi (2008). Using a comparable dataset, they find that Hermes mainly interacts with investee companies privately, and that it outperforms benchmarks: the returns mostly come from engagement rather than stock selection.

Our dataset is quite detailed, and will allow us to determine the exact timings of the engagements and their type—for instance, whether an engagement is hostile, friendly, etc. It also includes the “milestones" achieved. There is a record of whether the engaged companies have followed the advice they were given. This involves an index A1, A2, A3, B1, B2, B3, C1, C2, C3. Here, A to C shows the strength of the investor’s perceived influence on the company, with A being the highest, when the firm is the sole or lead investor engaging the company. Likewise, 1 to 3 shows the impact of the milestone on shareholder value, with 1 denoting high potential impact. We are planning to use these features of the dataset to help us solve the endogeneity problem between performance and socially responsible investment, which could not be tackled satisfactorily in the literature so far.

The dataset also contains very detailed information about the substantial voting activities of the organization. This is the power of the investor’s “voice”, and we plan to exploit it to examine the performance impact of CSR engagements with the company. Finally, we have access to the performance of the ethical funds run by the same investment manager, which will also help in understanding the returns to SRI.

Design and methodology

We plan to evaluate performance in calendar time, event time, and across CSR classifications, using a carefully constructed approach to performance measurement that builds on Ibbotson’s (1975) “RATS” experimental design. While doing this, we plan to exploit the time-series, cross-CSR activities and cross-country dimensions of our data and control for other factors that might influence both the performance and the CSR measures which has not and/or could not been addressed properly at many of the previous work in this literature.

Moreover, due to similarity of the data structure, and for the comparison purposes as well, we plan to employ the methodology developed by Becht, Franks, Mayer and Rossi (2008). In their clinical study, Becht et al. examine the contribution of shareholder activism to performance of the target company and ultimately to the activist fund’s returns. Similar to their approach, we will estimate the contribution of “activism” in responsible investing to performance first by noting the stated objective of the fund and then classifying the type of the engagement (e.g. public vs. private) and the degree of hostility (e.g. collaborative vs. confrontational). Finally, we will use these different engagement objectives and degree of hostility to relate the outcomes to the measured abnormal returns and/or other performance measures. The “milestones”, and the index created to measure the investor’s influence on the company, will also enrich our analysis.

Conclusion

We intend to study an investment manager who engages with companies, in order to encourage them to invest responsibly. By exploiting an extensive dataset of engagements with target companies, we aim to identify the causal relationship, if it exists, between the corporate social responsibility activities of a company and its performance. We expect our findings to enhance understanding of the returns to socially responsible investing.

References

Becht, M., J. R. Franks, C. Mayer and S. Rossi, 2008, “Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund,” *forthcoming in Review of Financial Studies*.

Edmans, A., 2007, “Does the Stock Market Misvalue Intangibles? Employee Satisfaction and Equity Prices,” *Working Paper, Wharton School*.

Fisman, R., G. Heal and V. B. Nair, 2005, “Corporate Social Responsibility: Doing Well By Doing Good?” *Working Paper, Columbia GSB.*

Hong, H. and M. Kacperczyk, 2007, “The Price of Sin: The Effects of Social Norms on Markets,” *Working Paper, Princeton University*.

Ibbotson, R. G., 1975, “Price Performance of Common Stock New Issues,” *Journal of Financial Economics*, 2, pp. 235-272.

Margolis, J. D. and J. P. Walsh, 2003, “Misery Loves Companies: Rethinking Social Initiatives by Business,” Administrative Science Quarterly, 48(2), pp. 268-305.

