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Can "doing good" lead to "doing well"?

— A Debate on Socially Responsible Investments

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Abstract:Socially responsible investments have been recognized as practical vehicles to boost global corporation's brand image. Among different major initiatives, Environmental, Social, and Governance (ESG) is a "popular" one and it essentially assigns ethical purposes to each investment and measures its societal impact and sustainability to address environmental, social and corporate governance concerns. Similar concepts can be found in the notion of Corporate Social Responsibility (CSR). Nonetheless, what are the actual driving forces behind this emerging movement? Is it a victory for social responsibility advocates of common welfares? Or rather, a new scheme for businesses to attract more investments? This paper aims to decode socially responsible investment mystery by deciphering different actors' interests, analyze the movement's financial impacts on corporation, and evaluate their outcome if possible. Essentially, this paper wants to address the question whether "doing good" can lead to "doing well"

Keywords:Socially responsible investments;Debate;financial

1 Brief History

Socially responsible investments' emergence has come a long way. In James S. Coleman's 1988 article Social Capital in the Creation of Human Capital, he questioned the overshadowing "self-interest" element of economics and advocated social capital's addition into the value measurement of investments. During the same year, John Elkington identified the "triple bottom line" as the emerging collection of non-financial considerations which should be included in businesses' evaluation. The coined phrase "triple bottom line" consists of financial, environmental and social factors. It was not until 1998 when journalists Robert Levering and Milton Moskowitz shed lights onto the corporate governance aspect of responsible investment. They authored the Fortune 100 Best Companies to Work For, in which the best-practicing US companies are ranked with regard to corporate social responsibility and linked to their financial performances. They found that optimizing corporate governance procedures maximized productivity and efficiency and led to superior utilization of talent management. There are various doubters who question the very existence of socially responsible investments and its potential impact on financial returns as well. Among many is Nobel Prize in Economic winner Milton Friedman, who famously argued in the 1970s that a firm's alignment with social responsibility negatively affect its ultimate financial performance— as profitability maximization should be companies' ultimate goals.[1]

2 Impacts of Firms

Before the discussion, it is essential for us to remind ourselves that corporations and firms are relatively new inventions of humans. Corporations and firms do not have physical presences like humans do - yet they have the enormous power to impose significant impacts on social and environmental matters. As Yuval Noah Harrari argues at the beginning of his book Sapiens: A Brief History of Humankind, a major reason why Sapiens took over the planet earth is the fact we, as a specie, have the capacity to imagine.[2]And corporations are indeed a form of imagination that might be too powerful to counterbalance in the future. At the very beginning of capitalism, the power of private enterprise grows with profits under no constraints, which often led to the terrible working conditions and severe environmental backlash. The city of London upon the beginning stage of industrialization can serve as a powerful example.

And a recent wave of immerse interests comes into wide attention, focusing on the optimal conducts of accomplishing productivity with adequate ethical behavior. Nonetheless, the fundamental discussion should be whether “doing good” will necessarily lead to “doing well”. “Doing good” should be broadly justified when a firm’s business ensures the fair shares of stakeholders and lives up to its social responsibilities. “Doing well” should be more roughly evaluated by a firm’s financial performances or social influence, as all for-profit firms were created to earn profits and all nonprofit corporations were created to win public recognitions.

3 Interests of Stakeholders and Shareholders

To understand why a firm wants to do “good”, we should first identify the chain of interests in business and decipher the inner dynamics within a firm. The most prominent dynamic should be the one between shareholders and stakeholders. Shareholders’ rights are open-ended, which means that shareholders’ payback is not guaranteed. However, shareholders have measures to name board members, including the group’s leader CEO. It is noticeable that the compensation of CEO has witnessed a vast increase recently.[3]While suspicion about CEO pay is rife, overall CEO pay in the United States, outside the financial sector, seems driven by company performance Pay tends to vary with performance; underperformers are replaced more quickly . This forces managers to align their interests with those of their shareholders by striving for revenue. While shareholders’ profits can be more ensured, firms’ managers might take extreme measures to secure better financial performances. This logistic should spark concerns over managers’ conducts that can be socially irresponsible. Another concern can be raised over short-termism.[4]It may lead businesses to neglect creating value in the long term. A typical fear is that the search for shareholder value will unduly favor cost cutting over long-term value creation . This is where the purpose of socially responsible investments can be potentially defeated. Instead of eyeing on long-term revenue, managers may target projects that promise more short-term income and please the shareholders.

