SOCIALLY RESPONSIBLE FINANCE and INVESTING

Financial Institutions, Corporations, Investors, and Activists

H. Kent Baker, John R. Nofsinger, Editors

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Editors

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John R. Nofsinger

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CHAPTER 1

Socially Responsible Finance and Investing: An Overview

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INTRODUCTION

What is the main goal of a business firm? Many have debated this question over the years. The response largely depends on one's view of to whom the firm is responsible. Some contend that corporations are only responsible to their shareholders and do not have other obligations to society besides complying with applicable laws, ethical standards, and international norms. Hence, corporations should operate to meet the best interests of shareholders within these constraints. Others take the broader view that corporations have responsibilities to stakeholders other than shareholders. *Stakeholders* refer to those who have an interest or concern in the firm because of how its activities affect them. Stakeholders consist of owners, management, employees, suppliers, customers, the local community, and others.

Donaldson and Preston (1995) discuss three versions of stakeholder theory: normative, instrumental, and descriptive. Normative stakeholder theory views a firm's behavior through an idealistic social or moral lens. That is, this version focuses on how firms "should" act. Instrumental stakeholder theory views stakeholder relationships as the means to some end, such as maximizing firm value. By contrast, descriptive stakeholder theory uses the stakeholder model as a tool for describing the activities and interests of the firm. In general, instrumental stakeholder theory seems to fit the needs of performance-oriented investors better than other approaches. Others provide an extensive treatment of stakeholder theory (Friedman and Miles 2006; Freeman, Harrison, Wicks, Parmar, and de Colle 2010; Phillips 2011).

Jensen (2001, p. 8) offers the following observation about a firm's goal:

> How do we want the firms in our economy to measure their own performance? How do we want them to determine what is better versus worse? Most economists would answer simply that managers have a criterion for evaluating performance and deciding between alternative courses of action, and that the criterion should be maximization of the long-term market value of the firm. . . . This Value Maximization proposition has its roots in 200 years of research in economics and finance.

Most financial economists would agree that the fundamental purpose of a business firm, especially a corporation, is to maximize returns to its shareholders. This view is consistent with instrumental stakeholder theory, which considers the stakeholder network as the means to the end of wealth creation. For example, Friedman (1962, 1970) treats shareholders as ends to firm performance and explicitly measures performance as profit. As Friedman (1970, p. 32) notes, the responsibility of business firms "will generally be to make as much money as possible." Proponents of this view contend that the notion of corporate social responsibility (CSR), which is also called corporate conscience, corporate citizenship, social performance, and responsible business, distracts from the economic role of business.

Others, such as Freeman (1984, 1998), have different views. Freeman (1998, p. 126) states that "we must reconceptualize the firm around the following question: For whose benefit and at whose expense should the firm be managed?" He proposes replacing the narrow focus on shareholders with a broader set of obligations. Porter and Kramer (2011) echo this sentiment by proposing that the purpose of the corporation be viewed as creating shared value and not just profit. They maintain that corporations can make more long-term profits by embracing CSR. According to Baker and Powell (2005), achieving shareholder wealth maximization assumes that managers operate in the best interests of shareholders, avoid actions designed to deceive financial markets in order to boost the firm's stock price, and act in a legally and socially responsible manner. Given these assumptions, Baker and Powell (p. 12) state that "shareholder wealth maximization is consistent with the best interest of stakeholders and society in the long run."

Although shareholder wealth maximization has gained considerable traction in the academic and business communities, the concept of social responsibility has also gained momentum. Socially responsible finance includes responsibility from the corporate side (corporate social responsibility) as well as the investor side (socially responsible investing) in the capital markets.

CORPORATE SOCIAL RESPONSIBILITY

In the late twentieth century, an increasing number of corporations started to think about their effect on society at large, mainly because of growing consumer awareness of corporate activities around the world. Some corporations decided to embark on corporate social responsibility programs designed to offset some of their effects on the world while also generally improving corporate practices (Campbell 2007). *Corporate social responsibility* (CSR) is a form of corporate self-regulation integrated into a business model. That is, CSR is the decision-making and implementation process that guides all company activities in protecting and promoting international human rights, labor and environmental standards, and compliance with legal requirements within its operations and in its relations to the societies and communities where it operates (Carroll 1999). CSR involves a commitment to contribute to the economic, environmental, and social sustainability of communities through the ongoing engagement of stakeholders, the active participation of communities affected by company activities, and the public reporting of company policies and performance in the economic, environmental, and social arenas.

In theory, CSR policy functions as a built-in, self-regulating mechanism whereby business should monitor and ensure its support to law, ethical standards, and international norms. Thus, business should embrace responsibility for the impact of its activities on the environment, consumers, employees, communities, stockholders, and all other members of the public sphere. Also, CSR-focused businesses should proactively promote the public interest by encouraging community growth and development, and voluntarily eliminating practices that harm the public sphere, regardless of legality. Norman and MacDonald (2004) show how CSR deliberately attempts to include public interest into corporate decision-making and focuses on a triple bottom line: people, planet, and profit.

The practice of CSR is much debated and criticized. Not surprisingly, CSR has both fans and detractors. Proponents contend that a strong business case exists for CSR. They argue that corporations can benefit in multiple ways by operating with a perspective broader and longer than their own immediate, short-term profits. Critics maintain, however, that CSR distracts from the fundamental economic role of businesses. Others argue that CSR is nothing more than superficial window-dressing while still others contend that it is an attempt to pre-empt the role of governments as a supervisory body over powerful multinational corporations (Archel, Husillos, and Spence 2011; Harrison, Bosse, and Phillips 2010).

SOCIALLY RESPONSIBLE INVESTING

Socially responsible investing (SRI), also called ethical investing and green investing, is an investment that is considered socially responsible because of the nature of the business the company conducts. SRI uses environmental, social, and corporate governance (ESG) criteria to generate long-term, competitive financial returns and positive societal impact (SIF 2010). That is, investors limit their investment alternatives to securities of firms whose products or actions are considered socially acceptable (Bollen 2007). For example, socially responsible investors might avoid investment in companies that produce or sell addictive substances such as tobacco, liquor products, or gambling and might seek out companies engaged in environmental sustainability and alternative energy/clean technology efforts (Statman 2004). Unlike traditional investing that focuses only on financial returns, SRI combines both financial goals and social responsibility (Derwall, Koedijk, and Ter Horst 2011).

Socially conscious investing is growing into a widely-followed practice. For example, retail investors can make socially responsible investments in individual companies, follow SRI indexes, or through a socially conscious mutual fund or exchange-traded fund (ETF). Mutual funds and ETFs provide an added advantage in that investors can gain exposure to multiple companies across many sectors with a single investment. Yet some question whether investors sacrifice performance for the sake of ideology (Hong and Kacperczyk 2009). That is, just because an investment touts itself as socially responsible does not mean that it will provide investors with a good return.

PURPOSE OF THE BOOK

The purpose of this book is to provide a comprehensive view of the growing field of socially responsible finance and investing. It discusses the socially responsible foundations and their applications to finance as determined by the current state of this research. The book is written by noted scholars—both academics and practitioners—who provide a synthesis of what is known about each topic no matter whether the evidence is flattering or not. Of the books currently available in this area, many tend to focus on one narrow topic, such as how to measure socially responsible activities in a firm, and to be written from a proponent's point of view. This is not the case with *Socially Responsible Finance and Investing*, which takes a wide-ranging view and offers multiple perspectives.

The socially responsible framework for viewing business activities is likely to increase in popularity. This movement is already becoming popular with the European business community and scholars there. The ideas are now gaining a foothold in the United States. With a focus on the recent financial collapse, other bailouts, and the environment, the U.S. interest in socially responsible finance is likely to continue increasing.

FEATURES OF THE BOOK

Socially Responsible Finance and Investing has several distinguishing features.

- Perhaps the book's most distinctive feature is that it provides a comprehensive discussion of the theory, empirical work, and practice within the various topics covered in socially responsible finance and investing. The book not only attempts to blend the conceptual world of scholars with the pragmatic view of practitioners, but also to synthesize important and relevant research studies including recent developments. The book takes an objective view and avoids an advocacy position.
- The book contains contributions from numerous authors. The breadth of contributors assures a variety of perspectives and a rich interplay of ideas.
- This volume discusses the results of empirical studies that link theory and practice. The objective is to distill them to their essential content so that they are understandable to the reader.
- Each chapter contains discussion questions that help to reinforce key concepts. This feature should be especially important to faculty and students using the book in classes.

INTENDED AUDIENCE

This book should appeal not only to an academic audience—researchers, professors, and students—but also to industry professionals, lawmakers, and regulators. For example, both academics and practitioners who are interested in socially responsible finance should find this book to be useful given the scope of the work. It should also be appropriate as a stand-alone book for undergraduate or graduate-level business courses related to the topics contained in this book. Further, libraries should find this work to be a suitable reference book.

STRUCTURE OF THE BOOK

The remaining 23 chapters are organized into four sections. A brief synopsis of each chapter by section follows.

