GovernanceMetrics
INTERNATIONAL
www.gmiratings.com

Ten Things to Know about Responsible Investment & Performance

Kimberly Gladman, CFA, Ph.D.
Director of Research and Risk Analytics

March 16, 2011

Introduction

As the practice of responsible investment (RI) grows, there is increasing interest in the ways that RI strategies may affect financial performance. To understand what academic research can teach us about this topic, GovernanceMetrics International has reviewed articles posted on the Social Science Research Network (SSRN), the leading database of scholarly abstracts and research papers in the social sciences. In the past three years, more than two dozen studies have focused on the empirical impact of responsible investment strategies on performance, including several that were themselves extensive reviews of earlier research.[1] Taken together, these studies provide an overview of the current state of academic knowledge on this issue. Below are ten main ideas that emerge from the literature.

1. The research shows that on average and in the aggregate, RI portfolios perform comparably to conventional ones.

The general consensus is that on average, responsible investment methods perform on par with conventional techniques, neither outperforming nor underperforming them on a regular and reliable basis. This finding applies both to theoretical performance simulations involving groups of "responsible" securities and to the behavior of actual responsible investment products already in the marketplace.[2] It is important to note, however, that this conclusion is a general statement, which sums up a heterogeneous group of studies. The portfolios they analyze are constructed according to many different methodologies, draw upon different asset classes and pools of securities, and in the case of the actual investable products, are managed by a wide range of asset managers in locations around the world.

2. Investment-specific definitions of RI vary.

Perhaps the most fundamental question in the field of RI is how to define responsible investment. In the case of public companies' securities, a common starting point is to analyze the issuer's relationships with multiple stakeholders who make contributions to its business and are affected by its operations. Typically these include employees, customers, communities, governments, and the environment, in addition to investors. Responsible investment managers form opinions about whether companies are treating these stakeholders well or poorly. They then incorporate these views into their ownership decisions in various ways (for details, see #3 below).

While this multiple-stakeholder approach is widely used among RI equity mutual funds, there are also many equity managers who focus on only a few environmental, social or governance (ESG) issues—for example, climate change, clean technology, employee relations, or women's empowerment.

In addition, RI investments are also being made in other asset classes such as private equity (where the social or environmental impact of the investee's core business is typically the key criterion), real estate (where eco-efficiency and affordable housing are key issues) and fixed-income investments (where the full range of stakeholder issues may come into play). However, because most public and academic attention has been focused on public equity, that is also the main subject of this discussion.

3. There are many RI strategies investors can apply.

Investors who analyze companies' stakeholder relations through an ESG lens may act on their findings in various ways. Some establish standards any company must meet in order for its securities to be included in a portfolio; for example, they may screen out companies with repeated labor law violations or environmental fines, or those whose core products they view as destructive (such as weapons or tobacco manufacturers). Others take a "best-in-class" approach, selecting companies with a better ESG profile than their peers; for instance, they may choose electric utilities whose carbon emissions are lower than the industry average, or retailers whose employee benefits are more generous than is typical. Still others use ESG analysis to identify particular trends that may be profitable investment themes (e.g., clean energy or women's empowerment funds). Finally, responsible investors who use any of these strategies—as well as those who do not use ESG analysis for security selection at all—may also use their ESG insights to inform their engagement with companies. Through letter-writing, direct dialogue, and shareholder resolution filings, responsible investors encourage companies to improve their social, environmental and governance practices.

4. RI does not have to be bad for diversification.

Given the variety of ways that RI factors into portfolio construction, it is not surprising that its effect on diversification varies. Academics have studied responsible investment in relation to three aspects of diversification: the number of securities available to choose from; the correlations among them; and the volatility of individual securities.

On the first two aspects, researchers have acknowledged that any reduction in investment choices will, by definition, somewhat restrict diversification options. Such a reduction in choice could result not only from exclusionary screening, but from worst-in-class rankings that limit portfolio weights in poor ESG performers. However, the practical impact of this restriction, on both a portfolio's return and its risk, depends on the investment strategy and method of portfolio construction. To be sure, if a large percentage of the universe is declared off-limits, investors may miss out on some lucrative opportunities. Similarly, if an investment strategy produces wide deviations from benchmark industry weights, it may increase correlations among portfolio assets, potentially making performance more volatile than that of the benchmark.

However, if a screening method excludes only the most problematic securities, investors may still have plenty of strong performers to choose from; and if a best-in-class strategy is employed that tracks benchmark industry weights, it may not significantly increase inter-asset correlations.[3] Moreover, an investment strategy that relies on a large number of holdings, such as passive indexing, might be more negatively impacted by ESG-related screens than a highly concentrated investment style such as a portfolio of between 30 and 50 stocks (a common approach used to manage high-net-worth client equity portfolios).

