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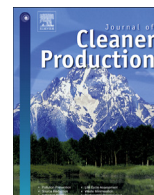
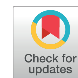


Screening activities by socially responsible funds: A matter of agency?



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ABSTRACT

This study analyzes the social and financial performance of firms that appear in the portfolios of European socially responsible funds (SRFs), relative to the performance of firms in portfolios of European conventional funds (CFs). Corporate social performance (CSP) reflects the extent to which a company engages with environmental, social, and corporate governance issues. Corporate financial performance (CFP) instead pertains to accounting-based profitability. The analysis reveals differences between CSP and CFP across companies in the two types of portfolios. First, firms held by SRFs exhibit poorer CSP than firms selected by CFs. Second, in the long term, companies in SRF portfolios achieve worse risk-adjusted returns than firms held by CFs. These results challenge the actual social responsibility of SRFs and further raise concerns about the screening activity of SRFs with regard to the profitability of the target firms.
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1. Introduction

In the broad debate over socially responsible investment (SRI), the central question is well-known: “Does it pay to be good?” (Barnett and Salomon, 2012, p. 1304). To address this key question, various studies consider the selection process of socially responsible funds (SRFs) (e.g., Cortez et al., 2009; Jin and Han, 2018; Lesser et al., 2016; Renneboog et al., 2008; Silva and Cortez, 2016), whose more stringent ethical and social criteria distinguish them from conventional funds (CFs). These studies generally reflect two opposing theoretical views. The first, primarily associated with Friedman (1970), regards investing in social performance as an agency problem. From a capital market perspective, stringent ethical and social criteria limit the diversification of the fund, thus violating a pillar of modern portfolio theory (Markowitz, 1952). The second perspective instead highlights the positive outcomes of SRI-related criteria, arguing that these benefits are greater than the screening costs, in accordance with stakeholder theory (Freeman, 1984) and the resource-based view (Barney, 1991). Empirical studies of the financial performance of SRFs relative to CFs offer mixed findings. Some studies indicate that their performance does not differ significantly (Ortas et al., 2013; Renneboog et al., 2008); others find a U-shaped relationship between the intensity of SRI screens and financial performance (Barnett and Salomon, 2006); and still others specify improved financial results of SRFs in some settings, such as during financial crises in capital markets (Gangi and Trotta, 2015; Lesser et al., 2016; Silva and Cortez, 2016).

Despite the widespread research interest in the performance of SRI, analyses of the corporate financial performance (CFP) and corporate social performance (CSP) of firms in the portfolios of SRFs versus CFs are rare. In their meta-analysis, Revelli and Viviani (2015) determine that academic research tends to use researcher-constructed SRI portfolios, rather than data obtained about existing funds. For example, studies of CSP and CFP at the firm level (Barnett and Salomon, 2012; Halbritter and Dorfleitner, 2015; Kim et al., 2018; Surroca et al., 2010) rely on data sets produced by social rating agencies (e.g., Kinder Lydenberg and Domini [KLD], Sustainalytics Responsible Investment Services) or investigate firms extracted from sustainability indexes (Cunha and Samanez, 2013; Ortas et al., 2013; Perez-Calderon et al., 2012; Santis et al., 2016), regardless of whether those firms appear in SRF portfolios. Revelli (2017) also notes that studies of SRI performance do not

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List of abbreviations

CF	Conventional fund
CFP	Corporate financial performance
CSP	Corporate social performance
CSR	Corporate social responsibility
ESG	Environmental, social, and corporate governance
SIF	Social Investment Forum
SRF	Socially responsible fund
SRI	Socially responsible investment

precisely address the debate regarding CSP and CFP, despite its importance for corporate social responsibility (CSR) research.[1] Thus, we lack sufficient evidence to answer confidently whether companies selected by SRFs—that thus should be more socially responsible—attain social or financial performance that is significantly different from that of companies held in CF portfolios.

To address this gap, we analyze companies held in the portfolios of SRFs, which represent financial products for investors interested in extra-financial returns in addition to financial outcomes (Bollen, 2007; Pasewark and Riley, 2010). To begin, we verify whether companies selected by SRFs actually exhibit greater CSP than companies chosen by CFs. Using accounting-based ratios, we also compare the CFP of companies held by SRFs versus CFs.[2] If SRF portfolio companies perform better on both financial and extra-financial measures, capital allocation would be consistent with the mandate issued by unit-holders (SRFs pick the "winners"). If the statistical tests instead indicate poorer CSP and CFP for these companies, we would have evidence of a twofold agency problem: between private and institutional investors and between SRFs and company managers.