Section I. Foundations and Key Concepts

Chapters 2 through 6 provide the foundation for understanding socially responsible finance and investing. Chapter 2 offers an in-depth discussion of stakeholder analysis, while Chapter 3 examines how different business disciplines view CSR. Chapter 4 introduces the concept of business models and social entrepreneurship. Chapter 5 discusses the legal framework in which SRI operates. Chapter 6 concludes this section by examining various international and cultural views toward SRFI.

Chapter 2 Stakeholder Analysis (Lloyd S. Kurtz)

Social investors often incorporate elements of stakeholder theory into their work. Many believe that firms with good stakeholder relationships should be viewed as better managed and therefore likely to offer superior financial performance. Empirical research has strengthened the case for a correlation between good stakeholder management and superior firm-level financial outcomes. These findings strongly suggest that a stakeholder worldview has validity and that analyzing stakeholder relationships can aid in investment analysis. Although many theoretical approaches are available, a modified form of instrumental stakeholder theory seems to fit best with the needs of investors. In this framework, good management may be defined as the efficient allocation of resources to stakeholder management, such that a large surplus remains for owners and managers. Stakeholder analysis of this type aids in assessing management quality and clarifies the relationships among stakeholders, owners, and managers. The resulting insights are often relevant for the valuation of the firm. Stakeholder analysis therefore has the potential to improve fundamental analysis, and stakeholder relationships deserve the attention not just of social investors, but of managers and investors in general.

Chapter 3 Corporate Social Responsibility (Heather Elms and Michelle Westermann-Behaylo)

This chapter identifies varying approaches to CSR in the business ethics, finance, accounting, and marketing literatures. In particular, it identifies a series of current themes in the business ethics literature that are not yet reflected in the finance, accounting, and marketing literatures as evidenced by a review of the articles published in the high-quality journals of these functional disciplines. The analysis suggests that greater consideration of these themes by the functional literatures and greater appreciation of the focus of the functional literatures by the business ethics literature may lead to a better understanding of the CSR phenomenon.

Chapter 4 Business Models and Social Entrepreneurship (Michael A. Pirson)
The 2007–2009 financial crisis caused many to question the basic premises of the current business system and the financial services industry. Some suggest that corporations should aim to regain legitimacy by pursuing shared value rather than mere financial value. Managers may be able to look at the field of social entrepreneurship to learn how to create such shared value. This chapter presents the concept of social entrepreneurship and introduces two areas in which social entrepreneurs have created novel business models: microfinance and social impact investing. The lessons that can be learned for shared value creation are discussed for the financial industry as a whole and those interested in socially responsible finance. The chapter concludes by presenting several caveats.

Chapter 5 Fiduciary and Other Legal Duties (Benjamin J. Richardson)
In common law legal systems, such as in the United Kingdom and the United States, fiduciary duties exert an important influence on institutional investors' latitude to practice SRI. Obligations on fund managers, trustees, and others who have custody of investors' money generally require that they invest prudently in their best financial interests. In limited circumstances, this legal framework may allow SRI such as when these investments offer comparable returns, the fund's constitution mandates SRI, or if beneficiaries consent to SRI. Recent statutory reforms in some jurisdictions have created a more enabling legal environment for SRI than in the past.

Chapter 6 International and Cultural Views (Astrid Juliane Salzmann)
Even though public and corporate interest in investment with social and environmental considerations is growing, the current literature remains vague about the underlying motives of investors. This chapter investigates the effect of the institutional environment on the social and ecological behavior of firms and investors around the world. It reviews four structural theories—legal origin, endowments, religion, and cultural values—and examines their usefulness to explain cross-country differences in social responsibility. Despite some isolated findings, where research has given explanations for developments in the field of sustainable finance, a deeper understanding of their general determinants remains incomplete. Existing research has primarily focused on religion and culture as explanatory factors for ethical issues in finance. Exploring the impact of the legal origin and endowments might also seem fruitful, but elaboration on the relevance of these theories remains a field for future research.

Section II. Society and Finance

The impact of social concerns on financial activities has evolved over time. Some of the nine chapters of this section describe this evolution in different segments of society, while others detail recent financially irresponsible events. Chapter 7 describes the history of the role of social, environmental, trust, and ethical issues in business. The religious aspects of social responsibility for finance are detailed in Chapter 8. Chapter 9 focuses on the development of microfinance and social banking. Managerial compensation has long been a controversial issue in society and is discussed in Chapter 10. Chapter 11 shows how externalities in the financial services industry have led to negative outcomes. A large energy efficiency and sustainability trend occurs in real estate. The aspects of real estate sustainability in society are the focus of Chapter 12. Chapters 13 and 14 describe the roles of federal housing policies and predatory lending to the financial crisis. Lastly, Chapter 15 details the history and recent developments in the financial secrecy industry and its role in society.

Chapter 7 Social, Environmental, and Trust Issues in Business and Finance (Christoph F. Biehl, Andreas G. F. Hoepner, and Jianghong Liu)

This chapter discusses social, environmental, and trust (SET) issues relating to business and finance in a historical context. Social issues relating to the concerned societal groups emerged beginning in the mid-twentieth century and have had an increasing impact on business ever since. Recently, societal groups have voiced anxieties about the trustworthiness of certain businesses, especially large financial institutions. These societal trends can be business relevant in both a positive and negative way. Managing these stakeholder concerns can, for instance, build trust and consumer loyalty, but it also costs corporate resources. Due to a consistently increasing complexity of business and finance and a similarly consistently increasing speed of information exchange among concerned stakeholders (e.g., via social media), trust-based businesses such as financial institutions are likely to increasingly face the challenges and opportunities resulting from societal concerns about SET issues.

Chapter 8 Religion and Finance (Luc Renneboog and Christophe Spaenjers)

Individuals' economic attitudes are frequently observed to vary in a systematic manner with religious affiliation or religiosity. As a consequence, religion is also correlated with a range of financial-economic outcomes. Research has established the importance of religion at the macro-economic level, and has shown that the religious environment may affect the behavior of managers and institutional investors. Much less evidence exists on the role of religion in the financial decision-making process at the household level. Therefore, this chapter uses data from a well-recognized household survey to investigate the relationship among religious affiliation, economic attitudes, and saving and investment decisions in the Netherlands. The evidence shows that differences in economic beliefs and preferences can partially explain the higher propensity to save by all religious households and the lower investments in stocks by Catholic households.

Chapter 9 Social Finance and Banking (Olaf Weber and Yayun Duan)

This chapter describes social banking, impact investment, and microfinance as areas of social finance. Each tries to achieve a positive social impact on society, the environment, or sustainable development through social finance and banking. The data show that social finance is successful in creating both a financial and a social return and has been growing in recent years. Impact measurement indicators have yet to be developed to adequately measure the financial and social impact of social finance. Furthermore, transaction costs have to be reduced to maintain attractive financial returns, and broader client groups have to be addressed to increase the impact of social finance.

Chapter 10 Managerial Compensation (Kose John and Samir Saadi)
This chapter surveys the recent literature on managerial compensation, focusing on the main issues that spurred intense debate in the popular press, academia, and from regulatory agencies. In particular, the literature review discusses whether the high levels of executive compensation are justifiable, and whether executive compensation schemes induce unethical behavior by executives. While most of the empirical evidence supports the view that the high levels of executive compensation are excessive and unethical, an emerging stream of literature provides rational explanations for the observed levels of executive pay. Ample evidence also shows that some compensation packages induce executives to manipulate their pay. This chapter also summarizes a limited, but growing, literature linking managerial compensation to corporate social responsibility. This literature suggests that the structure of managerial compensation matters to corporate social performance.

Chapter 11 Externalities in Financial Decision Making (Janis Sarra)
This chapter examines externalities in financial decision making. It explores how the structure of financial products and services has led to considerable harm to individuals and firms, suggesting that the incentives created by the current structure of financial services need serious re-examination. Socially responsible investment could play an important role in retooling the system to ensure that financial decision making and investment contribute to, rather than detract from, the long-term social, economic, and environmental sustainability of firms.

Chapter 12 Real Estate and Society (Piet Eichholtz and Nils Kok)
Real estate can play a key role in averting further climate change because of its high contribution to pollution and substantial energy consumption. Interest in green and sustainable buildings has grown dramatically in recent years with increasing awareness of these factors. This chapter explores the economic significance of the energy efficiency and sustainability trend in real estate, addressing the financial performance of green buildings, in both the United States and international markets. The behavior of corporations with respect to housing decisions is discussed, analyzing how real estate can be used as a proxy for corporate social responsibility. The chapter then investigates how institutional investors integrate sustainability in their allocations to real estate, measuring the environmental performance of dedicated property fund managers.