Nonetheless, maximizing the value of shares in a company does not mean that profits should be maximized period-by-period. Thus, the price of shares actually reflects the discounted value of the stream of net profits into the indefinite future. Therefore, it is potentially virtuous for shareholders to accept lower profits for a certain period, if this were the right step to longer-term value creation.[5] People with short-term vision are usually other stakeholders, such as politicians and creditors. Politicians are in favor of increases in local firms’ hires prior to their elections; short-term creditors are indifferent to firm’s long-term performance as long as they receive their paybacks in an agreed time period. Furthermore, the buyer’s expectations of the future net profit stream affect and decide the price of stock.[6]Wise investors actually chip into firms that did not have current profits but a solid future earnings streamline. For instance, Amazon hardly recorded any profit until 2016, while remaining one of the most powerful technology companies. Insightful investors would choose to work with price-revenue ratios over price-earnings ratio to assess the value of stocks. Hence, shareholders may seek optimal long-term strategies and consider socially responsible investments. [7]

4 Approaches to CSR

Reputational mechanism is a prominent incentive behind socially responsible investments. Since it will largely reduce the risk premiums required by stakeholders ex ante, it is an essential screening process for honest behavior ex post.[8]Thus, the concept of corporate social responsibility (CSR) perfectly explains its own birth and addresses a collection of stakeholder management issue. CSR described approach of “doing well by doing good” comprehends the firm’s gains from keeping a decent reputation for not exploiting stakeholders ex post.

There are mainly four varieties of CSR cases. Three of these major cases may lead to “doing well”, while the other approach may promise sub-commercial return. To begin with, there can be a “win-win” situation, in which firms find profitable investment opportunities. For instance, firms upgraded their infrastructures (i.e. production line) with energy efficiency equipment, which further reduces company's greenhouse gas emission and save costs at the same time. Although solar panel can be expensive to install, the long-term benefit can overcome the initial loss. In this case, the firms maintain their behaviors of profit-maximizing, while committing to CSR.

Additionally, more and more customers are inclined to pay extra for "fair trade" items or eco-friendly products from firms that conduct socially or environmentally responsible businesses. Consumers would like to make a positive social impact through their purchase.[9] The range of such category can be broad in marketing terms: a pack of "fair trade" coffee beans might actually attract more buyers' interests. A well-known coffee retailer actually sells fair trade and organic coffee for 15 and 30 percent premiums over otherwise similar products . Furthermore, about one million US electricity consumers opted to pay a price with a roughly 16% premium for green power products . Hence, profit maximization can be realized through this approach, as well as being included in "shared value" initiatives .[10]In an econometrics survey that evaluated price premiums for green buildings, Eichholtz, Kok, and Quigley found that those with green ratings earn rental rates that are 3 percent higher per square foot than rental rates for other buildings with same demographics. Furthermore, sale prices can be 16% higher. Therefore, it is wise for firms to take on more socially or environmentally responsible businesses to extract more income out of consumers.

Third, many firms address CSR out of their fear simply over the possibility of losing reputation or even operating license. This type of strategic CSR cases is prevalent. In the hope of a reduction in strikes and protests, a firm may support social initiatives that focus on workers' health or fair pay for labors. Active involvement in CSR can secure the company's long-term interest and align stakeholders' interests with the goal of maximizing shareholders' value.[11]There are various literatures that review neoclassical market interactions channels where social advocates, environmental activists, or stakeholders may influence CSR level. More than 200 large firms that were subject to at least one protest, boycott, or citizen suit between 1971 and 2003, as Eesley and Lenox's studies found. Furthermore, representatives from Canada's largest firms reflected that their corporate plans for environmental issues are highly influenced by neighborhood and community pressures . Consumers' resentments against firms with poorly environmentally or socially responsible strategies impose significant shocks to its stock price.[12]Multiple empirical literatures find that consumers and union boycotts result in statistically significant stock price declines among targeted firms . Hence, firms incorporate CSR as part of their own strategies in order to avoid unnecessary operational risk that can dramatically affect companies' financial performance.

