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OPINION

The impact of sustainable practices on shareholder value

By Liang Hao

CORPORATE social responsibility (CSR) has increasingly become a mainstream business activity, ranging from voluntarily engaging in environmental protection to increasing workforce diversity and employee welfare – although standard economic theories predict that it should be rather uncommon.

The neoclassical economic paradigm usually considers CSR as unnecessary and inconsistent with profit maximisation. This discrepancy between theory and real-world observations has attracted much scholarly attention in recent years.

Two general views on CSR and sustainable practices prevail in academic research. The first view argues that socially responsible firms can and often do adhere to value-maximising practices. As such, the reason why CSR prevails is because it creates a competitive advantage for the firm and thus contributes to firm value. The opposite view on CSR begins with American economist Milton Friedman's well-known claim that "the only responsibility of corporations is to make profits" in a 1970 *New York Times* article.

Extending this view, several argue that CSR is often simply a manifestation of managerial agency problems inside the firm and, hence, problematic. That is, managers engage in CSR to benefit themselves at the expense of shareholders and lose focus on their core managerial responsibilities. Therefore, the prevalence of CSR is driven by systematic frictions in the market that leave corporate managers largely unchecked.

Answering which view is correct will have significant implications not only for corporations, but also for over US$20 trillion in assets under management globally that are classified as "sustainable, responsible and impact (SRI)" investing.

Over 2,300 asset owners and asset managers have become signatories to the United Nations Principle of Responsible Investment (UN PRI), including many of the hedge funds which were traditionally criticised as greedy investors. There has also been a new trend of impact investing predominantly made by private equity investors which intentionally seek to create both financial return and positive social impact that is actively measured.

Are CSR and SRI just a sideshow, or do they actually bring value for corporations, investors and society at large? This is a multi-trillion-dollar question, and not an easy one to answer. This question can be broken down into smaller parts.

Corporate interests

First, do companies with higher CSR have superior financial performance? The answer from most academic and industry research is "Yes". Companies that receive high environmental, social and governance (ESG) ratings from major ratings agencies (MSCI, S&P, Thomson Reuters, Sustainalytics) usually have higher operating efficiency and higher market valuation. Studies have also found that when a firm passed a shareholder proposal on ESG-related issues during its annual shareholder meeting, it experienced a positive stock market reaction.

In my own research, I also find that following the passage of ESG proposals, a company's competitors experienced negative stock market reactions, implying that they face a competitive threat. Subsequently, these competitors will catch up in the following years by doing similar CSR projects. Overall, the evidence in the literature suggests that companies are "doing well by doing good", namely they can achieve better financial performance through engaging more in CSR.

Second, if CSR indeed increases firm value, what factors determine CSR? While many firm- and industry-level factors have been found to be related to CSR, the most recognised ones concern with the notion of "doing good by doing well". That is, companies that are profitable and have deep pockets tend to do more good by engaging in CSR.

I also find that companies with good corporate governance practices tend to do more CSR, which is against the agency view. However, some studies do find evidence that corporate donation is more prevalent in companies plagued with agency problems. In other words, not all CSR practices are equally "good", and some may indeed be driven by managers' pursuit of self-interest. Others find that a firm's CSR investment is related to its CEO's characteristics, such as gender, children and past personal experience, suggesting a behavioural explanation behind sustainable practice.

> Overall, with the UN's PRI initiative and Sustainable Development Goals, sustainable practice and CSR are becoming global trends that business leaders, asset owners and investment managers simply cannot ignore.

Third, do investors buying high ESG stocks (investing in high-CSR companies) expect to earn higher returns? This is the question in which one sees the greatest discrepancy in opinion between industry practitioners and academics. From my conversations with practitioners, most of them tend to believe that investing in high-ESG stocks should earn higher expected returns in the future, consistent with the evidence that high-ESG companies also have better financial performance.

However, academics usually have a different view on this. Precisely because companies with high CSR tend to have higher valuation, investing in these firms is essentially buying over-valued stocks. Also, SRI investment typically entails avoiding "sin stocks" such as those in the tobacco, weapon, gambling and pornography sectors, which also tend to be profiting businesses that generate higher expected returns.

Excluding them from the feasible investment set is like putting a constraint on portfolio optimisation. Indeed, most academic studies find that SRI funds usually do not deliver superior expected returns. Nevertheless, some practitioners argue that "active ownership" and engagement strategies that aim to improve the portfolio companies' CSR may still generate superior returns for investors. This is usually done by having an active dialogue with the management and influencing decisions through proxy voting during shareholder meetings.

As an improvement in ESG leads to an improvement in market valuation, a long-term investment combined with investor activism will imply a higher return over time. The question is, how feasible is it to implement such a strategy, given that most SRI funds hold only a very tiny stake in each portfolio company, and engagement effort is usually quite costly?

Fourth, if SRI investment usually underperforms financially, why do many investors still want to hold stocks of high-CSR firms? This has something to do with people's intrinsic social preference. The classical economic theory assumes that people are profit-maximising, and that's why finance research focuses on achieving the highest possible returns from an investment.

Global trends

However, in reality, people do have non-pecuniary utilities and may derive a warm-low feeling from supporting sustainability causes in their investment. Some studies indeed find that while many SRI funds deliver below-benchmark returns (for the case of impact private equity funds, investors can even accept 3-4 per cent lower returns), they do not have significantly fewer fund inflows. In addition, SRI investors also donate 40 per cent more to charity than conventional investors. These all suggest that some investors are willing to sacrifice some returns for feeling good (or they may not have realised that "ethical money" is not "financially smart").

Overall, with the UN's PRI initiative and Sustainable Development Goals, sustainable practice and corporate social responsibility are becoming global trends that business leaders, asset owners and investment managers simply cannot ignore. But the answer does not seem to be a straightforward one, which calls for more and deeper dialogue between academics and industry practitioners.

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