Does Sustainability Pay Rewards In The Financial Marketplace?

Charles McPeak

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Chuck McPeak, Pepperdine University

ABSTRACT

Although the field of Corporate Social Responsibility (CSR) is relatively young and constantly evolving, there is evidence that well-managed CSR efforts, specifically among leaders in the field, can lead to an increase in financial performance. The increased interest in CSR among corporations, investors, and stakeholders indicates that a sea change is taking place with regard to the role of CSR in business strategy. According to a study conducted by KLD Research and Analytics, a socially responsible investing firm, 79% of companies in the S&P 100 included some sustainability reporting in their core reports in 2006, up from 34% in 2005 (Baue, 2006). More than 80% of respondents to a survey of CEOs in the US last year said that good corporate citizenship helps the bottom line (Fittipaldi, 2006).

The growth in CSR activity and reporting is the result of increased pressure from stakeholders as well as the threat of decreased resources and increased costs. The issue of climate change and its effect on risk management is also a concern that is pushing companies to increase their CSR efforts.

Some skeptics have dismissed CSR efforts as an extension of public relations or a defensive reaction to pressure groups that has little bearing on a company's financial performance. CSR will be considered by skeptics to be a passing fad until companies can show that their efforts affect the bottom line, and in turn, pass on a benefit to shareholders.

That being said, companies are slowly shifting the focus of their CSR efforts from a traditional philanthropic model to a more progressive approach that identifies opportunities for innovation and market building (InsideGreenBusiness.com, 2006). This shift has, in turn, yielded positive financial results. This progressive approach to CSR and its integration into the value chain has the potential to produce higher than expected returns.

Of the 56 US companies examined in this study, all of which are members of the Dow Jones Sustainability Index, 66.7% surpassed market expectations over a five-year period. The companies also beat the S&P 500 with regard to return on equity, indicating a link between the efficient management of CSR efforts and financial performance. Does this mean that companies with high marks for CSR are better performers? If one is looking at the DJSI companies in this study, which boast best-in-class status of CSR leaders, then the answer is yes. If one looks past the DJSI to the CSR movement on the whole, the answer is more ambiguous and depends on the various components that comprise a company's CSR approach.

DJSI BACKGROUND

The 56 US companies included in this study were all members of the DJSI World Index as of December 2006. At the time of this study, the US was in second place behind Great Britain in terms of the number of companies listed on the DJSI World Index.

The Dow Jones Sustainability Index, launched by the Sam Group in 1999, was the world's first global sustainability benchmark. The DJSI World covers the top 10% of all of the biggest 2500 companies in the Dow Jones World Index (DJSI, 2007). According to Claudia Wais, of the Sam Group, the DJSI follows a best-in-class approach and only includes industry leaders in the area of CSR (C. Wais, personal communication, November 10th, 2007).

Before gaining membership in the DJSI, companies are extensively scrutinized based on a variety of criteria that are quantified and weighted. The SAM assessment criteria, as well as the weightings for the criteria, are set by the research professionals at SAM (Wais, 2007). A company's economic, environmental, and social behaviors are considered. According to Ms. Wais, one of the many factors that sets the DJSI apart from other

sustainability indexes, is its consideration of industry-specific criteria, which leads to more meaningful measurements. At least 50% of the assessment includes industry specific-questions. Another factor that sets the DJSI apart is the performance orientation of SAM research, which focuses specifically on long-term performance of the companies.

This best in class approach has resulted in an excellent reputation for the DJSI among companies and stakeholders. Total asset management of the DJSI grew 30% from 2005 – 2007, to over $5 billion USD (InsideGreenBusiness.com, 2006). According to Ms. Wais, there are many benefits of DJSI membership, one of them being public recognition for being an industry leader in strategic areas covering economic, environmental, and social dimensions. The results are also highly visible, both internally and externally, which is not the case with all CSR efforts outside of DJSI membership. All of the components of the DJSI membership are publicly announced by the index publisher -companies are entitled to use the official "Member of the DJSI" label. This type of public recognition can lead to better financial performance as legislators, customers, and employees respond positively to the DJSI recognition. Ms. Wais also mentions that members can see increased financial benefit because of investments that are based on the Index. Through becoming a member of the DJSI, companies become eligible to be included in DJSI-based portfolios.

ANALYSIS

Most of the 56 US companies that were included in this study had been members of the DJSI since 2002 or even earlier. It was important to examine their financial performance during the course of their membership, and not before, due to the importance of the DJSI benchmark in terms of recognizing CSR leadership. The time period during which returns were calculated was between December 30th, 2002 and March 30th, 2007. Adjusted monthly returns were used for the final calculations and were compared to the adjusted monthly returns for the S&P 50 during the same period. Jensen's Alpha and Return on Equity were the two metrics used to assess financial performance during this period.

Jensen's Alpha is a calculation that measures the ability of active management to increase returns above those that are purely awarded for bearing market risk (Financial-Dictionary.com, 2007). It is calculated by subtracting the return of the stock or the portfolio from its expected return, or its Capital Asset Pricing Model (CAPM). If the value of Jensen's Alpha is positive, the stock has achieved excess returns and has "beat the market". The stock or portfolio is earning a return that is above its proper return for its level of risk.

