

Responsible Investment and Financial Return
Insights and Perspectives from Research Groups

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AGENDA

- § The necessity of research
- § Where do we stand?
- § Moving forward with RI research
- § Examples of scientific contribution to the ongoing RI question
 - ▶ ESG factors and portfolio returns



WHAT CAN RESEARCH OFFER?

- § Financial market: mechanism to encourage responsible corporate behavior and sustainable development
- § But what has responsible investment to offer to markets (investors)?
- § Understanding the financial aspects of responsible investment is crucial to mainstreaming RI.
- § Research must still help tackle ongoing questions:
 - ▶ Is there a business case in favor of/against responsible corporate behavior?
 - ▶ Is there an investment case in favor of/against RI?



WAT *DO* WE NOW BY NOW?

- § **Ongoing debates on integrating ESG factors into (responsible) investment and business policies.**

- § **ESG mutual funds and conventional funds earn similar returns**
 - ▶ Mainly equity fund studies
 - ▶ >10 years of data

- § **But understanding *added value of responsible investment requires more research***
 - ▶ Theoretically RI can influence return
 - ▶ Mutual funds: indirect evidence
 - ▶ Disaggregate: value of each ESG factor /screen
 - ▶ Which criteria related to return?
 - ▶ Such knowledge creates RI mainstreaming incentives
 - ▶ Speak language of mainstream practitioner



OLD-GENERATION RESEARCH

PERFORMANCE OF ESG MUTUAL FUNDS

Our worldwide studies into equity ESG mutual funds

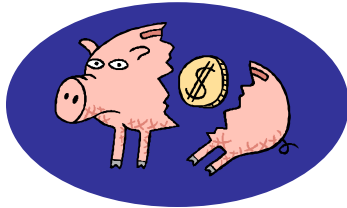
Land	Period	Scope	ESG funds vs. conventional mutual funds	
			Return difference (risk-adjusted)	Risk difference
U.S.	1990 -2001	Domestic	0	0
		International	0	0
Canada	1994 -2002	Domestic	0	0
G.B.	1990 -2001	Domestic	0	<
		International	0	<
Germany	1990 -2001	International	0	<
Sweden	1999 -2002	Domestic	0	0
		International	0	0
Australia	1994 -2003	Domestic	<	<
		International	0	<

0 = statistically not significant



OLD AND RECENT VIEWS

Responsible Investment: Help or Hurt?



- ESG / RI too subjective
- Costly at outset, benefits unsure
- Screening: investment restriction
- Stock neglect: “sin” outperforms



- CSR: reputational benefits
- CSR: operating efficiency
- CSR: lower risk / cost of capital
- ESG factors “mispriced”? If so, which?

Important empirical question. Outcomes also dependent on how markets further develop



KEY ACADEMIC HYPOTHESES

§ 1A. “The Neglect Hypothesis”

- ▶ Why can controversial companies deliver higher stock returns?
- ▶ Because certain (latent) risks are priced in the market?

§ 1B. “The Errors-in-Expectations Hypothesis”

- ▶ Why can responsible companies earn higher returns?
- ▶ Because ESG advantages mispriced by most investors and analysts?

§ 1C. “The Irrelevance Hypothesis”

- ▶ ESG factors are not priced in the market



THE “NEGLECT HYPOTHESIS”

Information on ESG-factors is relevant for the pricing and valuation of companies because there is a significant group of investors with “social preferences”. Their “boycotts” lead to “imperfect” markets

- ▶ E.g., not investing in so-called sin stocks (Alcohol, Tobacco etc.)
- ▶ Those who invest against “the social norm” have difficulties to share risk and to sell stocks (less liquidity: not a lot of people want to hold these stocks)
- ▶ Also heightened litigation risks will be factored into share prices
- ▶ This group requires higher returns to be compensated for these risks

- ▶ ***Hypothesis: “Neglected” stocks have higher returns as a compensation for these additional risks***



SUFFICIENT NR. BOYCOTTING INVESTORS?