Lastly, some firms may actually pursue social or environmental goals that reduce profitability at the expense of shareholders. Among many, socially responsible investment funds may avoid investment in "dirty" industries, along with market benchmarks such as the Dow Jones Sustainability Index.[13]Despite a below average return from the investments, various funds would still advocate that investing in CSR related sectors will also increase returns. This is an interesting phenomenon. Kitzmueller and Shimshack also supported that some shareholders who themselves care about social or environmental performance may be willing to trade profits for CSR.[14]They criticized Friedman's conclusion that "the only responsibility of business is to maximize profits" as too simplistic. CSR can be simply perceived as a form of corporate expenditure as well. This remains consistent with the discretionary, and institutional legitimacy principles developed in the social issues in management literature .[15]Similar views can also be found in an "owners as stakeholders" perspective from the management stakeholder theory literature . Moreover, Reinhardt, Stavins, and Vietor point out that a reduction of sacrifice in the social interest will appear when social or environmental costs cannot be rolled over to stakeholders. Considering that public watch scrutinizes industries increasingly these days, shareholders may now even prefer expending investment on CSR to giving out bonus payments to managers.

To further decipher firm's motives, a stretched perspective can argue that CSR has the potential to construct a unique form of investment into cost-cutting innovation in long time, while other factors remain unchanged. To support their argument, Kitzmueller and Shimshack demonstrated Porter and van der Linde opinions regarding environmental regulation.[16]Environmental regulation's nature of increasing costs and decreasing market competitiveness only exist in a static environment. Meanwhile, innovation and technological advance constantly challenge the static environment and create dynamics.[17]Hence, if the market encourages a dynamic environment with transforming technologies, the continuance may produce public goods, eliminate negative externalities, improve product quality and enhance company's competitiveness. Nevertheless, this does require a supporting policy environment that allows firms to overcome detrimental short-term incentives.

5 Trustworthiness Over Impact Measure Indexes?

There are existing impact measure indexes, however, the calculation method remains sketchy and cannot be fully integrated into revenue-loss estimate. This sparks the discussion that the single bottom line should be defined as a measure of client satisfaction — a notion that traces back to the origin of business .[18]This also leads to the debate over people's perceptions of "good" business conducts. Different cultures may share different views over what constitute social responsibilities. Therefore, the definition of "ethical" and "good" business may be elevated into the realm of philosophical discussion. Consumers would suspect firms' motives behind their "good" business conducts, since companies may aim for maximization of profits by pretending to be nice.[19]Thus, the discussion should be boiled down to the "trust" element. If laws and contracts are inherently not flawless, corporations may utilize their means to exploit gaps and flaws. This "illegal" motive was born with for-profit company's profit seeking nature and can be found in every financial crisis. Warren Buffet has a lucid explanation for 2008 financial crisis---"it's only when the tide goes out that you learn who's been swimming naked." Hence, it is possibly more vital to influence companies to be trustworthy in order to protect stakeholders' rights.

Nonprofit firms may be perceived as the extreme cases in this discussion. In their world, nonprofit firms do not seek for equity but donations. The stream of donation keeps their operation running and generate portioned revenues. After the donated resources were given, they are in complete custody of the receiving nonprofit firms.[20]Furthermore, donors tend to have perceivable limited control over the donated resources — a "worse" situation compared to that of for-profit firms' shareholders. Therefore, the longevity of nonprofit firms heavily relies on their reputations and trustworthiness. Following this logic, a company's trustworthiness or reputation may be a better solution to measure its social or environmental impacts in some situations.

6 Challenges in Social Impact Accounting

The discussion comes to the assessment of how "well" firms are doing while doing "good".[21]An adequate gateway to gain insights from is through the return of impact investments. The impact investments should be defined as investments made in companies or organizations with the intent to contribute measurable positive social or environmental impact, alongside a financial return . Unlike financial return, the assessment of impact has not yet evolved to the point at which common approaches, metrics, and conventions have become widely accepted. Impact measurement does not yet have its equivalent of Generally Accepted Accounting Principles (GAAP). Essentially, none of the index can grasp a true cost function of social or environmental "bottom line".[22]Till this date, a real accounting bottom line is capable of capturing all relevant costs and benefits and of aggregating them, with the help of prices or shadow prices, into a measure of net benefit produced by a firm. This is feasible only when we have prices for all relevant costs and benefits, a relatively rare case . Shadow prices allocate monetary values to positive or negative effects of company behavior that are not currently priced in the competitive market. For instance, the effect of pollution is considered as shadow cost. Yet, it is still difficult to agree upon how exactly to price the shadow cost. Hence, without a global consensus over the calculation of shadow prices, there may not be a widely recognized approach to evaluate the true financial performance of socially responsible investments.