Return on Equity (ROE) is another metric used in this study because it reveals how much of a profit the corporation generates with the money that shareholder's have invested. According to the Motley Fool, ROE is a "critical weapon in the investor's arsenal if understood for what it is." ROE is an important metric in this study because of the relationship between financial performance and effective management of CSR efforts. It encompasses the three main levers by which management can manipulate the corporation – profitability, asset management, and financial leverage. If one perceives ROE as a composite that represents management's ability to balance the three levers mentioned above, its value can be an accurate indication of whether the company will yield a decent return and also an assessment of how well management is performing (Fool.com, 2007).

RESULTS

Overall, the DJSI companies in this study outperformed expectations and the market from December 2002 to March 2007. Without taking risk or market expectations into account, the stock prices of the DJSI companies in this study increased, on average, 101%, while the S&P increased 57%. According to Jensen's Alpha calculations, 66.07% of the DJSI companies beat expectations, or had positive Jensen's Alpha values. 33.93% performed below expectations based on their level of risk. The average ROE value for the DJSI companies increased by 38% over this time period, while the ROE for the S&P 500 increased by only 12%.

One can conclude from these results that the DJSI portfolio, on the whole, produced better returns than the S&P 500. More importantly, however, the majority of stocks within this portfolio outperformed expectations, indicating a link between their status as CSR leaders and their superior financial performance. The growth in ROE is also an important result to take into account as it is indicative of superior management performance and supports the DJSI's "best in class" claim.

ANALYSIS OF RESULTS

There are several different strategic approaches to CSR management that could account for the link between the increased CSR and better financial performance of the companies in this analysis. In simple terms, the best CSR initiatives are also smart business decisions (Porter & Kramer, 2006). Successful CSR initiatives are integrated across the value chain and across business processes and are not relegated to one specific department (Porter & Kramer, 2006). Whether a company pursues CSR efforts to satisfy its stakeholders or to increase the efficiency of its supply chain, the efforts should be in alignment with the company's business strategy. In general, companies either take a soft or hard approach to CSR strategy, linking its value creation to brand equity or to supply chain efficiency, respectively.

One approach to CSR management suggests that a firm's market value relates directly to customer satisfaction. This is generally considered a softer approach with results that are more challenging to quantify. This approach creates value through CSR in that it helps to build a satisfied customer base and in turn, creates more brand loyalty and equity. In this situation, customer satisfaction partially mediates the financial returns to CSR (Luo & Bhattacharya, 2006).

A study published in the Journal of Marketing in October, 2006, showed that for a sample company with a market value of approximately $48 billion, one unit increase of CSR ratings would result in approximately $17 million more in profits on average in subsequent years (Luo & Bhattacharya, 2006). In other words, in order to reap a financial return from CSR, a company's efforts should be directly targeted to the stakeholders who will return profits back to the company, i.e. the people who care about and demand it (Marom, 2006). On the flip side, misalignment of CSR with internal factors can be detrimental and can lead to decreased value. When companies are not innovative in their approach they can run into costly pitfalls and can experience decreased rewards relative to cost (Marom, 2006).

Disney is an example of a company that has targeted the right stakeholders and has seen positive financial returns. Disney's value is augmented by its CSR initiatives through improved public perception and customer satisfaction. Many of Disney's CSR initiatives are crafted to maintain the wholesome reputation of its brand and to promote goodwill among employees and the community. According to Wendy Webb, the Executive Director of the Disney Foundation, metrics are still being developed to measure the financial impact of Disney's CSR efforts but the value of the Disney brand is still the primary metric. Ms. Webb cites several specific initiatives that have had a positive impact on the bottom line. The Foundation's "Disney Scholars" Program, as well as the company's "Volunt 'ear' ism" efforts, helps to retain employees and raise morale, leading to lower employee turnover costs. The Company's direct giving in community relations helps to promote good relations with the cities in which Disney does business, thereby assisting the Company in the kind of access it needs for lowering the costs of local expansion, hiring, and permitting. Over the long-run, Ms. Webb explains that "the Company's efforts should impact the consumer's perception of overall citizenship, thereby positively affecting reputation and brand value and translating directly into greater usage of Disney's products and services." She also cites another commonly seen benefit of CSR – that it can be used as "insurance" – building goodwill today to help offset ill-will from some future negative company event or issue. This "insurance" feature is especially important to a company like Disney, whose success is so closely tied to its brand perception (W. Webb, personal communication, November 2007).

A member of the DJSI, Disney is one of the companies in this study that outperformed expectations over the five-year period. It's stock price and ROE value increased by 114% and 129%, respectively (Yahoo Finance, 2007). Its Jensen's Alpha value was .66. Disney's CSR initiatives have contributed positively to its financial performance due to the fact that they are highly integrated into Disney's value chain. Disney is a prime example of company that has properly aligned its CSR and business strategies.