Chapter 13 Federal Housing Policies and the Recent Financial Crisis (Ronnie J. Phillips and Kenneth Spong)
The recent financial crisis and housing debacle destroyed wealth for homeowners and resulted in a substantial taxpayer bailout. Some contend that federal housing policies were a major reason for the crisis. In particular, public policies adopted under the goal of promoting greater home ownership, especially among low-income individuals, may have led to much weaker mortgage lending standards and put many homeowners at greater financial risk. This social goal of increasing home ownership, and thereby promoting wealth accumulation by low-income families, has a long history and has been supported by both political parties and a wide range of policy makers. This chapter reviews the key laws and policies adopted to promote homeownership and the manner in which they may have

contributed to weaker lending standards, excessive debt burdens, and, in turn, the housing and financial crisis. Several alternative approaches are suggested to promote the goal of greater homeownership and wealth building among lower-income families without threatening the financial health of such families or putting the financial system and taxpayer at risk.

Chapter 14 Predatory Lending and Socially Responsible Investors (Christopher L. Peterson)

This chapter attempts to provide a simple introduction to the complex finance, law, and policy of consumer credit markets with an eye toward helping responsible investors begin to develop the ability to shun predatory lending. While no consensus exists on what lending practices are socially corrosive, responsible investors looking for opportunities in consumer financial markets have an obligation to make their best effort to identify and avoid predatory loans. This chapter first provides a brief introduction to some of the more controversial current lending practices. Next, it summarizes evidence of self-defeating consumer borrower behavior. Then, it provides a cursory characterization of the rapidly evolving law of consumer finance. Finally, this chapter suggests several warning signs of predatory lending that can serve as a starting point for further investigation.

Chapter 15 Use and Misuse of Financial Secrecy in Global Banking (Ingo Walter)

This chapter explores financial secrecy as a product that is traded in organized and unorganized markets. It examines demand functions based on the disutility of financial disclosure, and supply functions based on the ability to impede financial disclosure. The "price" is defined as the displacement of the risk/return frontier incorporating financial secrecy, as opposed to a benchmark frontier lacking protection against financial disclosure. Agency and enforcement problems are examined in the presence of financial secrecy, with an emphasis on tax evasion and money laundering. The framework developed in the chapter is useful in explaining the behavior of principals active in the market for financial secrecy, namely, strategies of individuals, firms, and countries active in the supply of financial secrecy, civil and criminal enforcement actions, and financial flows across regulatory jurisdictions motivated by financial secrecy considerations.

Section III. Corporate Engagement

This section consists of five chapters dealing with the topic of corporate engagement. Chapter 16 focuses on the role of governance in CSR. Chapter 17 investigates the various ways of measuring CSR from the perspective of different stakeholders. Chapter 18 discusses corporate philanthropy from the perspectives of value enhancement and agency cost. Chapters 19 and 20 examine institutional investor and social activism.

Chapter 16 Corporate Social Responsibility and Governance (Lorenzo Sacconi)

Corporate social responsibility (CSR) is a model of corporate governance (CG) extending fiduciary duties from fulfillment of responsibilities towards the firm's owners to fulfillment of analogous fiduciary duties toward all the firm's stakeholders. After considering the place of CSR in the debate about alternative CG modes, a full-fledged social contract foundation of the multistakeholder and multi-fiduciary model is presented. The chapter shows that CSR is a social norm that would endogenously emerge from the stakeholders' social contract seen as the first move in an equilibrium selection process that reaches the equilibrium state of a CG institution. The social contract provides a model of the impartial mediating reasoning performed by a board of directors striving to balance different claims of stakeholders. It also allows deducing the multistakeholder objective function that socially responsible firms maximize, and then provides a specification of the particular fiduciary duties owed to each stakeholder according to its position.

Chapter 17 Measuring Responsibility to the Different Stakeholders (Amir Rubin and Eran Rubin)
This chapter provides a discussion of the complexity of having an all-encompassing measure that quantifies corporate social responsibility (CSR) performance of a firm. It suggests an approach for measuring the different aspects of CSR, aimed to better align social and corporate goals. The chapter analyzes the different stakeholders associated with CSR and their interrelationships. The chapter contains a survey of the literature on stakeholder specific measures, whose purpose is to provide transparency on how a corporation affects a specific group of stakeholders. The chapter also presents a brief history of stakeholder specific responsibility measures and discusses how these measures are used in both academic work and practice.

Chapter 18 Corporate Philanthropy (Janet Kiholm Smith)
This chapter explores a myriad of issues related to corporate philanthropy. The historical accounts of firm involvement in social causes provide perspective for understanding the empirical evidence regarding the determinants of corporate giving and its impact on firm performance. The two primary hypotheses for giving programs, value enhancement and agency cost, generate testable implications that have been widely studied. Overall, the results suggest that enhanced financial performance is not the overriding concern of managers when authorizing corporate contributions. Instead, most evidence points to the prevalence of agency costs. However, the evidence cannot refute the notion that some firms align their philanthropy with underlying strategy and may be successful at leveraging their giving to differentiate their product or work environment. This chapter identifies various methodological and data-related challenges for research on corporate philanthropy.

Chapter 19 Institutional Investor Activism (Diane Del Guercio and Hai Tran)
For the past quarter century, institutional investors have been frequent activist shareholders on corporate governance issues. A large literature of academic research examines whether this activity is effective in influencing target firms and enhancing the performance of both target firms and activists' portfolios. The importance of this question stems from the role of institutional investors as large and influential investors in the capital markets and as financial fiduciaries who are entrusted with the assets of millions of clients and beneficiaries. This chapter examines the many parallels between the issues that institutions face today in incorporating environmental, social, and governance criteria into their

investment and activism programs, and the issues arising 25 years ago in the context of corporate governance. In short, socially responsible activism appears to be in the early stages of gaining momentum and legitimacy among mainstream institutional investors, with a steady stream of academic research likely to follow.

Chapter 20 Social Activism and Nongovernmental Organizations (Jonathan P. Doh and Deborah Zachar)
This chapter provides an overview of the role of social activism in the realm of socially responsible finance and investing. The chapter begins with a brief review of various perspectives on corporate social responsibility, focusing especially on the role of stakeholder theory and stakeholder management. It then documents the emergence of civil society actors such as nongovernmental organizations (NGOs) as critical players in the process by which stakeholders influence financial decisions through their activism. Next, the chapter describes the various mechanisms through which activists influence finance and investments. The chapter concludes with suggestions for further research.

Section IV. Socially Responsible Investing

The four chapters in this section examine the investment aspects of social responsibility. Chapter 21 focuses on the corporate long-term value associated with the firm making socially responsible investments. The last three chapters discuss various aspects of social responsibility in the investment industry. Chapter 22 discusses the risk-adjusted performance of SRI institutional investors and financial companies. This is followed by Chapter 23, which details the historical development of SRI and its investment performance, and concludes with predictions about its future. Lastly, Chapter 24 demonstrates the money flows into and out of SRI funds globally.

Chapter 21 Corporate Socially Responsible Investments (John R. Becker-Blease)
Corporations making socially responsible investments have attracted considerable interest in the popular press over the past several decades. The impact of these decisions on corporate value and the intended beneficiaries is the subject of a substantial academic literature in management and economics, and a small but growing literature in finance. Researchers suggest five potential sources of long-term value from corporate social responsibility (CSR) focused investments. This chapter reviews the literature associated with each potential source of value, and concludes that the preponderance of evidence is consistent with the hypothesis that CSR-focused investments are associated with long-term value creation.

Chapter 22 SRI Mutual Fund and Index Performance (Halil Kiymaz)
This chapter provides a review of the literature on socially responsible investing (SRI) with particular emphasis on empirical evidence of mutual fund and index performance. SRI is no longer a negligible segment of international capital markets. During the last two decades, SRI has increased sharply, reflecting the changes in investor sensitivities in social, environmental, and ethical issues. The main issue for firms is whether providing a risk-adjusted return to investors is possible while being socially or ethically responsible. Although the issue is far from being

resolved, the existing literature tends to report that a cost is associated with investors willing to invest in SRI. Further, investors appear to accept lower performance to seek their moral choice of investment.

Chapter 23 Performance Implications of SR Investing: Past versus Future (Nadja Guenster)

This chapter discusses the impact of socially responsible investment (SRI) strategies on portfolio performance. It focuses on two common investment strategies: investing in firms with leading environmental, social, and governance (ESG) policies and shunning firms that are involved in "sinful" business activities. Examples of so-called sinful business activities are tobacco, alcohol, gambling, and weapons. Two opposite effects have influenced the performance of SRI methods over the last decades. First, a strategy of overweighting firms with high ESG standards and underweighting firms with poor standards earned positive abnormal returns. Second, SRI investors lost out on high returns on sin stocks. Although socially responsible investors, in aggregate, often experience similar performance to conventional investors, this is likely to change. In an efficient market, firms with high ESG standards should not earn higher returns than firms with low standards. The empirical evidence suggests that this equilibrium is approaching. Then, socially responsible investors missing out on the high sin stock returns are likely to underperform conventional investors.