Additionally, some scholars have noted that limiting the investment pool may, in some cases, actually improve portfolio performance. While this proposition directly contradicts traditional efficient market theory, it is supported by a recent body of literature on the success of narrower investment strategies, including those focused on particular industries or on firms located close to the investment company.[4] The explanation for this effect is a commonsensical one: even in our information age, it is impossible for investors to become adequately informed about all possible investments. They therefore do not benefit fully from having all options available to them. In fact, if they focus on a smaller group of investments with which they become very familiar, they may be more likely to identify market inefficiencies—instances where relevant information is not currently reflected in security prices, and may be exploited by active managers.

There have also been interesting findings regarding the third aspect of diversification, individual security volatility. A number of researchers have found that securities—usually stocks—favored by responsible investment strategies tend to be less volatile than securities that rank poorly on ESG metrics. This is true even when controlling for size and other factors.[5]

5. Responsible investors' analysis of ESG factors sometimes flags unpriced risks and opportunities that are soon to be recognized by the market.

A number of studies have found that individual ESG data points may serve as indicators of future firm and stock price performance and may therefore be incorporated profitably into active investment management. For example, Fu and Shan (2009) found evidence of a causal relationship between more inclusive policies towards gay and lesbian stakeholders (as rated by the Human Rights Campaign) and higher stock returns at U.S. companies in 2002-2006.[6] Edmans (2010) found that a portfolio of firms rated "The Best Companies to Work For in America" would have outperformed benchmarks in 1984-2009. Derwall et al. (2004) found that returns to a portfolio of companies receiving positive Innovest ratings for energy efficiency would have exceeded those of a low efficiency counterpart in 1995-2003.[7] Finally, Spellman and Watson (2009) found a positive relationship between corporate governance ratings assigned by GovernanceMetrics International and future stock returns.[8]

6. In other cases, the ESG risks and advantages identified by responsible investors are either already priced by the market, or will only affect stock prices in the long term.

Another group of studies suggests that the value of some ESG factors is already recognized by the market and therefore offers limited advantages to active managers. For example, in a 2009 paper, Darren David Lee and Warren W. Faff, using Dow Jones Sustainability Index data, found that a portfolio of companies ranking better than average on ESG issues tracked the overall market in 1998-2002. However, a group of laggards in what the authors called corporate social responsibility (CSR) had higher returns than both the market and the socially responsible group. The authors provided statistical evidence that this outperformance occurred because low-CSR performers had over 20 percent more idiosyncratic risk than the CSR leaders, with idiosyncratic risk defined as price variability that is specific to the firm. (The authors controlled for size, industry, and country factors, among others.) Because of this risk differential, investors demanded a higher risk premium for CSR laggards than for CSR leaders. In other words, the market expected the CSR leaders to have less volatile returns, possibly because they experienced fewer lawsuits, fines, boycotts and scandals that could affect stock price. Investors thus paid a price premium for responsible companies (or put another way, they accepted a return discount). Two other studies, focusing on different time frames and regions, also found that firms defined as leaders in corporate responsibility have lower idiosyncratic risk.[9]

In a similar vein, Gregory et al. (2010) found that companies with better CSR records on diversity, employee relations, and the environment tended to have higher valuations, even when controlling for industry effects and other factors. (They theorized that this may be because such companies have fewer adverse cash flow shocks and a lower cost of capital.) While their study implies that investing in companies that already have strong CSR may not lead to outperformance, the authors suggested that changes in these CSR practices may lead to abnormal returns (in other words, returns beyond what would be expected for the stock's level of risk).[10]

In addition, there are situations where ESG analytics may give clues as to the long-term fate of a company and its securities, but it is difficult to make these insights actionable due to the generally short-term orientation of the market, as well as uncertainty about how and when the ESG issues will interact with the many other factors affecting security prices. Finally, the qualitative nature of much ESG analysis makes it challenging to incorporate into quantitative statistical models that are central to much active management.

7. The impact of ESG variables varies with industry, firm and other factors.

ESG factors are increasingly being analyzed in a disaggregated, industry- and company-specific fashion—mirroring the way that traditional financial and economic variables are viewed. For example, it is well understood that some, but not all, securities are sensitive to inflation or commodity prices, and a financial ratio like inventory turnover may be crucial for one firm and irrelevant to another. Similarly, some firms are affected by their relationships with repressive overseas governments or the rise in water scarcity, while others are not. For some firms, the number of work hours lost each year due to accidents is a key indicator while for others it is of lesser importance.

