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The impact of the dimensions of social performance on firm risk

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ABSTRACT

This paper examines the impact of the individual dimensions of social performance (SP) on firm risk (total and idiosyncratic) using 16,599 firm-year observations over the period 1991–2007. We find that firm risk for S&P500 members is positively affected by Employee, Diversity, and Corporate Governance concerns. On the other hand, Community (Diversity) strengths negatively (positively) affect their risk. As to non-S&P500 members, firm risk is positively affected by Employee concerns and Diversity strengths. However, firm risk of non-S&P500 members is negatively affected by Environment strengths. The direction of causation between firm risk and SP depends on the dimension examined.

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1. Introduction

In recent years, corporate social responsibility (CSR) has received growing attention from firms, the financial community, regulators and policy-makers. For example, 93% of the 766 CEOs surveyed by the UN Global Compact in 2010 believe that CSR issues will be critical to the future success of their business (Lacy et al., 2010). Enhanced reputation and the potential for revenue growth and cost reduction are the main factors driving CEOs to take CSR actions. On the demand side, assets in Socially Responsible Investing (SRI) represent 12.2% of all assets under management in the US,¹ and major institutional investors from different countries have signed the Principles for Responsible Investment (PRI) agreement which aims to integrate environmental, social and governance (ESG) issues into investment decision-making and ownership practices.²

The concept of social performance (SP) is the operationalization of CSR in a managerial context (Carroll, 1979, 1999; Wood, 1991; Waddock and Graves, 1997). According to MSCI ESG STATS,³ SP

includes several dimensions such as Community, Diversity, Employee Relations, Environment, Product, Human Rights and Corporate Governance. Most empirical CSR research, which has focused on the relationship between SP and financial performance (FP) or value, does not provide a general consensus about whether SP is value enhancing, reducing or irrelevant (e.g., Margolis and Walsh, 2003; Orlitzky et al., 2003; Mattingly and Berman, 2006; Baron et al., 2011). From a financial point of view, SP can affect firm performance or value *if and only if* it affects expected future cash flows and/or risk. This study focuses on the risk effects associated with SP.

Some studies argue that SP only affects systematic risk based on the main insight of portfolio theory that only systematic risk is priced in financial markets, whereas others suggest that SP affects only idiosyncratic risk because SP is firm specific. For example, Boutin-Dufresne and Savaria (2004) and Lee and Faff (2009) find a negative relationship between idiosyncratic risk and an aggregate measure of SP (using the Canadian Social Investment Database and Dow Jones Sustainability Index, respectively). Luo and Bhattacharya (2009) find a negative relationship between an aggregate measure of SP, based on *Fortune's* Most Admired Companies in 2002 and 2003, and both types of risk (idiosyncratic and systematic). Using KLD data, Goss (2012) finds that higher aggregate concerns (strengths) are related to a higher (lower) idiosyncratic risk measured using a vector autoregressive model. He concludes that concerns are more value relevant than strengths.

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¹ Social Investment Forum (SIF), 2010 Report on Socially Responsible Investing Trends in the United States. <http://www.ussif.org/>.

² <http://www.unpri.org/>.

³ MSCI ESG STATS (former KLD Research & Analytics, Inc.). For simplicity, we use the KLD abbreviation.

Some studies examine the impact of one or more SP dimension on risk. Bauer et al. (2009) appear to be the only study that examines the impact of one SP dimension on idiosyncratic risk. They construct an employee relations index (strengths minus concerns of Employee Relations and Diversity dimensions of KLD), and find that firms with stronger employee relations have a lower cost of debt, higher credit ratings, and lower idiosyncratic risk (residual volatility from the CAPM). Other studies examine the relation between SP and systematic risk. Salama et al. (2011) find a negative relationship between systematic risk and a measure of SP which combines two dimensions (community and environment). Oikonomou et al. (2012) find a negative (positive) relation between systematic risk and a measure of aggregate strengths (concerns) for S&P500 firms. They also find that community, employment, and environmental concerns are significantly and positively related to systematic risk. However, limiting the sample coverage to only S&P500 firms could introduce a size bias into their results, which we identify herein.

Thus, most previous studies use aggregate measures of SP combining strengths (positive actions) and/or concerns (negative actions) of several dimensions which are not equally important for a specific firm or investor. There are two drawbacks associated with the use of composite (or aggregate) measures of SP. First, aggregation may confound the effects of the individual SP dimensions that are not equally important and relevant (Griffin and Mahon, 1997; Johnson and Greening, 1999). This strongly suggests that we should consider the individual dimensions of SP separately (Hillman and Keim, 2001; Rehbein et al., 2004). Second, Mattingly and Berman (2006) argue that positive and negative social actions (i.e., strengths and concerns as assessed by KLD) are both empirically and conceptually distinct constructs and should not be combined. They find that KLD strengths and concerns for a particular dimension do not covary in opposite directions (i.e., they do not measure opposing sides of the same underlying construct). It is also important to distinguish between strengths and concerns because there could be compensating effects. In summary, prior research highlights the importance of distinguishing between aggregated and disaggregated SP measures at two levels: (1) individual SP dimensions; and (2) strengths and concerns within each individual SP dimension.