Chapter 24 Money Flows of Socially Responsible Investment Funds around the World (Luc Renneboog, Jenke Ter Horst, and Chendi Zhang)

This chapter studies the money flows into and out of socially responsible investment (SRI) funds around the world. In their investment decisions, investors in SRI funds may be more concerned with ethical or social issues than with fund performance. Therefore, SRI money flows are less related to past fund returns. Ethical money is less sensitive to past negative returns than are conventional fund flows, especially when SRI funds primarily use negative or sin/ethical screens. Social attributes of SRI funds weaken the relationship between money inflows and past positive returns. However, money flows into funds with environmental screens are more sensitive to past positive returns than are conventional fund flows. Stock picking based on in-house SRI research increases the money flows. These results give evidence on the role of nonfinancial attributes, which induce heterogeneity of investor clienteles within SRI funds. No evidence of a smart money effect is found, as the funds that receive more inflows neither outperform nor underperform their benchmarks or conventional funds.

SUMMARY AND CONCLUSIONS

Since the late 1960s and early 1970s, CSR and SRI have gained considerable momentum. Since that time much discussion and research has focused on these two areas. According to Sparkes (2002, p. 65), "CSR and SRI are two sides of the same coin. Yet, the two terms differ in that SRI takes a bottom-up approach that focuses mainly on the power of investors, while CSR is a top-down approach that requires more action from corporations than investors."

Both the theory and practice of CSR and SRI have been moving ahead at a rapid pace, and this momentum is likely to continue in the future. Thus, gaining an understanding of the key principles and concepts of CSR and SRI as well as the empirical evidence involving these topics is more important than ever. Although this is a daunting task, this book can help provide the basis for achieving this understanding. Enjoy the trip as you explore the many facets of socially responsible finance and investing.

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PART I

Foundations and Key Concepts

CHAPTER 2

Stakeholder Analysis

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INTRODUCTION

The stakeholder worldview—the idea that the firm is best described as a network of relationships with a diverse group of constituencies—has great intuitive appeal. Social investors often incorporate elements of stakeholder theory in their work, and many believe that stakeholder principles can be used to improve on conventional investment analysis.

A logical premise is that a company that treats employees well and works hard to maintain good community relationships would have numerous advantages over companies that do not make similar efforts. These efforts would likely help the company's brand image, aid employee retention and new employee recruitment, and provide an advantageous starting point for negotiations with regulators. Taken together, these advantages should allow the company to be more productive and profitable, and therefore be worth more than other firms. The U.S. social investment firm Pax World Investments (2011), one of the first investment firms to formally implement a stakeholder framework, puts it this way: "[W]e believe that well-managed companies that maintain good relations with employees, consumers, communities, and the natural environment, and that strive to improve in those areas, will in the long run better serve investors as well."

Implementation of this intuitively appealing idea is challenging, however. Stakeholder theory has been discussed intensively by management theorists, ethicists, and legal scholars for almost 20 years. But it has so far had little influence on fundamental analysis, which remains grounded primarily in traditional economics and finance, as well as in customary practices of the investment industry. Of the thousands of analysts employed by mainstream investment banks, only a small fraction specializes in areas requiring stakeholder analysis.

In the past 10 years, however, some social investment firms have sought to directly incorporate stakeholder information into their investment decision making, particularly with respect to environmental, social, and governance (ESG) metrics. This is known as ESG integration. Unlike the older practice of values-based investment, which typically reflects the salient features of a particular religious or ethical paradigm, ESG integration seeks to exploit intangible information gleaned from stakeholder analysis to obtain an investment advantage. Some social investors choose only one approach or the other, while others seek to employ elements of both.

Like the field of corporate social responsibility (CSR), which it resembles in many ways, stakeholder analysis seeks to employ a more robust set of metrics than are offered by the traditional toolkit. The differences are primarily of perspective. As Crane and Matten (2010, p. 61) note, "[u]nlike the CSR approach, which strongly focuses on the corporation and its responsibilities, the stakeholder approach starts by looking at various groups to which the corporation has a responsibility." In practice, social investment analysis usually involves using data elements traditionally associated with CSR, such as corporate charitable giving, product safety, and executive pay, but uses frameworks derived from stakeholder analysis to place them in the proper context. CSR provides the data, and stakeholder analysis provides the structure.

Modern stakeholder analysis is therefore concerned with all aspects of a firm's business. Good financial results are appealing, but the stakeholder analyst asks: How have they been achieved? Does the company's superior return on capital result from outstanding labor productivity, or is it due to imposing externalities through environmental pollution or the sale of harmful products? Does the company engage in activities that might harm its reputation? If so, what steps have its managers taken to mitigate these impacts? Social investors employ stakeholder analysis to address these questions and develop a view about management quality and the long-term sustainability of the firm's business model.

The purpose of this chapter is to critically evaluate how stakeholder frameworks may be applied in investment analysis. The rest of this chapter is organized as follows. The remainder of this introduction discusses historical precursors to stakeholder analysis, notably the input/output model. The chapter then reviews the empirical support for a stakeholder worldview and proceeds to a discussion of stakeholder theory. This is followed by a detailed discussion of instrumental stakeholder theory as adapted to investment analysis, with particular attention paid to the relationship between noncontrolling owners and controlling managers and shareholders. The chapter concludes with a brief discussion of the impact of stakeholder information on financial markets.

STAKEHOLDERS VERSUS SHAREHOLDERS

Despite its intuitive appeal, a stakeholder worldview also elicits plausible objections. If the owner of a shop increases worker pay above the market rate for labor, why wouldn't that be a direct subtraction from his or her wealth? Or, if a publicly traded company decides to donate $1 per share to charity, shouldn't the share price rationally be expected to fall by $1? Such expenditures appear to be a poor allocation of resources, particularly to those who view the primary mission of the firm as the maximization of its share price. Micklethwait and Woolridge (2002, p. 187) describe the dispute in the following manner:

> Since the mid-nineteenth century, there has been a battle between two different conceptions of the company: the stakeholder ideal that holds that companies are responsible to a wide range of social groups and the shareholder ideal that holds that they are primarily responsible to their shareholders.

In the shareholder-first narrative, proponents of stakeholder theory hope to reduce shareholder wealth in order to increase the wealth of others. Ironically, some stakeholder theorists seem to agree. For instance, Freeman (1998, p. 126) states that "we must reconceptualize the firm around the following question: For whose benefit and at whose expense should the firm be managed?" Freeman (p. 126) indicates that the narrow focus on shareholders should be replaced with a broader set of obligations:

> [We] can revitalize the concept of managerial capitalism by replacing the notion that managers have a duty to stockholders with the concept managers bear a fiduciary relationship to stakeholders. Stakeholders are those groups who have a stake in or claim on the firm . . . [including] suppliers, customers, employees, stockholders, and the local community, as well as management in its role as agent for these groups.

In framing the central problem as the division of wealth generated by the firm, both narratives draw attention away from the value-creation process. But surely what the firm does is of greater importance to society and the environment than how it allocates the resulting cash flows. A major polluter might redirect profits away from shareholders and toward community stakeholders, but trying to minimize the pollution in the first place would probably be more sensible.

THE INPUT/OUTPUT MODEL

How does a firm create value? The classical input/output model, in which managers marshal a variety of resources to serve customers, embeds many elements of a stakeholder worldview. Exhibit 2.1 illustrates the model, in which suppliers, shareholders, and employees cooperate to produce goods or services for customers.

Inputs are priced according to the logic of supply and demand, and in equilibrium each supplier earns normal economic profits. Each of the inputs competes continuously with the others for its share of the firm's wealth. If higher costs for

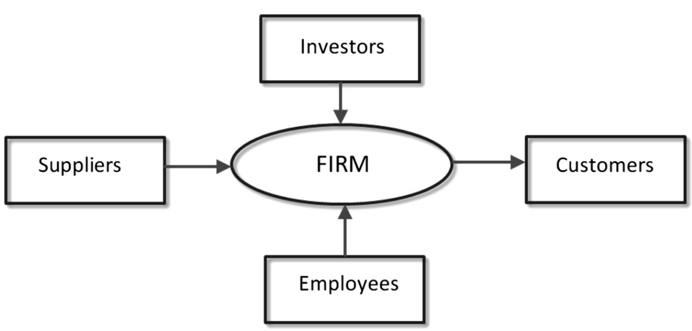

Exhibit 2.1 Input/Output Model

This exhibits shows an input/output model of the interaction between the firm and various parties, specifically investors, suppliers, and employees who provide inputs so that the firm can provide its products and services to its customers.

Source: Modified from Donaldson and Preston (1995).

one input cannot be passed on to customers through a price increase or offset by cost reductions elsewhere, owners will bear the ultimate costs.

This model has considerable practical appeal. Evidence suggests that firms can work this way in the real world. Studies of the auto industry, such as Abowd (1989) and Gorton and Schmid (2000), find that economic benefits for labor such as favorable wage settlements can negatively affect firm value. The Costco Corporation's (2011) Codes of Ethics uses language that closely parallels the input/output model: (1) obey the law; (2) take care of our members; (3) take care of our employees, (4) respect our suppliers; if we do these four things throughout our organization, then we will achieve our ultimate goal, which is to (5) Reward our shareholders.