Part of a responsible investment professional's expertise is the ability to assess how industries, and individual companies, are differentially affected by ESG issues—and how these effects may interact and reverberate portfolio-wide. In the academic realm, too, interesting work is being done on these differential effects. For example, in a 2010 study, Hoepner et al. suggested that the importance of ESG issues varies with an industry's degree of dependency on different stakeholder groups; its proximity to the end consumer; its potential for social and environmental damage; and its level of product or service differentiation. Using Innovest data that flagged key indicators for each industry group, the authors found abnormal excess returns for the top 100 ESG leaders in the health care, industrials, and consumer discretionary sectors from 2005-2008.[11]

8. Responsible investment is a specialized skill.

Given the complexity of the research findings described above, it makes intuitive sense that significant manager skill would be required to figure out when ESG-related insights can contribute to outperformance, and how they can best be incorporated into portfolio construction and security selection. Indeed, several empirical studies support the idea that specialist expertise is required to outperform using responsible investment strategies. For example, a 2008 study of active responsible investment funds listed in the SIF Trends reports from 1997-2005 found that those sponsored by management companies specializing in responsible investment significantly outperformed conventional funds. Those run by generalist companies, however, underperformed. This was true both before and after fees (which were comparable for responsible and conventional funds).[12]

Similarly, in a 2009 study of 265 Islamic investment funds from 20 countries, Hoepner et al. found that those based in the six largest Islamic financial centers of the world were generally competitive with conventional funds, with funds from two countries—Qatar and the United Arab Emirates—outperforming generalist benchmarks. Islamic funds based in seven Western nations, however, underperformed. (The authors controlled for equity market and investment style exposure.) These findings support the idea that responsible investing is a specialized skill, which managers develop in settings with a high density of like-minded professionals.

9. Responsible investment may confer benefits by correcting the externalization of costs, and encouraging positive externalities.

Many responsible investors evaluate their portfolios' performance in a broad economic context, which incorporates an understanding of externalities—the financially or economically measurable impacts that a company may have on employees, communities, ecosystems, or other stakeholders. Often, these impacts also directly affect investors—although not in their capacity as holders of that particular company's securities. For example, a state pension fund may hold stock in a company whose toxic emissions cause illness in state residents and pollute its parks, thereby imposing costs on the state's health system and reducing state tax revenues from the tourism industry. The company's pollution may even harm, directly or indirectly, other companies in the state pension fund's portfolio. Seen from the perspective of the state as institutional investor, pension fund returns from this company's stock may not look as positive after accounting for these related costs. Alternatively, a company that invests in employee education and training may raise the long-term earnings potential of its workers, resulting in higher future tax payments from those individuals to cities and states that may hold the company's securities in their funds.

Quantifying and modeling these sorts of externalities is a very complex task, which researchers are only beginning to address. For example, no research we are aware of has tried to assess the stock price or earnings impacts of ESG-related costs imposed by "bad actors" on portfolio companies; e.g., by tobacco firms on health care stocks. Similarly, little or no scholarship has yet sought to assess the investor's share of costs that companies externalize onto other stakeholders (for example, taxpayers) and deduct them from returns. However, an important first step in this area was made in October 2010, with the release of a report entitled "Universal Ownership: Why Externalities Matter to Institutional Investors," commissioned by the UN Principles for Responsible Investment from environmental research firm Trucost. Synthesizing and building upon a wide body of research in environmental economics and related fields, the report estimated that the cost of environmental damage caused by the world's 3,000 largest public companies amounts to $2.15 trillion annually.[13] Responsible investors have long sought to evaluate the economic impact of their investment decisions in this kind of system-wide, relational fashion.

10. "Values" can be linked to "value."

Finally, it is important to note that some of the company impacts responsible investors consider may not be financially or economically quantifiable, but are important to investors morally, emotionally or aesthetically—they give investors what economists call "a gain in utility." For example, some investors do not want to hold retailers whose overseas factories employ children or subject workers to harassment or violence; they do not want their manufacturing companies to deplete the drinking water of communities in the developing world; and they do not want the fast food chains they hold to build restaurants next to ancient ruins or on indigenous sacred sites. In some cases, these "utility" issues can become financially material—for example, if a developing country government shuts down a company's operations because of protests over water scarcity, or if consumer outrage over sweatshop conditions begins to harm a company's brand. Even if these issues remain unquantifiable, however, many responsible investors will insist on their importance. It may not be possible to make a "business case" for the prevention of labor abuses, drought, and cultural destruction, but responsible investors also see themselves as citizens and human beings who have broader interests than the simple maximization of profit.

RI's focus on the investor's multiple motivations has been one of the drivers of the industry's success. As RI practitioners know, RI assets tend to be "stickier" than conventional ones: because clients value the positive impacts RI has on the world beyond their portfolios, they tend to remain invested even through the ups and downs in performance that are inevitable for any active manager.

Conclusion

It has long been known that responsible investment need not cost investors money. Recent literature on RI and performance shows that RI portfolios can sometimes outperform benchmarks, and conventional active funds, but that specialist expertise is often crucial to their success.

