The Implications of Corporate Social Responsibility for Investors[1]

An Overview and Evaluation of the Existing CSR Literature

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Abstract

This paper reviews the most important academic studies on CSR and ESG to show where the current research on this topic is standing. Along these lines we provide our assessment of the CSR literature where appropriate.

Key questions of this report are: What are the effects of superior CSR on corporate financial performance? What are the effects that particular aspects of ESG have on the cost of equity or cost of debt for firms? Does CSR make sense from a strategic management perspective? Are financial markets aware of CSR? And if so, what can investors do with those firms that display inferior CSR and ESG standards? These are questions this research paper endeavours to answer while reviewing the most important research studies on CSR and ESG.

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1. Introduction

The concepts of sustainable and responsible investing have been developed over more than three decades (Margolis, Elfenbein, and Walsh, 2009). Scholars have investigated what sustainable and responsible investing means, and what the consequences of responsible investing are for corporations, investors, corporate managers, and trustees. The most important question has been whether sustainable investing pays off in one way or another. Research has been conducted to show relationships between corporate environmental performance and corporate financial performance (CFP) (see, e.g., Derwall, Guenster, Bauer and Koedijk, 2005), between corporate social performance (CSP) and CFP (see, e.g., Edmans, 2011, 2012), and between corporate governance quality and CFP (see, e.g., Gompers, Ishii, and Metrick, 2003). Other questions centred on whether responsible business practices of firms are relevant from a corporate strategic management perspective (see, e.g., Porter and Kramer, 2006, 2011).

What the literature on sustainable and responsible investing has in common is that most research studies undertake efforts to find a causal relationship between some form of corporate sustainability and corporate performance, riskiness, or costs of financing. However, the literature on responsible investing suffers from a lack of commonality in the use of concepts. More specifically, some research papers investigate the effects of corporate social responsibility (CSR) on CFP (see, e.g, Eccles, Ioannou, and Serafeim, 2013), others investigate the effects of corporate environmental management on firm performance (e.g., Klassen and McLaughlin, 1996), and still others look at the corporate eco-efficiency and its effect on corporate performance (e.g. Guenster, Derwall, Bauer and Koedijk, 2011).

These different research focuses indicate that there is no common denominator in terms of defining CSR because these concepts embrace all kinds of different facets. Therefore, we will briefly outline the terminology that we use in the remainder of this paper.

1.1 Some terminology

We use the term "sustainable investing" to summarize all activities undertaken by investors to invest in a sustainable and responsible way.[4] Generally, a corporation's quality of CSR can be considered to be an indicator whether a company is suited for a sustainable investment portfolio or not. Since CSR is the focus of this report, it is important to stress that a corporation's social responsibility comprises many different facets and dimensions. But how can corporate social responsibility be defined? In our view, CSR embraces all corporate behaviours and organizational processes which directly or indirectly affect the corporation's stakeholders—be it in a monetary or non-monetary way. More specifically, we argue that extra-financial information on a corporation's environmental, and social behaviour as well as its governance structures can be used to assess corporations regarding CSR. In this paper, the information on **e**nvironmental (**E**), **s**ocial (**S**) and **g**overnance (**G**) quality of firms is summarized using the term ESG.

Each of the three dimensions consists of particular sub-topics. For example, the environmental domain consists of the quality of environmental practices such as the introduction of environmental management systems, pollution abatement, or measures for limiting carbon emissions. Similarly, the social dimension of ESG consists of the human rights policies and the presence of particular worker safety standards, etc. The governance dimension comprises issues related to executive compensation, the firm's board structure, and anti-takeover defences. There is

[4] We use the terms "sustainable investing" and "responsible investing" interchangeably throughout this research paper.

broad consensus in the academic literature that environmental, social, and governance information is extra-financial information which can be used by market participants like investors or analysts to value and assess corporations regarding their overall ***corporate social responsibility (CSR)*** quality.[5]

However, the literature on ESG, CSR, and responsible investing often investigates only parts of the entire ESG or CSR universe. For example, Edmans (2011, 2012) investigates the "100 Best Companies to Work For" in which he emphasises the employee relations as an important intangible social aspect of corporations. Other studies focus on corporate environmental behaviour as part of the entire CSR universe (see, e.g., Sharfman and Fernando, 2008). Still others do not consider governance as part of the CSR universe.[6] To overcome the pitfalls of a standard meta-study on CSR and ESG, we adopt a different approach. Here, we provide a review of the most important studies on CSR in general, but also on subtopics of ESG in particular. That is, with more general studies in which CSR is treated as a holistic concept, we also review those studies which in particular focus just on a single dimension of ESG because also particular subtopics of CSR are often of special importance to particular firms operating in specific industries.