7 Possibilities of Sub-Commercial or Commercial Returns

Despite a yet-to-achieve consensus over the exact impact measure index method, numerous studies suggest it is possible for impact investors to earn sub-commercial returns and even commercial returns in their models. World leading organizations such as International Finance Corporation (IFC) has been active in impact investments that target low-income and fragile countries with targeted sectors.[23]According to IFC's report The Promise of Impact Investing

, their equity projects have performed competitively with emerging markets public equities from 1988-2016, whereas their senior loans have performed competitively with emerging market hard currency corporate bonds during the same time period. In details, IFC's completed equity investment projects had an average public market index (PME) of 1.36 since 1988 , meaning that their projects have returned 36 % more than an investment in the MSCI EM index during the same period of time. Furthermore, senior loans from IFC scored an average PME of 0.96 – a 4% deficit from the JPM CEMBI index.[21] An important caveat is that IFC's country and sector investment portfolio target financial services and infrastructure in less developed regions, which may not represent the actual average commercial returns in the industry. Meanwhile, the majority of impact investments' portfolio focus on East Asia or other more developed areas that have pre-existing necessary infrastructure and social welfare condition. Hence, the performance of IFC's investment may not be substantial and representative enough to justify a shift of interests into impact investment.

While it is essential to distinguish motives from those of traditional investments, there are two major challenges in assessing impact investment strategies. To begin with, the population of managers that implement impact investment strategies may be deficient, which may lead to miscalculation of the average return.[25]The number can be biased accordingly to the degree that worse performing mangers fail to participate. Furthermore, managers' expectation of returns can be hardly grasped. It is possible that some investors are not trying to achieve commercial returns in the first place. In other words, some impact investment fund managers mat be willing to accept sub-commercial returns, which can be misleading for the data set.

Two major studies made great progress in overcoming these biases by focusing on a comprehensive dataset of venture capital funds (VCs). Both of them find that impact funds deliver relatively lower returns on average. By using the Preqin dataset to identify impact funds through keyword searches, Barber, Morse, and Yasuda discover that the internal rate of return (IRR) of impact funds was 4.7 percentage points lower than those of all traditional VC funds. Further, Kovner and Lerner find that investees of these impact funds are noticeably less likely to achieve an initial public offering (IPO) or be acquired than those of traditional VCs. However, once one controls for industry and geography, the performance gap between impact funds and VC funds catches up.[26]This suggests the trend that fund managers might have systematically chosen sectors and locations with lower average commercial returns. Whether the fund managers knew about the expected decrease in returns remains unclear. Thus, Barber, Morse, and Yasuda advocates that impact fund investors may even have a preference to proceed with sub-commercial returns, which resonates with the fourth case of CSR. At the same time, this should be perceived as a warning signal that indicates doing "good" may not be compatible with doing "well".

Studies issued by the Global Impact Investing Network (GIIN) report average returns specifically for impact funds seeking average market rates in certain instances . In a sample identified by the Cambridge Associates, it is found that smaller funds (raising less than $100 million) returned a net IRR of 9.5%, while funds over $100 million achieved a net IRR of 6.2%. Moreover, a study conducted by the Wharton School of Business discovers that a sample size of 53 market-rate seeking impact funds achieved an IRR of 12.9%, which is almost identical to Russell 2000 index.[27]Nevertheless, it is possible that other poor performing funds refused to submit the data, driving the average IRR upwards. Conclusively, variations in the samples cannot provide a concrete argument. In this case, the correlation between doing "good" and doing "well" is still uncertain.

There are various literature pieces that suggest some impact investors have identified better opportunities because of impact seeking initiatives, and social and environmental criteria may be positively correlated with returns . They imply that the relationship, between funds' alliances with ESG and their financial performances, is likely to be positive or at least non-negative. Desai, Kharas, and Amin found this positive correlation in the IFC portfolio. Friede, Busch, and Bassen 's analysis of 1812 studies also identify the positive relationship in 48 percent if the studies, and a non-negative relationship in 93 percent of studies. The studies also argue that an independent firm is more likely to find this positive correlation than an investment portfolio. A score of 48 percent in positive relationship still would not overwhelmingly favor the notion that doing "good" is compatible with doing "well". Hence, this conclusion suggests that not all fund managers are able to beat public market's performance.