Endnotes

[1] One especially useful paper analyzes the 51 studies of responsible investment which have been most influential (measured by number of citations by academics and industry practitioners) in the English-speaking world since the 1990s. See Hoepner, Andreas G. F. and McMillan, David G., Research on 'Responsible Investment': An Influential Literature Analysis Comprising a Rating, Characterisation, Categorisation and Investigation (August 14, 2009). Available at SSRN: http://ssrn.com/abstract=1454793. Other useful surveys have been produced by the European Corporate Governance Institute (see Ter Horst, Jenke R., Zhang, Chendi and Renneboog, Luc, Socially Responsible Investments: Methodology, Risk Exposure and Performance (June 2007). TILEC Discussion Paper No. 2007-013; ECGI - Finance Working Paper No. 175/2007. Available at SSRN: http://ssrn.com/abstract=985267) and by the consultancy Mercer (this November 2009 study is not available on SSRN but is entitled "Shedding Light on Responsible Investment: Approaches, Returns and Impacts" and is available for purchase at http://www.mercer.com/ri).

[2] See, for example, Renneborg et al. (2007) and Hoepner and McMillian (2009), cited above.

[3] For a lucid discussion of these possibilities, see Hoepner, "Portfolio Diversification and Environmental, Social or Governance Criteria," cited above. For evidence that screening need not meaningfully reduce diversification, see Galema, Rients, Scholtens, Bert and Plantinga, Auke, The Cost of Socially Responsible Portfolios: Testing for Mean-Variance Spanning (February 1, 2009). Available at SSRN: http://ssrn.com/abstract=1086560. This study finds that exclusionary social screening (based on KLD data) produced no significant decrease in diversification opportunities for long-only investors in an investable pool of 2,000 U.S. stocks in 1991-2004. (Short-sellers, however, would have been able to gain risk reduction by expanding their universe to the excluded stocks.)

[4] For citations to this literature, see Gil-Bazo, Javier, Ruiz-Verdú, Pablo and Santos, André A. P., The Performance of Socially Responsible Mutual Funds: The Role of Fees And Management Companies (September 25, 2008). Available at SSRN: http://ssrn.com/abstract=1307043.

[5] For a discussion of this point see Hoepner, Andreas G. F., Portfolio Diversification and Environmental, Social or Governance Criteria: Must Responsible Investments Really Be Poorly Diversified? (May 2, 2010). Available at SSRN: http://ssrn.com/abstract=1599334.

[6] Fu, Shihe and Shan, Liwei, Corporate Equality and Equity Prices: Doing Well While Doing Good? (March 12, 2009). Available at SSRN: http://ssrn.com/abstract=1368422.

[7] Derwall, Jeroen, Bauer, Rob, Guenster, Nadja and Koedijk, Kees C. G., Socially Responsible Investing: The Eco-Efficiency Premium Puzzle (May 17, 2004). EFMA 2004 Basel Meetings Paper; Erasmus University Working Paper. Available at SSRN: http://ssrn.com/abstract=551590.

[8] Spellman, G. Kevin and Watson, Robert, Corporate Governance Ratings and Corporate Performance: An Analysis of Governance Metrics International (GMI) ratings of US Firms, 2003 to 2008 (January 1, 2009). Available at SSRN: http://ssrn.com/abstract=1392313.

[9] For example, Boutin-Dufresne and Savaria (2004) found in a study of 300 Canadian firms from 1995 to 1999 that bottom-quartile ESG performers had 40 percent higher firm-specific risk than top-quartile firms; Bauer et al. (2009) found an inverse relationship between employee relations and specific risk at 976 US-firms from 1995-2006. Cited in Hoepner (2010).

[10] Gregory, Alan, Whittaker, Julie M. and Yan, Xiaojuan, Stock Market Valuation of Corporate Responsibility Indicators (November 30, 2010). Xfi Centre for Finance and Investment, University of Exeter Discussion Paper No. 10/06. Available at SSRN: http://ssrn.com/abstract=1723126.

[11] Hoepner, Andreas G. F., Yu, Pei-Shan and Ferguson, John, Corporate Social Responsibility Across Industries: When Can Who Do Well by Doing Good? (March 1, 2010). Available at SSRN: http://ssrn.com/abstract=1284703.

[12] Gil-Bazo, Javier, Ruiz-Verdú, Pablo and Santos, André A. P., The Performance of Socially Responsible Mutual Funds: The Role of Fees And Management Companies (September 25, 2008). Available at SSRN: http://ssrn.com/abstract=1307043.

[13] See preliminary report at http://www.unpri.org/files/6728_ES_report_environmental_externalities.pdf.

For more information about GovernanceMetrics International and our products and services, please contact us:

www.gmiratings.com

info@gmiratings.com

+1 212 949-1313

GovernanceMetrics
INTERNATIONAL
www.gmiratings.com