The input/output model also offers a useful expression of the duties of the firm's managers. Multiple relationships must be negotiated, and wealth creation depends on coordinated effort. Some inputs to the model such as labor have quasi-social characteristics. These elements make the input/output model a useful starting point for discussing stakeholder analysis.

STAKEHOLDERS AND CORPORATE STRATEGY

What would be needed to modify the input/output model to make it more complete? The stakeholder worldview expands the number of relationships associated with value creation. Government, for example, could be added to the diagram, given that companies must pay taxes and maintain good relationships with regulators.

Allowing for the possibility of win/win opportunities would be useful. Increasing worker pay and benefits might be a good idea, for example, if doing so could improve the firm's productivity and profitability. Superficially charitable expenditures might confer important benefits through advertising effects, community goodwill, or strengthening of existing firm competencies.

Some prominent business strategists endorse this idea. Porter and Kramer (2006, p. 56) introduce the idea of strategic corporate responsibility, which "does not treat corporate success and social welfare as a zero-sum game." They note that private firms often have unique capabilities and resources, and therefore have an opportunity to deploy them in ways that can benefit both their strategic position and society at large. In some situations, social challenges may occur where a particular company is the only societal resource with the appropriate combination of assets and expertise to address them.

McElhaney (2008) develops the concept further, classifying the development of firms' CSR activities into five levels of development, from "defensive" to "strategic." At the defensive level, a firm makes CSR investments to repair its reputation after bad behavior or as a reaction to unexpected negative events. At the strategic level, by contrast, a firm makes CSR investments proactively and with a strategic mind-set. As McElhaney (p. 11) notes, "A company at the highest stage of corporate social responsibility embeds CSR into its daily business operations, collaborates with other companies, and attempts to change the rules of the game or attack a problem or social issue at its cause." But firms must carefully choose areas of involvement. McElhaney (p. 42) remarks: "To be an effective business strategy, CSR must be tied to the business objectives of the firm."

EMPIRICAL SUPPORT FOR A STAKEHOLDER WORLDVIEW

If the stakeholder worldview has validity, the advantages for firms with strong stakeholder relations should be observable. That is, market participants should be able to observe both financial and reputational benefits for companies that are particularly attentive to stakeholder management.

A growing body of empirical research suggests that this is indeed the case. Over the past 10 years, researchers report a positive correlation between stakeholder management and financial outcomes. Firms with superior stakeholder performance have had superior financial results on average. They have had greater earning power, better reputations, and in some cases superior stock performance.

Orlitzky, Schmidt, and Rynes (2003), who conduct a meta-analysis of CSR studies, find a positive correlation with financial outcomes, including both reported earnings and stock market performance. One major problem with such studies is that sorting out causality is difficult. Is Wells Fargo the largest corporate giver in California because it is already a large, successful company, or is the company's success due in some way to its generous charitable giving programs? Orlitzky et al. (p. 427) directly address the issue of causality, finding that richer companies are more likely to engage in CSR, but that they appear to earn superior returns from doing so:

> [P]ortraying managers' choices with respect to corporate social performance and corporate financial performance as an either/or trade-off is not justified in light of 30 years of empirical data. [We find] . . . (1) across studies, Corporate Social Performance is positively correlated with Corporate Financial Performance, (2) the relationship tends to be bidirectional and simultaneous, [and] (3) reputation appears to be an important mediator of the relationship. . . .

Numerous studies show that firms with superior CSR performance have above-average capital efficiency ratios. For example, using similar procedures over different time periods, Waddock and Graves (1997b) and Tsoutsoura (2004) find that a broadly defined CSR measure is correlated with higher returns on assets. Guenster, Derwall, Bauer, and Koedijk (2010) focus on corporate sustainability practices and also find that higher-ranked firms have higher returns on assets.

Some evidence also suggests that good CSR performance is correlated with firm growth, and that positive stakeholder performance in one area may positively affect other areas as well. Lev, Petrovits, and Radhakrishnan (2010) find that generous corporate givers tend to have faster revenue growth. Gong and Grundy's (2011) analysis of corporate matching charitable grants finds that labor productivity is higher at firms with matching schemes and employees are happier working for those firms. Edmans (2011) demonstrates that firms with superior employee relations have a greater propensity to deliver earnings that exceed Wall Street estimates.

Researchers also find that strong CSR performers tend to have better reputations. Waddock and Graves (1997b) report that the *Fortune* magazine "most admired" companies have superior CSR ratings. Graves and Waddock (2000) show that companies featured in the book *Built to Last* by Collins and Porras (1997) also had superior CSR ratings. Apparently, companies that invest aggressively in stakeholder relationships—even those outside the narrow value creation process described by the input/output model—can gain meaningful benefits from doing so.

TYPES OF STAKEHOLDER THEORY

While studies support elements of a stakeholder worldview, theorists differ on the appropriate interpretation of these findings. However, two general points of strong agreement exist. First, virtually all stakeholder theorists believe that the firm is accountable to a broader set of interests than those described in the input/output model. Although details may differ, most theoretical presentations are consistent in their broad outlines with the diagram presented in Exhibit 2.2.

In this visualization the corporation is accountable not only to suppliers, employees, and shareholders, but to other constituencies. Both the nature of the accountability and the identities of various stakeholders and the underlying definition of stakeholder, vary markedly among theorists. Yet, virtually all stakeholder theorists agree that the firm's obligations go beyond the narrow specifications of the input/output model.

Second, most agree that the relationships between firm managers and stakeholders go beyond the basic logic of supply and demand. In his classic work *Exit, Voice, and Loyalty*, Hirschman (1970) persuasively argues that many economic relationships have a substantive social or political dimension. In economic relationships, when one party is confronted with deteriorating or unacceptable quality, he will seek to end the relationship in favor of a more appealing alternative (exit). But relationships may also depend, according to circumstances, on socio-political logic. When that is the case, the party complains and seeks change, possibly using the threat of exit to obtain bargaining leverage (voice). Such decisions are mediated in Hirschman's framework by loyalty, which he defines as a function of a realistic estimate of the probability of change, the cost of switching, and the quality of the alternatives.

Hirschman's (1970) approach appears well suited to stakeholder analysis. Customers who have a bad experience will often complain before switching to another

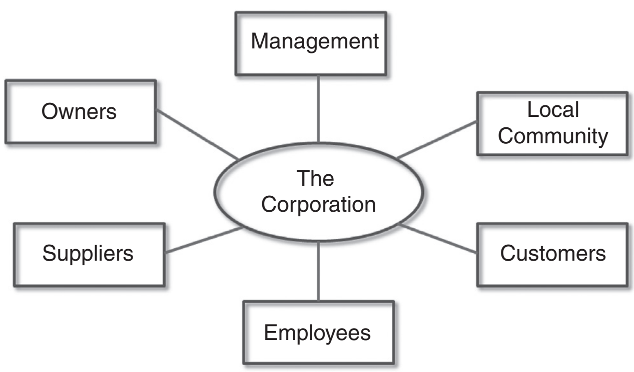

Exhibit 2.2 A Stakeholder Model of the Corporation
Source: Modified from Freeman (1984).

product. Employees who are dissatisfied with their pay may try to negotiate before moving to another employer. Shareholders who dislike some aspect of the firm's behavior may choose to engage firm management rather than sell the stock. In each case, an astute management response may mean the difference between continued success and a negative outcome for the firm. This is why many social investors believe stakeholder analysis can shed fresh light on questions of management quality.

The literature contains many different versions of stakeholder theory. Donaldson and Preston (1995) usefully separate them into three nested categories: normative, instrumental, and descriptive. These are more than academic distinctions because each category focuses on a different purpose, and the definition of a stakeholder varies as well.

Normative Stakeholder Theory

Early iterations of stakeholder theory were normative. In the classic formulation, Freeman (1998, p. 129) describes stakeholders as "groups and individuals who benefit, or are harmed by, and whose rights are violated or respected by, corporate actions. Just as stockholders have a right to demand certain actions by management, so do other stakeholders have a right to make claims." Unlike the input/output model, relationships between the firm and stakeholders are not strictly economic or even quasi-economic as described by Hirschman (1970), but may also be mediated by laws, duties, or expected ethical conduct.

The normative formulation does not attempt to explain how firms work. It is intended instead as a model or idealization of how they should work, according to a particular philosophical viewpoint. As such, normative stakeholder theory does not lend itself to empirical analysis or offer explicit tools for choosing among a set of investment opportunities. This limits its applicability to ESG integration and the search for superior investment performance.

Still, normative stakeholder theory is of great utility to values-based investors who want to systematically describe their social and environmental priorities. It offers a framework whereby they can make their expectations around CSR behavior explicit, and communicate to companies and clients about how they view such issues.

Instrumental Stakeholder Theory

Discussion of normative stakeholder theory has been extensive among management theorists, ethicists, organizational scientists, legal scholars, and others. But investors and economists have made only modest contributions. In their book-length treatment of stakeholder theory, Friedman and Miles (2006) cite more than 500 distinct sources, but fewer than a dozen from contemporary financial or economic journals. Freeman, Harrison, Wicks, Parmar, and de Colle (2010) devote major sections of their book to traditional disciplines of business, ethics, and corporate social responsibility, but not to economics or finance.