Another common CSR strategy focuses on increasing efficiency and innovation within the supply chain. This "hard" approach is generally more integrated across business processes and the results can more easily quantified than the approach previously mentioned. In the supply chain there are operational, financial, and reputational risks that can be mitigated through proper CSR management (Valentino, 2007). Supply chain management focuses on bottom line impact, cutting costs and preserving reputational value through ethical

labor practices. Weaving CSR into this business process can create a competitive advantage and can be more beneficial than CSR that is primarily focused on public relations efforts.

Cory Lowe, of the Rocky Mountain Institute (RMI) in Denver, Colorado, believes that increasing efficiency in the supply chain and achieving greater productivity from energy and resources should be the focus of a company's CSR effort. RMI is a not-for-profit think tank that changes how companies approach design in order to maximize efficiency. RMI helps companies see the ROI from their efforts through lower costs and increased environmental performance. One of their clients, Wal-Mart, is saving over $500 million per year in fuel costs due to RMI's truck efficiency strategies. These savings clearly affect the bottom line and are passed on to shareholders. Wal-Mart can also reap reputational benefits from the positive public perception of its environmental stewardship (C. Lowe, personal communication, October 25th, 2007).

How do these two CSR approaches affect market value? Through cost-cutting and through positive public perception. The advantage that the companies in this study have is that their CSR efforts are integrated into their value chain and also made transparent, due to their status as DJSI members. This advantage translates directly into improved financial performance.

WHY IS IT IMPORTANT TO PAY ATTENTION TO THIS SEA CHANGE?

CSR activity and advocacy have been growing across the entire stakeholder spectrum – from the CEO level down to the level of individual investors. The growth of socially responsible investing, or SRI, indicates that stakeholders believe there is a positive correlation between increased CSR and better financial performance.
Case in point, socially responsible investment has grown faster than the entire universe of managed assets in the US during the last ten years, according to the Social Investment Forum's fifth biennial report on SRI trends. Total socially responsible investment assets increased from $639 billion to $2.29 trillion - more than 258% - between 1995 and 2005 (Green-Money.com, 2007).

According to a Forbes study, investments in socially screened mutual funds have also grown significantly in recent years - from $12 billion in 1995 to $179 billion at the end of 2006. The best performing no-load SRI is the Winslow Green Growth Fund, with a 3-year annualized return of 35%. The Winslow Green Growth Fund has close to $300 million in assets and primarily screens for companies with positive environmental records. The Ariel Fund, started in 1986, is the largest no-load SRI, with assets of close to $5 billion. The fund has a 3 year annualized return of 19%, versus the 15% for the S&P 500 (Murdock, 2006).

In contrast to SRI funds is the Vice Fund, which boasts a minimum 80% investment in alcohol, gambling, defense, and tobacco stocks. Between 2003 and 2006, the Vice Fund outperformed all but 1 of the 9 top-performing SRI funds in the Forbes study, with a 27% annualized return (Murdock, 2006).

The growth of SRI is an important part of the overall CSR trend, but do increased holdings translate to higher returns? Not necessarily. It is important to look at several different factors, such as reporting and screening criteria, before drawing conclusions about the performance of SRI funds or any other CSR index, such as the DJSI. For example, one of the major reasons why some of the SRI funds in the Forbes study have lagged behind the market is because they do not invest in oil companies, which have been some of the top performers in recent years (Shanley, 2006). Also, several of the SRI funds, such as the Ariel Fund, are better at preserving capital in bear markets than making gains in bull markets (Shanley, 2006).

The field of SRI is still so undeveloped, relative to the larger universe of traditional investing, that it is difficult to draw any sweeping conclusions about the SRI on the whole. There is no denying the sea change, however, that is taking place with regard to the increase in SRI and the growth in CSR reporting. Given the lack of uniformity in the CSR reporting and CSR index criteria, one can only draw meaningful conclusions on a case-by-case basis.

CONCLUSION

There have been several studies conducted in recent years on the relationship between CSR and financial performance. Results vary but there is an increasing amount of evidence to support a positive correlation between the two factors. A study conducted by Morgan Stanley in 2003 found that the best CSR performers in their sample also yielded the highest returns. In their study, Morgan Stanley examined 602 companies that received the highest and lowest CSR ratings from Germany's Oekom Research independent rating agency. The companies rated by Oekom were also included in the Morgan Stanley Capital International (MSCI) World Index. Through calculating share performance from December 31st, 1999 to October 27th, 2003, they found that the best-in-class portfolio outperformed the CSR laggards by 23.4% (Fittipaldi, 2007). Their conclusion was that good corporate management tends to produce better financial results *and* sustainability performance.

The Morgan Stanley conclusion supports the results put forth in this study in that it not only identifies a link between CSR and financial performance but it points out the significance of CSR management in the creation of value. Part of the sea change that is taking place is the evolution of CSR management. As corporations find more innovative ways to weave CSR into their overall business strategy, they will increase their competitive advantage and improve their long-term financial outlook. At the same time the increasing demand for CSR - the growth of shareholder advocacy and SRI – will push innovation further. The DSJI index is ahead of the curve in terms of identifying that market leaders in this area.

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