- § U.S. studies show that – for years – several institutional investors have been more invested in responsible companies than in non-responsible counterparts
- ▶ But mainly (public) pension funds
 - ▶ Not mutual funds and hedge funds
 - ▶ Why these differences? They are equally financially smart
 - ▶ Differences in social preferences?
 - ▶ Long- versus short-term fixation?

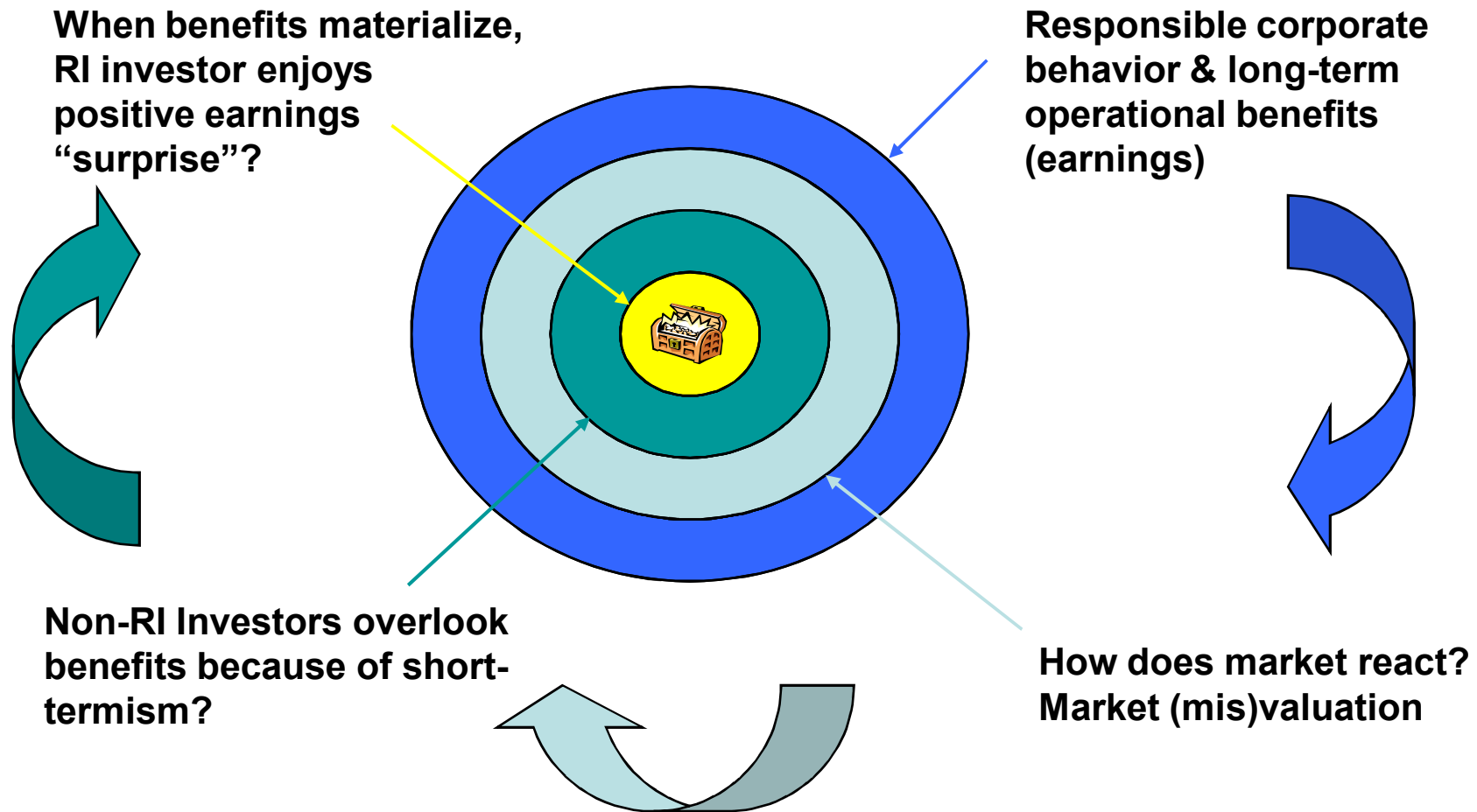


ERRORS-IN-EXPECTATIONS HYPOTHESIS

- § *Information on ESG factors is relevant for the pricing and valuation of companies on the stock market. But: is this information already used by analysts and investors, and subsequently priced on the stock market?*