Instrumental stakeholder theory retains the stakeholder concept and, like the normative approach, represents the firm as a network of relationships. But instrumental stakeholder theory views the stakeholder network as the means to the end of wealth creation. Jones (1995, p. 235) presents instrumental stakeholder theory as a synthesis of stakeholder conceptions and economic thought:

> [Instrumental stakeholder theory] implies that behavior that is trusting, trustworthy, and cooperative, not opportunistic, will give the firm a competitive advantage. In the process, it may help explain why certain "irrational" or altruistic behaviors turn out to be productive and why firms that engage in those behaviors survive and often thrive.

Therefore, instrumental stakeholder theory fits the needs of performance-oriented investors better than other approaches. In instrumental stakeholder theory, investors are not seen as adversaries, but as the beneficiaries of effective management.

Unlike normative stakeholder theory, instrumental stakeholder theory does not presuppose a particular philosophical viewpoint or legal environment, which is also true of descriptive stakeholder theory, discussed below. This is a major advantage for investors engaged in the analysis of global businesses. A global corporation may interact with dozens of governments, hundreds or thousands of communities, and many different cultural environments. In such a situation, definitions of the firm in terms of a single ethical framework or legal system are unlikely to be of much value.

This is a critical point because many stakeholder theorists view the firm as first and foremost a legal entity. But trading networks recognizable as firms have existed for a thousand years or more, predating modern legal systems, and their underlying dynamics are best explained by economic and reputational dynamics, not legal ones. Gordon (2008, pp. 827—829) describes the experience of a group of traders in 1138:

> Although the partners recognized that Abraham bin Yiju had himself been defrauded, they had no means, legal or otherwise, to recover a bad debt in Mangalore. All they could do to help was to threaten the reputation of the dealer who defaulted. Madmun's cousin suggested this sort of censure in a letter to Abraham. "Perhaps you should threaten him that here in Aden we censure anyone that owes us something and does not fulfill his commitments. Maybe he will be afraid of the censure. If he does not pay, we shall issue an official letter of censure and send it to him, so that he will become aware of his crime."

Reputation was not incidental to the conduct of business for these traders; it was integral and remains so for most businesses today. In a global business environment where firms cannot master the elements of each legal system to which they are exposed, trust and reputation remain paramount. When he assumed the role of chief executive officer (CEO) at Salomon Brothers, Warren Buffett (1991) told employees: "lose money for the firm and I will be understanding; lose a shred of reputation for the firm, and I will be ruthless."

Descriptive Stakeholder Theory

Both normative and instrumental stakeholder theory operate from a relatively narrow perspective. The normative version idealizes firm behavior through a social or moral view. The instrumental version views stakeholder relationships as the means to some objective, such as maximizing firm value. Descriptive stakeholder theory, by contrast, seeks to adopt the broadest possible perspective and use the stakeholder model as a tool for describing the activities and interests of the firm.

- A normative stakeholder theorist might say: Coca-Cola has a duty to protect the environment, so it should pay more attention to its water policies.
- An instrumental stakeholder theorist might say: Coca-Cola should manage its water policies so as to minimize the negative impact of reputational effects on firm value.
- A descriptive stakeholder theorist might say: Coca-Cola's water policies are an important defining characteristic of the firm.

Social investors may, depending on their needs, incorporate normative, instrumental, or descriptive stakeholder approaches into their activities. Values-based investors will use models that are largely normative in character, whereas performance-oriented investors will more likely employ some type of instrumental stakeholder analysis. Policy makers and academics may well prefer the broader perspective of descriptive stakeholder theory. The sections that follow describe an instrumental framework intended to enhance traditional fundamental analysis.

STAKEHOLDER ANALYSIS FOR INVESTORS

Some stakeholder theorists conceive of "the firm" or "the corporation" as the center of the stakeholder network. Exhibit 2.2 is a representative example. Hill and Jones (1992) contribute a crucial refinement to this view. In their account, the firm is a "nexus of contracts" between the controlling managers and other stakeholders. The firm cannot make decisions or enter into contracts on its own. Managers are the only ones with direct control over the decision-making apparatus.

In practice, a control group is at the center of each firm. A *control group* is the group of managers and controlling owners whose consent is required for major investments. Although the control group cannot necessarily be defined in terms of traditional job titles, such as a chief financial officer (CFO), it can be identified by the group's leadership role in capital allocation. The control group, through its allocation of money and management attention, makes the decisions that determine whether the firm's stakeholder relations will be good, bad, or indifferent. Thus, an investment-oriented approach to stakeholder analysis must focus on the activities of this group.

This is consistent with both agency theory and investment practice. There is a market for corporate control. In corporate takeovers, the seller typically demands and receives a control premium. This is in addition to the intrinsic economic value of the target enterprise as defined by the market, and in practice is often large enough to negatively impact the long-term economics of the transaction for the buyer (Sirower 1997).

As a first approximation, the control group might think of itself first in all decisions, while still recognizing the many constraints under which it operates. Each stakeholder relationship requires continuous negotiation, usually some economic investment, and an ongoing assessment of its competitive benefits.

Given the control group's ability to contract for whatever materials and services are needed, one might ask why formal corporate structures are necessary at all. Why cannot the control group simply contract for everything needed on the open market? Williamson (1985, 2009) extensively analyzes this question and concludes that, due to differing transaction costs, in some cases the hierarchical organization and other attributes of the firm allow it to be more efficient than open market contracting. The internal organization and the market are complementary—neither can fully supplant the other. In his Nobel Prize lecture, Williamson (2009, p. 468) concludes that "markets and hierarchies differ in discrete structural ways and we need to come to terms with the strengths and weaknesses of each."

The direct implication is that the control group must assess, for all of the firm's activities, which should be internal and which should be contracted externally. A decision to close a plant and subcontract production work to facilities elsewhere could have major impacts on multiple stakeholders. This is a primary area of interest for stakeholder analysts, who focus on situations where outsourcing or subcontracting could entail operational or reputational risks.

The control group negotiates continuously, through both economic and sociopolitical mechanisms, with three distinct stakeholder types: customers, suppliers, and contextual stakeholders. These will be reviewed briefly in the sections that follow, using the U.S. retailer Wal-Mart as a primary example.

TYPES OF STAKEHOLDERS: CUSTOMERS

Customers are the essential stakeholders of the firm. According to Wyly (2000, p. 279), Sam Walton, the founder of Wal-Mart, said "there is only one boss—the customer. And she can fire everybody in the company from the chairman on down, simply by spending her money somewhere else." In his biography of Walton, Trimble (1990, p. 268) reports "[he] harps constantly that customers must feel 'it is their store' and know they will be 'treated fairly, honestly, and with respect.' Against competitors who employed intermittent promotional strategies ('high/low pricing'), Walton offered customers a compelling alternative: "Always Low Prices."

Customer relationships vary widely, but in most cases reputation is a critical component in the firm's value proposition. A customer is unlikely to buy a product—be it food, tires, or industrial services—without some reference to the reputation of the offering firm. According to Rosenbloom and Barbaro (2009):

> A 2004 report prepared by the consulting firm McKinsey found that 2 percent to 8 percent of Wal-Mart consumers surveyed had ceased shopping at the chain because of "negative press they have heard." Wal-Mart executives and Wall Street analysts began referring to the problem as "headline risk."

The same report also stated that 82 percent of customers expected Wal-Mart to act as a role model for other companies.

When firms are faced with a customer complaint, they have at least three response strategies. The simplest and most straightforward is to modify the product. If a restaurant's food is not very good, investment in a new chef may be the best response. Product modification may be expensive, however, or in some cases even impossible. Many efforts have been made, for example, to make airline travel pleasant and convenient, but the task has defeated even the greatest minds.

Some firms invest in customer service initiatives, offering customers a higher degree of voice through telephone support, feedback surveys, or special training for staff. This must be done judiciously, however, as the most vocal customers may also be the least profitable.

A third option is for the firm to employ its own voice to influence customers. Advertising is powerful and arguably underemphasized by Hirschman (1970) in his original analysis. Rather than modify its products, the company may seek to instead modify customers' opinions of them. This may be as straightforward as employing a celebrity endorser or as complex as rebranding following a major crisis.

TYPES OF STAKEHOLDERS: SUPPLIERS

Even in a simple business, the control group must coordinate the efforts of many suppliers. The input/output model views the firm primarily as a network of supplier relationships, managed for the benefit of the customer and the owner. Fundamental analysis is well-suited to many aspects of these relationships, but some supplier relationships have unique characteristics that are not widely followed by the investment industry. For example, supplier relationships may have important social and environmental impacts. According to Humes (2011, pp. 1320−1321), when Wal-Mart evaluated its environmental footprint in the mid-2000s, management concluded that 90 percent of the firm's environmental impact was transmitted through its supply chain.