While these found evidences do suggest that doing “good” can lead to doing “well”, they also present an inarguable reality that doing “good” may not be the prominent cause to doing “well”. The impact measurement index vary greatly in different models and the studies’ sample size is constrained substantially by funds’ performance reports. Some firms and funds do find “good” opportunities that are also profitable — similar to the “win-win” CSR model. Nevertheless, these data do not indicate follow the steps of successful cases because clearly not all projects with positive environmental and social impacts are also financially sound.

8 Mediocre Compatibility

There are abundant empirical evidences that hold pessimistic perspective over the relationships between corporate social and financial performance. In many cases, these socially or environmentally responsible initiatives perform poorly.

As mentioned before, this movement might encourage environmental innovations that induce operational costs for responsible business. However, scarce evidences support this view that environmental performance stimulates financial performance through these innovations, and therefore CSR activities are unlikely to be costless to firms . Smaller enterprises will not be wise to opt for such attempts since it is most likely to cause more harm than good. Furthermore, extensive review literatures constantly report no systemic evidence that environmental performance encourages innovation at all, and the majority of empirical economic studies showcase a mild negative relationship between environmental performance and overall competitiveness.

Thus, the conversation comes back again to whether companies do “well” by doing “good”. Unfortunately, there is only a modest positive average correlation between corporate social and financial performance. Among many papers, Margolis, Elfenbein, and Walsh perform a comprehensive analysis of 192 relationships from 167 studies from 1972 to 2007. A major approach to understand the presented results in an economic context is as a test of not-for-profit CSR. While not-for-profit CSR to satisfy manager preferences is consistent with the moral hazard hypothesis most often attributed to the views of Friedman , their “desires” to satisfy investor preferences is consistent with the sacrificing profits in the social interest perspective of Reinhardt, Stavins, and Vietor . On average, the observed evidence fails to backup either not-for-profit CSR hypothesis. Furthermore, Davidson, Worrell, and El-Jelly identifies no significant financial market impact when a cohort of investors publicly announce stock divestitures for social purposes. Their announcements of doing “good” did not drive up stock prices in perceived amount. Another viable approach to test out the hypotheses forecasting that the correlation is through scores in average profitability. Margolis, Elfenbein, and Walsh only found a median correlation between social performance and financial performance of 0.08, a relatively small fraction in practical terms. Therefore, a firm’s commitment to socially responsible investment cannot guarantee desirable financial performance. In other words, doing “good” may not lead to doing “well”.

9 Conclusion & Outlook

The emergence of socially responsible investment is an undeniable trend in modern business world. As firms and corporation become more and more influential in the society, the conversation regarding their optimal conducts of accomplishing productivity with adequate ethical behavior gains huge momentum.[28]Having acquired a long-term perspective, stakeholders and shareholders have been intrigued to find the magical recipe that promise doing “well” while doing “good”.

They did find various approaches to obtain the perfect formula of CSR, including the creation of a “win-win” situation, the production of “fair trade” goods, the incorporation of CSR into their private politics, and even their acceptance of sub-commercial returns. Nevertheless, the exact measure of social or environmental impact and how exactly the cost can be weighed into revenue-loss calculation remain highly debatable. IFC did achieve some impressive above the average or non-negative financial performance from their impact investment projects and some studies do show that commercial or sub-commercial returns are viable. Yet, there are identified biases in the outcome since poor-performing fund managers may refuse to report their marks. Moreover, more empirical studies suggest that the correlation between corporate social and financial performance often lies in inadequate range. Therefore, this paper concludes that it is often less likely that firms can do “good” by doing “well” under current circumstances.

Nonetheless, this view does not present a pessimistic future for socially responsible investments. Alpha players in the market, including pension funds, sovereign wealth funds, and insurance companies, seek for more opportunities in this field. Their comparably long-term perspective and clients’ increasing demands for products that can demonstrate social and environmental impacts with adequate financial returns will only nurture more interests in socially responsible investments. It is up to every stakeholder and shareholder to push forward this valuable initiative together for a promising future and better environment.

Author Bio

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