- ▶ Short-term performance focus, fixation on quarterly earnings, investors evaluated with short-term measures
 - ▶ Long-term benefits of (ESG) projects overlooked
 - ▶ Change short-term obsession into long-term satisfaction by exploiting the systemic flaw: use ESG in investment decisions.
 - ▶ ***Hypothesis: Strong-ESG portfolios have relatively higher returns (even after correcting for portfolio risk)***

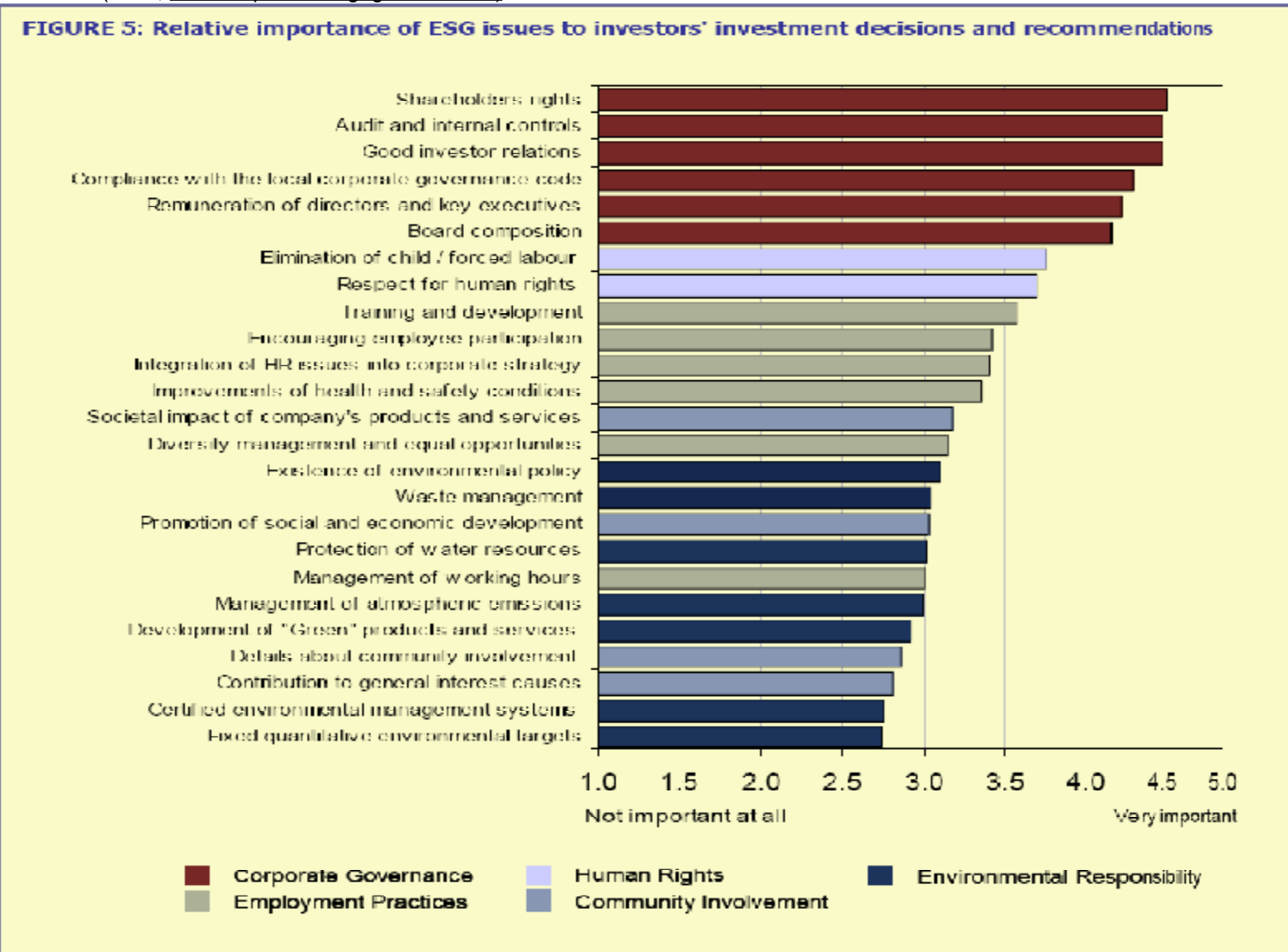


UNDERSTANDING MISPRICING POTENTIAL



WHICH FACTORS MIGHT BE OVERLOOKED?