Labor is a critical input in many businesses and in some cases, such as software development, may be the dominant supplier relationship. Successful firms often have highly skilled workforces, and therefore must make substantial investments to retain scarce skills. McWilliams and Siegel (2000) demonstrate that some CSR metrics correlate strongly with research and development (R&D) expenditures. They inspect Waddock and Graves's (1997a) finding that high CSR companies are more capital efficient, and show that it disappears when the CSR rating is replaced with a research and development (R&D) variable. This strongly suggests that one reason for the correlation between high CSR and firm profitability is that highly profitable firms are more likely to engage in R&D, and more likely to offer programs and benefits to retain the skilled labor required to conduct it.

Innovative labor practices may make an important difference even in lower-margin businesses, however. Tedlow (2003, pp. 340−341) reports that in the competitive U.S. retail industry of the 1950s and 1960s, Sam Walton placed heavy emphasis on attracting the best possible workforce.

> Walton knew he had to hire the best store managers he could. As he put it, from early in his career Walton would do what he would always "do for the rest of my run in the retail business without any shame or embarrassment: nose around other people's stores searching for good talent." Walton kept the talent loyal to the company by "giving them a piece of the action" in both monetary and psychic terms . . . store managers and later the 'associates' who staffed the stores benefited from a generous profit-sharing program.

The profit-sharing program, in which Wal-Mart stock was allocated to employee retirement accounts, allowed even rank-and-file employees to retire with substantial wealth in the early days of the company. This resulted in an exceptionally loyal and motivated workforce.

Investors may also be viewed as suppliers. The most problematic aspect of the shareholder-first narrative of the firm is that noncontrolling shareholders are essentially just suppliers of a widely available input to production, in this case capital. From a theoretical perspective, why they should expect, or be offered, more than normal economic profits from this exchange is unclear. Because many investors subscribe to the shareholder-first narrative, this makes the relationship between the control group and noncontrolling owners a point of particular interest for stakeholder analysts, and this relationship will be discussed in detail in the section called Owners as Stakeholders.

TYPES OF STAKEHOLDERS: CONTEXTUAL

Contextual stakeholders include local communities, governments, the environment, and the international community. These stakeholders stand outside the normal trading dynamics of the firm, but may nonetheless have large impacts on firm value. While some commentators stress nonfinancial aspects of these relationships, the firm has a direct economic relationship with contextual stakeholders in virtually all cases. The relationship with government, for example, includes tax payments. Community relationships may include fees, incentive payments or tax breaks from the community, or contractual arrangements at the local level. In the case of the environment, the economic components of the relationship include costs of prevention and cleanup, and revenue impacts due to loss of reputation in the case of accidents or excessive pollution.

The most directly powerful contextual stakeholders are governments, which in the event of a poorly managed relationship can pursue remedies up to and including a shutdown of the firm's operations within its jurisdiction. Companies have many resources available to manage these relationships. In some cases, however, firms may actually co-opt those charged with regulating them, a phenomenon known as *regulatory capture.* This in itself may represent a threat to owners' interests, as in the absence of normal safeguards the control group may engage in excessive risk-taking (Taylor 2011).

Governmental relationships are receiving fresh scrutiny in the United States following a Supreme Court decision affirming the right of corporations to actively participate in politics (Liptak 2010). In August 2011, a group of law professors formally petitioned the U.S. Securities and Exchange Commission (SEC) to require companies to disclose their political contributions (Bebchuk and Black 2011). At that time, about 60 percent of the firms in the S&P 100 index voluntarily disclosed their political contributions.

Community relationships likewise embed both opportunity and risk. Hirschman (1970, p. 63) observes that "in addition to maximizing profits, the firm will tend to minimize discontent of its customers, for the highly rational purpose of earning goodwill or reducing hostility in the community of which it is a part." Failure to do so may be costly. Hoge (2006) reports on a unanimous decision by the city council of Hercules, California, to seize a Wal-Mart building site by eminent domain: "the vote caused most of the 300 people who had packed Hercules City Hall for the meeting to break out in cheers and applause." Although Wal-Mart successfully challenged the decision in court, it ultimately relinquished the building site in a negotiated sale.

In the mid-2000s, Wal-Mart's senior management decided to carefully review its sustainability practices. According to Humes (2011, p. 1221), the decision to focus on sustainability first, rather than social relationships, was deliberate:

> [Consultant Jib Ellison said:] "If you really want to take on sustainability with a capital 'S,' it's not just the environment. It's health care, it's wages, it's ethical sourcing, it's globalization. Everything. A sustainable economy, a sustainable society." "Yes," Scott said warily, "but let's start with the environment." Scott knew it was too late to limit Wal-Mart's "exposure" on the sorts of social issues Ellison suggested.

The program began to deliver economic results almost immediately. Humes (pp. 1203–1207) describes the savings achieved by reducing the packaging for a single item sold in the company's stores:

> The minor size reduction would allow a much greater number of toys to be boxed and loaded inside a single shipping container. The same number of toys could be shipped using 497 fewer shipping containers—the trailer-sized metal boxes used to haul goods around the globe. These changes led to $2.4 million in annual savings. . . . Then [management] started asking . . . : Where else can we do this?

Although social investors place considerable emphasis on contextual stakeholder relationships, firms may also become very successful before having to put much conscious effort into them. For a small or medium-sized firm, outstanding execution on the relationships described in the input/output model may be all that is needed for the company to achieve good business results. Humes (2011, p. 1298) quotes former Wal-Mart CEO Lee Scott as saying that he enjoyed the early days of the company when it was not so well-known: "[Competitors] ignored us, and we could focus on the core of our business." However, Humes argues (p. 1299) that "the flip side of this inward focus was a kind of tunnel vision that left many in the home office incapable of accepting any criticism of Wal-Mart as constructive, and suspicious of outsiders bearing new ideas." As the firm grows, management of contextual stakeholder relationships becomes unavoidable.

OWNERS AS STAKEHOLDERS

Given the centrality of the control group in stakeholder analysis, the most important and problematic relationship is likely to be between noncontrolling owners and the control group, which is usually centered on the CEO. These relationships are challenging because noncontrolling owners are entrusting their wealth to others, and even in highly developed legal systems may have little recourse if the firm misallocates their money.

In evaluating management quality, research suggests noncontrolling owners should take a close interest at least three distinct areas. Expressed as risks these areas are expropriation, overreach, and overinvestment.

Expropriation

Expropriation is the tendency of the control group to use firm resources for its own benefit. If the relationship is not monitored, the control group has every incentive to arrange the firm's affairs to its own advantage. Abundant evidence indicates that this often happens, negatively affecting shareholder wealth. Analysis by Heron, Lie, and Perry (2007, p. 24) suggest that "slightly less than 30 percent of public companies that used stock options for executive compensation manipulated at least one grant between 1996 and 2005." Bebchuk, Grinstein, and Peyer (2011) find that executives and directors receive an abnormally high percentage of grants at the lowest price of the grant month. As Bebchuk et al. note (p. 1), these "lucky" grants are more "associated with higher CEO compensation from other sources, and are correlated with a lack of majority of independent directors on the board, no independent compensation committee with an outside blockholder, or a long-serving CEO."

Stakeholder-oriented investors must therefore be exceptionally attentive to the integrity of the control group. Gawer (2010) finds that deterioration in corporate governance ratings was a leading indicator of underperformance in the European equity market from 1999 to 2009, although there was not a comparable effect for improving scores. But monitoring may be expensive. In his study of the CalPERS corporate governance program, Barber (2006, p. 4) describes the dilemma this way:

> Absent any monitoring by investors, agency costs take a (relatively) large percentage of [firm] valuation. Investors can reduce the agency cost bite taken out of the valuation pie by monitoring corporations, but monitoring is costly, varies in effectiveness, and, no doubt, has diminishing marginal returns.

Although Barber concludes that the CalPERS program had positive valuation effects on targeted firms, it has not been widely imitated. In 2010, CalPERS substantially modified its program.

In his updated edition of Graham (2004, p. 6491), journalist Jason Zweig speculates on why the noted investor said less about investors' relationship to management in each succeeding edition of the book: "Why did Graham cut away more than three-quarters of his original argument? After decades of exhortation, he evidently had given up hope that investors would ever take any interest in monitoring the behavior of corporate managers." Investors still have the opportunity to take Graham's advice, and the data suggest they would be wise to do so.

Overreach

All leadership positions require self-confidence, but self-confidence is a double-edged sword. *Overreach* refers to the degree to which the control group engages in activities as a result of overconfidence, such as exceeding the contractual authority granted by owners or engaging in self-promotional behavior to the detriment of the business.

Harding (2011) cites New York Stock Exchange (NYSE) data showing that the average holding period for stocks fell from eight years in 1960 to three years in 1990, to about one year in 2000. With the advent of high-frequency trading strategies, this figure has continued to decline, and by 2010 it was approximately six months. Given the ease and low cost of exit, investors typically prefer exit over voice when they are disappointed in management performance.