Resources required

The resource requirements comprise the following:

Elroy Dimson	200 hours	No charge
Principal researcher, Oğuzhan Karakaş	800 hours	See below
Research assistance from the data provider	200 hours	No charge
Research assistance from London Business School	200 hours	No charge

The time estimated by the principal researcher, Oğuzhan Karakaş, will be required for the following activities: literature review (50 hours), discussions with CSR professionals and formulating testable hypotheses (50 hours), organizing and supervising the data collection (100 hours), initial analysis of the data (150 hours), econometric testing of the main hypotheses (100 hours), robustness checks and further discussions with practitioners (50 hours), preliminary draft of the paper (100 hours), presenting preliminary results (50 hours), revisions and extensions (50 hours), preparation of a distributable paper (100 hours).

The research assistance involves codifying, organizing and cleansing the data, and will involve resources provided by the data provider and by London Business School. The research assistance tasks include the following: data retrieval from the underlying databases and other sources (50 hours) and data cleansing and organizing (350 hours).

Time scale

The time scale envisaged is as follows:

Literature review, data collection and cleansing	Nov 2008 – Jan 2009
Analysis of the data	Feb 2009 – Jun 2009
Preparation of preliminary paper	Jul 2009 – Aug 2009
Presentations, revisions and preparation of distributable paper	Sep 2009 – Jan 2010

Deliverable outputs

The immediately deliverable output will be a paper suitable for presentation at professional meetings, and at academic meetings such as the American or European Finance Associations. The paper will be in a form suitable for dissemination on Social Science Research Network, and in due course, publication in a top academic finance journal, alongside parallel publication in a top professional investment journal.

Budget

Funding requested from French Social Investment Forum (French SIF)

Funding is not required for Elroy Dimson's time.

The funding requested for this project is to support Oğuzhan Karakaş while he undertakes the study, which is incremental to his doctoral research. The project will require approximately 800 hours of his research time. This would normally be compensated at the rate of £25 per hour with a total of £20,000 (≈ €25,000). However, because he already receives limited financial support from London Business School, we are seeking a contribution from French Forum for Socially Responsible Investment (French SIF) that is lower than one eight of this level, and which also falls within French SIF's normal limits for support (i.e., €3,000).

Co-funding

The project will also require some work on cleaning up the database and to assemble it in a form that is suitable for the research. Some of this work will be undertaken by the data provider, who will provide in-house resources free of charge. The monetary value of this support is estimated at £4,000 (≈ €5,000).

Other information processing and data-filtering work will be subcontracted to a research assistant who will be paid by London Business School. The budget for this is estimated at £2,000 (≈ €2,500).

Brief CVs of researchers

Elroy Dimson

Elroy Dimson is BGI Professor of Investment Management and a Faculty Governor of London Business School, where he is Director of the Initiative on Foundation and Endowment Asset Management. He was formerly Chair of the Finance and of the Accounting areas, and Dean of MBA Programmes. He has served as President of the European Finance Association, on the Executive Committee of the Financial Economists Roundtable, as Advisory Council Member for the CFA Institute, and as Associate Editor of the *Journal of Finance*, Review of Finance and other journals. Co-author of *Triumph of the Optimists* and of the *Global Investment Returns Yearbook* (with Paul Marsh and Mike Staunton) and of *Endowment Asset Management* (with Shanta Acharya). His board and investment positions include the Norwegian Government Pension Fund, Guy's and St Thomas' Charity, the Foundation for Social Entrepreneurs, and the University of London. An Honorary Fellow of the UK Society of Investment Professionals and of the Institute of Actuaries, his PhD is from London Business School.

Elroy Dimson's CV is attached to this proposal.

Oğuzhan Karakaş

Oğuzhan Karakaş is a PhD Student in Finance at London Business School. His research focuses on Corporate Governance, Private Equity and Dynamic Investment Strategies. He is a recipient of the Marie Curie Host Fellowship for Early Stage Research Training (EST) in addition to the PhD Programme Financial Award from London Business School. He was also granted an American Finance Association (AFA) Student Travel Grant in 2008. Previously, he received his master's degree in Operations Research & Financial Engineering from Princeton University and worked as a consultant at the Mount Lucas Management Corp in Princeton, NJ.

Oğuzhan Karakaş' CV is attached to this proposal.

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