Thus, the objective of this paper is to examine the impact of the individual dimensions of SP on a firm's risk (total and idiosyncratic) using a large panel dataset of 16,599 firm-year observations over the period 1991–2007. We use individual dimension measures of SP which first combine and then separate strengths and concerns. To the best of our knowledge, our study is the first to provide a comprehensive assessment of the effects of SP dimensions on a firm's idiosyncratic risk.⁴

The contributions of this paper are threefold. First, our study explicitly quantifies the risk effects associated with SP dimensions which allows for a better understanding of the risk implications of SP for investors, corporate managers and policy makers. For example, if the risk effect of SP is significant statistically and economically it would be rational for a firm's managers to improve their SP and to integrate it into their overall managerial strategy. We provide a direct test of the risk management/mitigation/insurance hypothesis using a large panel of US firms covering the period 1991–2007. The risk insurance hypothesis states that firms use SP to control risk which is consistent

with a large literature on why firms hedge as a means to reduce cash flows volatility and costs of financial distress, among other things (e.g., see Stultz, 2002). Prior research finds that risk management is value relevant because of market imperfections (Stultz, 2002). Therefore, risk management of social, environmental and governance issues, which is equivalent to strategic risk management (Sharfman and Fernando, 2008), can be priced in financial markets.

Second, we examine the relation between the individual dimensions of SP and a firm's total and idiosyncratic risks. Based on theoretical arguments and empirical evidence (e.g., Heinkel et al., 2001; Barnea et al., 2005; Mackey et al., 2007; Fama and French, 2007), we hypothesize that SP will affect idiosyncratic risk which is priced in financial markets because of the "neglect effect" (i.e., the presence of investors with tastes for assets as consumption goods). SP is likely to affect idiosyncratic risk because the implications of SP actions and practices (e.g., employee commitment and effort, lawsuits, strikes, fines, reputational risk, boycotts) are mainly firm-specific in nature (Lee and Faff, 2009; Bauer et al., 2009). Prior research finds that idiosyncratic risk is priced in financial markets (e.g., Goyal and Santa-Clara, 2003; Ang et al., 2006; Fangjian, 2009; Bodnaruk and Ostberg, 2009) more likely because of market imperfections (e.g., limited arbitrage, investors' limited ability to fully diversify their portfolios, incomplete information, and constraints on market participations). For example, Shleifer and Vishny (1997) show that arbitrage is limited because it can be costly and risky. Finally, we identify heterogeneity in the SP-risk relation that is consistent with the notion that only some SP dimensions will affect significantly firm risk.

We find that members of the S&P500 index are larger, less risky, and highly visible for media and analysts, which suggests that they have more transparent practices regarding their SP actions and impacts. We provide evidence that is consistent with our argument that S&P500 firms have less information asymmetry relative to non S&P500 firms regarding SP information, and consequently the relation between a firm's risk and strengths and concerns for the various SP dimensions is more pronounced for S&P500 firms relative to non S&P500 firms.

When we combine strengths and concerns, we find that not all SP dimensions are relevant for firm risk. Only two dimensions (Employee relations and Human Rights) are negatively related to firm risk when the firms are not differentiated by S&P500 membership. For S&P500 firms, we find that Employee relations, Corporate Governance and Community negatively affect firm risk, whereas Environment positively affects firm risk. For non S&P500 firms, only Employee relations, Community and Environment negatively affect firm risk.

When we separately examine strengths and concerns for each SP dimension, we find that Employee, Diversity, Corporate Governance and Human Rights concerns, as well as Diversity and Corporate Governance strengths positively affect a firm's risk. For S&P500 firms, we find that Employee relations, Diversity and Corporate Governance concerns and Diversity strengths positively affect a firm's risk, whereas Community strengths negatively affect a firm's risk. For non-S&P500 firms, Employee relations concerns and Diversity strengths positively affect a firm's risk, whereas Environment strengths negatively affect a firm's risk. We find some bidirectional causality as well as some unidirectional causality in both directions between risk and specific SP dimensions.

The remainder of the paper is organized as follows. Section 2 presents the theoretical framework and research hypotheses. Section 3 describes the data and sample selection procedure. Section 4 describes the methodology used in order to test our hypotheses. Section 5 presents and discusses our empirical results. Section 6 concludes and provides avenues for future research.

⁴ There are two main differences between our study and those of Goss (2012) and Bauer et al. (2009) in terms of what is examined. First, Goss (2012) focuses on aggregate SP measures of strengths and concerns, whereas we focus on individual measures of strengths and concerns of SP dimensions. Second, Bauer et al. (2009) examine only one SP dimension (an index combining strengths and concerns of employee and diversity), whereas we examine all SP dimensions covered by KLD.

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