As owner time horizons continue to shorten, managers have become restive, and some have sought to change the rules of the relationship. Christensen and Anthony (2007) go so far as to argue that managers would be better off ignoring some stockholders:

> Perhaps it is time for companies to adjust the paradigm of management responsibility: "You are investors and speculators, not shareholders, and you temporarily find yourselves holding the securities of our company. You are responsible for maximizing the returns on your investments. Our responsibility is to maximize the long-term value of this company. We will therefore act in the interest of those whose interests coincide with our long-term prospects, namely employees, customers, the communities in which our employees live, and the minority of investors who plan to hold our securities for several years."

But is this responsibility or arrogance? Page (2005, p. 10) argues, along with many others, that final control of the firm must reside with owners, for both legal and moral reasons:

> because they shoulder most of the risk, shareholders have every right—within the law—to exclusively enjoy, benefit from, and dispose of the entity they created. To deny this right would be tantamount to annihilating ownership privileges and would deal a severe blow to individual liberties, something no democratic regime would tolerate.

No matter how fickle or short-term the behavior of owners, managers cannot simply ignore them.

Khurana (2002) contends that shorter time horizons have distorted the CEO selection process in the United States, causing it to overvalue "charismatic" external candidates. In many cases, Khurana (p. 20) says that "less emphasis is placed on the company's strategic situation and how appropriate the background of the candidate is in light of this," at the expense of qualified but less famous or inspiring internal candidates. Malmendier and Tate (2007) find evidence that companies managed by these "superstar CEOs" underperform on average. Bebchuk, Cremers, and Peyer (2011) indirectly arrive at a similar finding, demonstrating that the CEO's pay fraction—the percentage of senior management compensation taken by the CEO—is negatively correlated with risk-adjusted returns for shareholders.

The converse also appears to be true: One striking finding of the Collins (2001) study of companies that had dramatically improved their performance was that in every instance the CEO was not well-known and typically sought to deflect credit to other members of his senior team.

Overinvestment

Given the tensions described above, managers face major temptations to overinvest in stakeholder relationships to advance their own personal interests. Consider CEOs who are planning a political career in a few years' time. Such individuals may want to be seen as generous and civic-minded while in their management role, and might approve excessive expenditures for charitable giving, employee compensation, or other measures likely to benefit their reputations.

Cai, Jo, and Pan (2011, p. 6) test this by comparing CEO pay at high CSR companies to compensation at low CSR companies:

> as their reputations improve, CEOs will enjoy better outside career opportunities and greater bargaining power, which will eventually increase their ability to negotiate a higher level of compensation. If CEOs tend to overinvest in CSR to build their reputations, we would expect a positive association between CSR and CEO compensation.

Their analysis suggests an alternative explanation. High CSR CEOs tend to have lower pay than their low CSR counterparts, which suggests that agency-motivated overinvestment in CSR is not widespread. Cai et al. propose that CSR instead functions as a conflict resolution mechanism among stakeholders, a view consistent with that held by many social investment practitioners.

Few studies appear to support the overinvestment hypothesis. Orlitzky et al.'s (2003) meta-analysis of the CSR literature suggests that firms do not systematically overinvest in stakeholder relationships. Kim and Statman (2011) review the environmental expenditures of large U.S. firms and do not find evidence of overinvestment. Identifying individual cases of overinvestment, however, is a necessary competency of the stakeholder analyst.

Stakeholder Information in Financial Markets

Many types of stakeholder information can be value-relevant, and therefore of interest to financial markets. The first presumption of a financial theorist, however, would be that this information is already correctly incorporated into valuations. Some evidence suggests that this is the case. Kurtz and diBartolomeo (2011) find that, after adjusting for conventional investment factors, a longstanding U.S. social investment index had alpha that was statistically indistinguishable from zero over an 18-year time period. Petrillo (2010) reports positive results for a backtest of an optimized portfolio intended to maximize exposure to CSR, but out-of-sample performance (now known as the iShares MSCI Select ESG Fund) has closely tracked the overall stock market.

In their important study of intangible information in markets, Daniel and Titman (2006, p. 1640) conclude that the search for relevant insights is likely to be a difficult one:

> An interesting avenue for future research would be to explicitly identify sources of intangible information that lead to overreaction. We conjecture that this is information that is related to firms' growth opportunities. In particular, it may be the case that investors overestimate the precision of relatively nebulous information

about future growth opportunities, and as a result, tend to overreact to the information. Unfortunately, testing this possibility is likely to be difficult since, almost by definition, it is difficult to identify and characterize this nebulous information.

A few studies demonstrate how this can work in practice. Derwall, Guenster, Bauer, and Koedijk (2005) find significant unexplained outperformance in portfolios constructed using a widely used assessment of sustainability practices. Edmans (2011) finds that a portfolio consisting of a list of superior employers outperformed the market on a risk-adjusted basis for long time periods. According to Edmans (p. 1), "the stock market does not fully value intangibles, even when independently verified by a highly public survey on large firms."

Stakeholder analysis may also be relevant to portfolio risk management. Kumar (2009) finds that investor mistakes are larger and more frequent when firms are difficult to value, for example, when intangible value represents a large percentage of firm value.

Therefore, stakeholder analysis provides a set of tools that is likely to be useful to investors. The correlation of strong CSR performance and high R&D expenditures is provocative, for example, because high R&D expenditures are also associated with high levels of intangible value. Governance metrics and sustainability initiatives such as the one pursued by Wal-Mart may signal changes in the economics and future prospects of the firms. Stakeholder frameworks can help investors identify, assess, and prioritize situations in which markets have not fully assimilated this intangible information.

SUMMARY AND CONCLUSIONS

Putting stakeholder analysis into practice requires acknowledging that some versions of stakeholder theory are more consistent than others with the economic realities of the firm. The input/output model is a good starting point for investor-oriented stakeholder analysis. Although it depicts the struggle for resources within the firm somewhat simplistically, this model also embeds elements that are consistent with a stakeholder worldview.

Research has strengthened the case for a correlation between good stakeholder management and superior financial outcomes at the firm level. Studies show that firms with superior ESG (environmental, social, and governance) and CSR (corporate social responsibility) performance have, on average, experienced superior financial results. They have had greater earning power, better reputations, and, in the cases of environmental practices and employee relations, superior stock performance as well. These findings strongly suggest that a stakeholder worldview has validity, and that analysis of stakeholder relationships can aid in the analysis of firm-level financial performance.

A modified form of instrumental stakeholder theory lends itself to empirical analysis and fits well with the needs of investors. Under this approach, the firm is viewed as a network of complex economic relationships in which both sociopolitical and financial logic govern most participants' behavior. These relationships are dynamic and continuously negotiated. At the center of the network is the control group, which allocates resources and attention to stakeholder relationships in order to maximize its own wealth. Good management may be defined as the efficient allocation of resources to stakeholder management such that a substantial surplus remains for owners and managers. Modern stakeholder analysis of this type aids in the assessment of management quality. It also clarifies the economic relationships among stakeholders, owners, and managers, and underscores the importance of corporate governance initiatives to protect owners' interests.

The resulting insights are value relevant. While efficient market theory predicts that all available information about the firm is already incorporated in market valuations, a few studies show significant performance effects that appear to be directly attributable to stakeholder relationships. Thus, stakeholder relationships deserve the attention not just of social investors, but of managers and investors generally.

DISCUSSION QUESTIONS

1. Despite being intuitively appealing to many, what are some objections to a stakeholder worldview?
2. What are examples of specific evidence supporting a stakeholder worldview?
3. What are some major points of agreement among stakeholder theorists?
4. Which type of stakeholder theory is most likely to be useful for performance-oriented investors? Why?
5. How might stakeholder analysis be useful in assessing management quality?

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CHAPTER 3

Corporate Social Responsibility

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INTRODUCTION

Corporate social responsibility (CSR) attracts considerable attention among academics, practitioners, and the popular press. Yet understandings of CSR and the foci of analyses vary across these discussions. This chapter focuses on various academic discussions of CSR among several business disciplines (business ethics, finance, accounting, and marketing). The intention is to further acquaint each of these fields with the others' research, and thus provide each with material for future investigations including interdisciplinary studies. In particular, because other disciplines' literatures do not reflect several key themes in the business ethics literature, the chapter discusses the evolution of CSR thinking in business ethics and identifies several key issues currently at the forefront of the business ethics discussion.

The remainder of the chapter has the following organization. The first section provides an overview of the business ethics literature on CSR. The next two sections discuss how the finance, accounting, and marketing literatures currently reflect the evolution of thinking on CSR in business ethics, including key issues. These sections discuss how greater use of the business ethics literature on CSR might contribute to CSR discussions in each of these functional literatures. The fourth section examines emerging directions of scholarship. Suggestions are provided on how a greater use of these functional literatures may help develop the business ethics literature. In doing so, the hope is also to move discussions in the practitioner and popular arenas forward. This latter aim is particularly appropriate given that many business ethics discussions of CSR begin with Friedman's (1970) article in *The New York Times Magazine*, entitled, "The Social Responsibility of Business Is to Increase Its Profits." The final section provides a summary and conclusions.

THE BUSINESS ETHICS LITERATURE

In reviewing the business ethics literature, this section identifies six key themes in the evolution of, and current thinking in, the business ethics discussion of CSR.