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## Finance Research Letters

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# The mispricing of socially ambiguous grey stocks<sup>☆</sup>



Swee-Sum Lam<sup>a</sup>, Weina Zhang<sup>a,\*</sup>, Gabriel Henry Jacob<sup>b</sup>

<sup>a</sup> Department of Finance, NUS Business School, 15 Kent Ridge Drive, National University of Singapore, Singapore 119245, Singapore

<sup>b</sup> Department of Management and Organization, NUS Business School, 15 Kent Ridge Drive, National University of Singapore, Singapore 119245, Singapore

### ARTICLE INFO

#### Article history:

Received 12 January 2015

Accepted 26 February 2015

Available online 14 March 2015

#### JEL classification:

G02

G11

G12

G30

#### Keywords:

Corporate social responsibility (CSR)

Community

Controversial industries

Environment

Socially ambiguous grey stocks

Sin stocks

### ABSTRACT

The study examines how stock market prices the stocks of socially ambiguous “Grey” firms, who are socially responsible in certain corporate social responsibility (CSR) dimensions while being socially irresponsible in other dimensions. Using firm data from 1992 to 2011, we find that the value-weighted “Grey” portfolio earns an annual abnormal return up to 3.6% relative to “Neutral” portfolio that consists of neither socially responsible nor irresponsible firms. Interestingly, “Community” and “Environment” sub-dimensions of CSR are the main drivers for the overpricing. The overpricing phenomenon is robust and is not driven by small firms, the “Sin” stocks or “Controversial” industries.

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*“Let us not lose heart in doing good, for in due time we will reap if we do not grow weary.”*

[Galatians 6:9]

<sup>☆</sup> The authors would like to thank David Hirshleifer, and all the participants at PRI-NUS Asia-Pacific Forum: Investing for Sustainable and Long-term Returns in the Asia-Pacific Region held in November 2013. All remaining errors are our own.

\* Corresponding author.

E-mail addresses: [swee.sum@nus.edu.sg](mailto:swee.sum@nus.edu.sg) (S.-S. Lam), [weina@nus.edu.sg](mailto:weina@nus.edu.sg) (W. Zhang), [bizhvj@nus.edu.sg](mailto:bizhvj@nus.edu.sg) (G.H. Jacob).

## 1. Introduction

The existing finance theories such as *stakeholder theory* and *investor recognition theory* predict that socially responsible firms have higher valuation, lower returns, and lower risk and vice versa for socially irresponsible firms. Specifically, the *stakeholder theory* predicts that socially responsible firms may be subjected to lower social or environment risk than socially irresponsible firms that lead to the reduction of deadweight costs (e.g., Oikonomou et al., 2012). On the other hand, the *investor recognition theory* predicts that when a big segment of investors are interested in investing in socially responsible firms, such demand would result in higher valuations and thus lower returns on these firms (e.g., Dhaliwal et al., 2009).

Nevertheless, it is challenging to categorize all firms into two dichotomies of “socially responsible” or “socially irresponsible” in reality. Firms can be both socially responsible and irresponsible at the same time making them socially ambiguous. We define these socially ambiguous firms as “Grey” firms. Given that there exists no theory on how these “Grey” firms are priced by the market for their mixed social actions, we conduct an empirical exploration on how they are priced relative to other clearly socially responsible or irresponsible firms.

We compute the firm-level social strengths and social concerns scores from KLD. When a firm scores highly in both social strengths and social concerns, drawing from the top 50 percentile of the respective distributions, we label it as the “Grey” firm. We compare it to other three categories of firms, namely “Good”, “Bad”, and “Neutral” firms. “Good” firms have higher than median scores in social strengths but lower than median scores in social concerns. “Bad” firms have lower than median scores in social strengths and higher than median scores in social concerns. “Neutral” firms have lower than median scores in both social strengths and social concerns. We perform the analysis on six long-short portfolios formed from the four categories.

We have two main results. First, we find that the “Grey” portfolio is consistently overpriced relative to the “Neutral” portfolio by 3.6% per year at the 5% significance level and “Bad” portfolio by 3.2% at the 10% significance level. Combining the evidence that the “Good” portfolio is overpriced to the “Neutral” portfolio at the 10% significance level, the overpricing of “Grey” portfolio is likely due to the overpricing of social strengths within the “Grey” firms.

Second, we find that the overpricing of “Grey” stocks is consistently observed under “community” and “environment” sub-dimensions of KLD scores up to 4.2% per year. This result shows that the stock market highly values “Grey” firms for their responsible community and environmental practices while reasonably pricing the other four sub-dimensions, such as corporate governance, diversity, employee relations, and product.

We perform several robustness tests. First, we find that the overpricing of “Grey” portfolio is not observed among S&P500 firms, which is not surprising because these firms attract a lot of investors’ attention and analyst coverage (e.g., Oikonomou et al., 2012). We also find that the overpricing

of “Grey” stocks is not driven by “Sin” stocks (i.e., those stocks in alcohol, gambling and tobacco industries) or “Controversial” industries (i.e., “Sin” industries and firearms, military, and nuclear power industries). Lastly, we confirm that the result is not driven by small firms.

Our study contributes to the literature in two important ways. First, there is no prior study to our knowledge that has studied “Grey” firms from an asset pricing perspective. Mattingly and Berman (2006) are among the first to point out that positive and negative social actions are both empirically and conceptually distinct constructs and should not be combined in future research. Our finding of overpricing of “Grey” firms on their social strengths provides an important implication that firm’s socially responsible behavior is rewarded by the financial market. Second, our study further extends the understanding of the sub-dimensions of CSR (e.g., Galema et al., 2008; Bouslah et al., 2013). Given that many institutional investors have signed the Principles of Responsible Investment (PRI) that aim to integrate environmental, social and governance issues into the investment decisions. Such demand may lead to the overpricing of the responsible “community” and “environment” actions.

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