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Toward a theory of responsible investing: On the economic foundations of corporate social responsibility

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ABSTRACT

Studies that link corporate social and financial performance usually find a positive association between the two. However, the literature does not establish a significant impact of socially responsible investing on stock market returns. We develop a coherent economic framework of responsible investing to address this paradox. The framework offers theoretical underpinnings for all research on responsible investment as it provides the theoretical underpinnings for the actual behavior of market participants. We associate corporate social performance with key financial accounting ratios like the market-to-book ratio (market value of the firm in relation to accounting value), return on assets, and stock market return. We conclude that there is a strong theoretical foundation for a positive relationship between corporate social responsibility and financial performance, though the relation is conditional on which financial performance measure is considered. We illustrate that the empirical literature about responsible investing is well in line with our model's propositions.

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1. Introduction

Margolis and Walsh (2001, 2003) provide a thorough review of the literature connecting corporate social performance with financial performance. Based on more than 100 studies, they conclude that there is a positive association between social and financial performance and little evidence of a negative association (see also Orlitzky et al., 2003). In contrast, the literature about stock market returns in relation to corporate social responsibility does arrive at a somewhat different conclusion: many researchers (e.g. Bauer et al., 2005; Bello, 2005; Renneboog et al., 2008) find that socially responsible investments yield returns that are not significantly different from those on conventional investments. Others (e.g. Geczy et al., 2003; Hong and Kacperczyk, 2009) even find that socially responsible stocks are overpriced. Thus, it appears that there is a paradox: social performance of firms seems to be valued differently, depending upon the perspective taken, which is the supply-side or the demand-side of social responsibility.

In this paper, we provide a coherent theoretical framework for responsible investing. We build on a coherent economic framework from which we can logically derive propositions about the relationship between social and financial performance. We come up with a model that is based on the models of Heinkel et al. (2001) and Mackey et al. (2007). We integrate two of the model's extensions as suggested by Mackey et al. (2007), namely that firms vary in their responsible performance and that investor preferences are heterogeneous. As such, we explicitly link the supply and demand side for corporate social responsibility. Furthermore, we explore specifically what the consequences are of the choice of firms to meet investor's demand for corporate socially responsible behavior on three popular financial ratios.

The key ingredients of our model are that socially responsible investors take account of external effects of production, which we label "social damage", and as a consequence accept a lower financial return on a responsible stock compared to an irresponsible stock. The way we model this is by endowing consumers with a preference for "more responsible" firms. Formally, consumers receive a *warm-glow*, as in the seminal paper by Andreoni (1990), if they own shares of firms that produce more responsibly (i.e. their production is to be associated with less social damage). So in a way, consumers are purely egoistic in the setting; they do not actually care whether, for example, the firm pollutes or not, as they do not value the environment directly. They only care if they have shares of the firms that pollute. We do not consider where the preferences for socially responsible production come from; in this paper we are only interested in the consequences for firms' financial performance due to the demand for socially responsible production. To be clear, in the narrative of the paper, we often refer to "pollution" as the unwanted side-effect of production, but we do not model the standard external effect of pollution. The model's assumption that firms generate social damage as a byproduct also suits problems such as child-labor or poor health and safety standards in working conditions. For these two examples it is perhaps even more clear that consumers are not directly affected by variation in the standards of production. Hence, it is important to realize that we do not consider the standard (environmental) externality framework in this paper but only the warm glow effect. Furthermore, regarding the supply side of the economy, socially responsible entrepreneurs may meet the interest in the demand for socially responsible production. This results in less input of capital and a higher return on assets because of decreasing marginal returns to production. The implication from the demand side assumption is that responsible firms are characterized by higher market-to-book ratios than irresponsible firms. The implication from the supply side assumption is that more responsible firms are characterized by a higher return on assets. Combining the two in the equilibrium situation regarding stock market returns shows that the overall effect is conditional on the parameters of the model: stock market returns can both be higher or lower for responsible firms compared to those of irresponsible firms. Intuitively, this ultimately depends upon the relative strength of how much investors and firms respectively value the internalization of irresponsibility or social damage.

The structure of the remainder of this paper is as follows. Section 2 briefly reviews socially responsible investing. Section 3 discusses the models from which we derive our propositions regarding the relationship between social and financial performance. Section 4 discusses the propositions of our model. Section 5 is an illustration of our model as it reorganizes the literature covered by Margolis and Walsh (2001, 2003) by linking this literature to the propositions. Section 6 concludes.