In the next section, we provide a theoretical background and derive the hypotheses, which we present as two sets of contrasting predictions. After outlining the methodology in Section 3, we present the empirical results. Section 5 then provide a discussion of the results, which leads in to the conclusions of this study and a further research agenda.

2. Theoretical background and hypotheses

Both the selection process adopted by SRFs and the returns on corporate investments in sustainable and socially responsible practices are topics at the basis of a broader academic debate. Many studies compare the financial market performance of SRI funds versus CFs, but we propose a different focus, shifting from the financial performance of SRFs to a comparison of the CSP and CFP of companies in the different portfolios.[3] Accordingly, we can capture the fulfillment of the fiduciary mandates underlying a nexus agency model (Fig. 1), which includes both private and institutional investors, as well as managers of the target companies (Black, 1992; Woidtke, 2002). One fiduciary mandate pertains to unit-holders and managers of SRFs. This mandate requires the application of environmental, social, and governance (ESG) screening criteria. A second fiduciary mandate involves the SRFs and managers of target firms, and it demands socially and economically responsible management practices. This model, in which an agent (fund manager) controls another agent (company manager), may generate additional agency costs to execute the two distinct fiduciary contracts (Schneider, 2002). Therefore, the following subsections discuss the application of selection criteria by SRFs and the financial implications of CSR engagement by target companies.

2.1. Pursuit of restrictive SRI

No universally accepted definition of SRF exists. The Social Investment Forum (SIF, 2003) proposes that SRFs generally adopt an investment process that considers social and environmental consequences, both positive and negative, without ignoring the need for a rigorous financial analysis of the firms. The motivation for SRI is to achieve both financial returns and responsible investments that facilitate societal development (Camilleri, 2017; Schueth, 2003; Sparkes and Cowton, 2004). Furthermore, prior literature (Renneboog et al., 2008; Trinks and Scholtens, 2015) identifies ESG-oriented screens as selection criteria of SRFs.[4] Some screens reflect the company's policies for protecting the natural environment. Another type of screen relates to the company's socially responsible programs. Consistent with a corporate responsibility *continuum* (Bhimani and Soonawalla, 2005; Jamali et al., 2008), a third type of screen refers to best practices in corporate governance. These combined ESG criteria commonly are referred to as extra-financial issues (Juravle and Lewis, 2008). In research that relies on risk-adjusted returns and Jensen's alpha to determine whether SRF screens lead to decreased performance, compared with conventional financial criteria, no significance evidence of different levels of financial performance has emerged (Mill, 2006; Ortas et al., 2013; Renneboog et al., 2008).

As SRI has evolved, several strategies have emerged for allocating these investments (O' Rourke, 2003; Renneboog et al., 2008). First, a negative screening approach excludes specific investments. In Europe, this approach represents up to 40% of the market (Eurosif, 2016). Negative screening avoids investing in firms that fail to respect personal dignity or work-related conventions, as well as products that are potentially harmful to human health or the environment and whose production demands excessive use of non-renewable resources. Other criteria exclude investment in countries whose political regimes are oppressive and undemocratic. At the industry level, the negative selection criteria avoid investments in controversial sectors, such as tobacco, alcohol, pornography, and weapons. This screening policy tends to produce suboptimal financial performance (Trinks and Scholtens, 2015), though a recent investigation of fossil fuel divestment indicates that the strategy did not impair the financial performance of these investment portfolios (Trinks et al., 2018). According to Henriques and Sadorsky (2017), portfolios that divest from fossil fuel to invest in clean energy perform better than those that include fossil fuels. These studies highlight the mixed results in research investigating

[1] Similar to Renneboog et al. (2008, p. 1723), we define CSR as "corporate decisions fostering social, corporate governance, ethical and environmental issues." For our measure of CSP, we therefore assess the extent of the company's engagement in social, environmental, and corporate governance issues. Both meta-analyses (Orlitzky et al., 2003) and literature reviews (Margolis and Walsh, 2003) suggest that, even in the presence of various methodological imperfections, there is a positive association and little evidence of a negative association between CSP and CFP.

[2] According to Orlitzky et al. (2003), CSP tends to be more associated with accounting-based measures of CFP than with market-based measures of financial performance.

[3] By measuring the financial performance of the target company, rather than the total returns to investment funds, we neutralize the effect of the management capability related to total assets in place.

[4] Prior literature includes corporate governance among the pillars of CSR (Elkington, 2006). In particular, an effective corporate governance mechanism is necessary to guarantee responsible behavior toward all stakeholders of the business (Huse, 2005). In turn, corporate governance is essential for sustaining effective social and environmental responsibility (Jamali et al., 2008).

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