Jaworski (2007, www.corporate-engagement.com)



WHICH HYPOTHESIS? LATEST EVIDENCE...

1B. Employee Satisfaction and Superior Returns

EDMANS (2007)- “An annually rebalanced portfolio of Fortune magazine’s Best Companies to Work For in America earned 14% per year from 1998-2005, over double the market return. The portfolio also outperformed industry-matched benchmarks” It yielded a monthly alpha of 0.64%... Intangible investment (i.e., in employees) may not be incorporated into short-term prices.

1B. Responsibility Factors and Alpha Strategies

KEMPF & OSTHOFF – ...we implement a simple trading strategy...buy stocks with high responsibility ratings and sell stocks with low ratings. We find that this strategy leads to high abnormal returns of up to 8.7% per year... The maximum abnormal returns are reached when investors employ the best-in-class screening approach, use several responsibility screens at the same time, and restrict themselves to stocks with extreme ratings...

1B & 1C. Responsible Fixed-Income Portfolios

DERWALL & KOEDIJK (2007) – “We show that the average U.S. SRI bond mutual fund performed similar to conventional funds over the period 1987-2003, while the average SRI balanced fund outperformed its conventional peers by more than 1.3% per year. The expenses charged by SRI funds, match those charged by conventional funds and, evidently, do not cause SRI funds to underperform. “

1A. The Price of Sin?

HONG & KACPERCZYK (2007) - “We hypothesize that there is a societal norm to not fund operations that promote vice and that some investors, particularly institutions subject to norms, pay a financial cost in abstaining from these stocks” ...”Sin stocks also have higher expected returns than otherwise comparable stocks, consistent with them being neglected by norm-constrained investors and facing greater litigation risk heightened by social norms.”



CONCLUDING REMARKS

- § “Alpha potential” of RI awaits further research, but there is progress
- § Increasing evidence of return – or risk - associated with ESG factors, which is relevant to investors
- § Which hypothesis holds – and whether RI adds to financial return - not only awaits further research, but the answer could also change as RI further develops
- § As with any form of active investment, there will be uncertainty about future return



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The screenshot shows the homepage of the European Centre for Corporate Engagement (ECCE). At the top, there is a navigation menu with links for home, publications, expertblog, partners, news, media, about, and contact. The main header features the ECCE logo, which consists of a circular arrow graphic and the text 'ECCE'. Below the header, there is a search bar and a date filter set to '11 09 2007'. The main content area is divided into several sections: a featured article titled 'The European Centre for Corporate Engagement (ECCE) is a 'lab for sustainable investment'' with a sub-headline 'ECCE helps practitioners and scholars understand how businesses and financial markets can promote sustainable development by considering Environmental, Social and Corporate Governance (ESG) issues. Read more...'; a 'publications' section with two entries: 'Extra-Financial Corporate Communication' (221x viewed) and 'De Kracht van Pensioenfondsen' (761x viewed); a 'media' section with a collage of news articles from BusinessWeek online, De Persgroep, and Economist.com, and a 'Subscribe to RSS feeds' box; an 'expertblog' section with a quote from a man and the text 'Dutch pension fund engagement seminar' (25 06 07); and a footer with the ECCE logo and the text 'European Centre for Corporate Engagement'. On the right side, there is a 'news' section with two entries: 'This Year's European Pension Summit in Amsterdam' and '5th Green Business conference to San Francisco'. At the bottom right, there is a 'Subscribe to the ECCE Newsletter!' form with fields for Name and E-mail, and a 'submit' button.



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