ESG ACTIVITIES
RESEARCH SPOTLIGHT

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Environmental, social, and governance (ESG) activities involves activities or investment that companies make to address environmental or social issues that impact the firm from a total stakeholder perspective.

– ESG is alternatively referred to as corporate social responsibility (CSR) or socially responsible investing (SRI).

• Potential benefits.
  – Considers the interests of all stakeholders, not just shareholders.
  – Can decrease risk by internalizing costs that might damage the firm or its constituents over the long-term.

• Potential costs.
  – Can reduce value if it requires substantial investment.

Research shows that ESG is modestly associated with higher firm performance.
Dowell, Hart, and Yeung (2000) study the relation between corporate commitment to environmental standards and firm value.


Categorize companies according to whether they adhere to 1. local environmental standards, 2. U.S. standards, or 3. internal standards that are more stringent than any national standard.

Find that companies that adopt stringent internal standards have higher value (Tobin’s Q) than companies that adopt local or U.S. standards.

Conclusion: companies committed to the environment perform better.

“This paper refutes the idea that adoption of global environmental standards by [multinational corporations] constitutes a liability that depresses market value.”
Lins, Servaes, and Tamayo (2017) study the performance of companies with high CSR scores during the financial crisis.

Sample: 1,673 nonfinancial firms, 2005-2013. CSR data from MSCI.

Find that during the crisis, high-CSR firms experienced higher returns, profitability, growth, and sales per employee than low-CSR firms.

Find no significant associations during the periods before and after the crisis.

Conclusion: companies committed to CSR have lower risk.

“Trust between a firm and both its stakeholders and investors, built through investments in social capital, pays off when the overall level of trust in corporations and markets suffers a negative shock.”
Manchiraju and Rajgopal (2017) study the relation between CSR and firm value in the context of a law that required minimum CSR spending.

Sample: 2,120 Indian companies, 2009-2013.

- Indian Companies Act 2013 required companies meeting certain thresholds for net worth, sales, and profit to spend at least 2% of average profits on CSR activities.

Find that companies affected by the law declined by a market-adjusted 4.1% over the 4 years between introduction of the bill and final passage.

Interpret results as evidence that firms choose optimal levels of CSR spending and that mandatory spending beyond this is value decreasing.

Conclusion: forced CSR spending decreases firm value.

“Mandatory CSR activities can impose social burdens on business activities at the expense of shareholders.”
Deng, Kang, and Low (2013) study the relation between CSR and firm value by examining stock price returns around acquisition announcements.

Sample: 1,556 successful mergers, 801 firms, 1992-2007. CSR data from KLD.

Find modest evidence that companies with high CSR scores exhibit:

- Higher returns around the announcement (3-day period, but not 5- or 10-day).
- Higher long-term operating performance (operating cash flow, 2 years post-merger).
- Difference in returns is driven by the fact that firms with low CSR perform below average; high CSR firms do not perform above average.

Conclusion: companies committed to social goals might perform better.

“Firms that integrate various stakeholders’ interests … ultimately increase shareholder wealth and corporate value.”
Atkas, de Bodt, and Cousin (2011) also study the relation between SRI and firm value by examining merger-announcement and post-merger performance.


Find that companies that acquire targets with high SRI scores:
- Have higher announcement returns (3-day period).
- Exhibit an increase in their own SRI score following the announcement (measurement term not specified).

Conclusion: ESG increases firm value.

“Our results support the idea that the acquirer learns from the target’s SRI practices and experiences, and socially responsible investing pays for acquiring shareholders.”
Dimson, Karakaş, and Li (2015) study the impact of activist engagements on firm performance.


Find that successful ES-related engagements are associated with:

- Positive abnormal returns (7.2% over 18 months).
- Improved accounting performance (ROA).

Conclusion: ESG increases firm value.

“Consistent with arguments that ESG activities attract socially conscious customers and investors, we find that, after successful engagements, particularly for those on ES issues, engaged companies experience improvements in their operating performance, profitability, efficiency, shareholding, and governance.”
Krüger (2015) examines how shareholders respond to CSR-related events.

Sample: 2,115 events, 745 companies, 2001-2007. Event data from KLD.

- “Events” consist of instances where KLD makes positive or negative note of a social, environmental, or product-related occurrence at the company.

Find that shareholders:

- React negatively to negative events (0.9% over 11-day period). (breakdown: no reaction to events related to diversity or human rights; negative reaction to those related to environment, product, community, or employees.)
- Have no reaction to positive events.

Conclusion: some CSR-related events can impact firm value.

“A negative reaction with respect to negative events is consistent with the view that a substantial cost is associated with corporate social irresponsibility.”
Ferrell, Liang, and Renneboog (2016) study the relations between CSR, agency problems, and firm value.

Sample: 2,500 global companies, 1999-2011. CSR data from MSCI and Vigeo.

Find that firms with:
- Low agency problems have higher CSR ratings.
- Low agency problems and high CSR ratings also have higher value (Tobin’s Q).

Conclusion: companies committed to CSR do not have higher agency problems.

“Corporate social responsibility … can be consistent with a core value of capitalism, generating more returns to investors, through enhancing firm value and shareholder wealth.”
Margolis, Elfenbein, and Walsh (2011) conduct a meta-analysis of the research on CSR and firm performance.


Find:
- Small positive relation between CSR and firm performance.
- Over time, the positive relation declines (i.e., it is more prominent in early studies than later studies).

Conclusion: CSR might increase value; it does not decrease value.

"After thirty-five years of research, the preponderance of evidence indicates a mildly positive relationship between corporate social performance and corporate financial performance. The overall average effect ... across all studies is statistically significant, but, on an absolute basis, it is small."
Geczy, Stambaugh, and Levin (2005) study the investment returns generated by mutual funds dedicated to socially responsible investing (SRI).


Find that:
- SRI mutual funds have higher annual fees (1.36%) than non-SRI funds (1.10%).
- SRI mutual funds have lower performance (0.3% per month).
- Shareholders do not receive diversification benefits.

Conclusion: SRI investments underperform peers.
Renneboog, Ter Horst, and Zhang (2008) also study the performance of SRI mutual funds.


Find that:
- SRI mutual funds underperform their benchmarks by 2.2% to 6.5% annually.
- Risk-adjusted returns in many countries are not significantly different from comparable funds.

Conclusion: SRI mutual funds might underperform peers.

“It seems that investors pay a price for ethics.”
El Ghoul and Karoui (2017) also study the performance of CSR mutual funds.

Sample: 2,168 U.S. mutual funds, 2003-2011. CSR data from KLD.

- Rather than compare SRI-funds with unconstrained funds, the authors use the CSR ratings of the companies in the portfolio to derive a CSR score for the fund.
- CSR is graded on a spectrum, not a binary metric.

Find that funds with high CSR scores perform worse than those with low scores.

Conclusion: CSR investments underperform non-CSR investments.

“Our empirical results reveal that the CSR score of the portfolio is negatively related to risk-adjusted performance. … Furthermore, we find that the CSR score negatively predicts future fund performance.”
Gerard (2018) conducts a literature review of the research on ESG, including equity and fixed income performance.


Finds that:
- High ESG scores are related to higher profitability and stock value (Tobin’s Q).
- Relation between ESG scores and fixed income price and risk is mixed.
- Positive performance differentials recorded in the 1990s decreased in the early 2000s and disappeared in the 2010s.

Conclusion: companies committed to ESG perform better and have lower risk but their actions are largely priced into securities markets.
The research generally shows that companies committed to environmental and social goals have better performance and lower risk.

The relations in most studies are modest.

Research generally suffers from a problem of causality: does a commitment to environmental or social goals make companies more profitable, or are more profitable companies able to spend more on these activities?

Socially responsible investing is associated with lower risk-adjusted returns; any corporate benefit to ESG is priced in the market.

It is not clear that the metrics that third-party firms develop to measure companies on ESG dimensions are accurate or reliable.


Elroy Dimson, Oğuzhan Karakaş, and Xi Li. Active Ownership. 2015. Review of Financial Studies