Thus, we treat the concept of CSR as being the corporation's overall ESG quality, where the aforementioned sub-issues are part of the corporation's total CSR.

[5] Hence, we use the terms ESG and CSR as terms describing both the overall concept of corporate social responsibility because the "sum" of E, S, and G information is generally treated as a firm's quality of social responsibility.
[6] In this paper, we treat corporate governance as part of CSR. We do so, because certain aspects of a firm's governance structure, as e.g., co-determination of employees, or executive compensation practices designed to make managers adopting a more long-term orientation, are all aspects of CSR.

1.2 The goals of this paper: What it does and what not

This paper reviews the most important academic studies on CSR and ESG to show where the current research on this topic is standing. Along these lines we will provide our assessment of the CSR literature where appropriate. That is, we do not provide a pure meta-study of the topic.

Key questions of this report are: What are the effects of superior CSR on CFP? What are the effects that particular aspects of ESG have on the cost of equity or cost of debt for firms? Does CSR make sense from a strategic management perspective? Are financial markets aware of CSR? And if so, what can investors do with those firms that display inferior CSR and ESG standards? These are questions this research paper endeavours to answer while reviewing the most important research studies on CSR and ESG.

The objective of this research is not to provide a mere review of the existing CSR literature, but also to depict certain directions of future research which are – from our perspective - necessary to be undertaken, and what the consequences of the existing research findings for financial markets, institutional investors, and other market participants are.

From a philanthropic point of view it might sound reasonable to invest into "green" or "sustainable" companies because philanthropists often view the non-monetary "return" on their investments as more important than the financial return. Therefore, companies with superior CSR or ESG quality could be regarded by these investors as superior investment options because they provide a social benefit to stakeholders and society as a whole. Critics of CSR often call those investors depreciatively "tree huggers" or impact investors that have an overarching goal not to create financial return, but a social one.

Here, we do not argue that a company or an investment should be evaluated solely based on its CSR quality. Also, the ESG quality of a company should never be the only decision criteria in the financial industry. Contrary to a pure philanthropic view, we argue that investors should strive for a financial return which is generated in a socially responsible and sustainable way. In doing so, investors contribute to a more sustainable economy and society. In a sense, our argumentation follows Jensen (2002) who puts forward the so-called "enlightened value maximization" concept as the corporate's single objective. In his concept, the overall firm value maximization remains the overarching corporate objective. However, he claims that value maximization should also recognize other stakeholders because "it is obvious that we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency" (Jensen, 2002: 246). He also calls for better relations of corporations with their customers, employees, suppliers, investors and communities in order to ensure an enlightened value maximization strategy. However, he also makes clear that an organization cannot fulfil the needs of any stakeholder group; rather he calls for a prioritization for "choosing among those competing interests" of stakeholder groups in order to ensure that the firm "is to flourish and survive" (Jensen, 2002: 246).

In the remainder of this paper, the argument is: The overall goal of investing in a corporation is to generate a financial return, that is, to maximize shareholder value. However, it matters how this return is generated. We claim that investors have the responsibility to ensure that returns are created in a sustainable and responsible manner.

1.3 How to invest sustainably?

The financial industry generally suggests two distinct (but not mutually exclusive) ways of investing in a sustainable and responsible way. The first one is to apply certain "exclusion criteria" resulting in the exclusion of firms operating in particular industries, the so-called "sin industries". They comprise all firms involved in tobacco, gambling, defence, or alcohol industries. However, research on these sin stocks has shown that if these stocks are shunned by many institutional investors, the so-called "neglect effect" drives up the expected rates of return on those stocks (Hong and Kacperczyk, 2009). Hence, we argue that simply excluding stocks from the investment portfolio is not a viable option for institutional investors who would like to generate a financial return in a sustainable manner: "Irresponsible" firms are simply left aside without caring about their ESG standards.

The other option to invest responsibly is to apply particular inclusion screens which are used to evaluate a corporation's quality regarding its ESG practices. These screens are used to rank firms according to their performance regarding particular CSR criteria. In a next step, just the "top performers" within a single criterion are selected for investment, leaving the inferior corporations aside. This approach can be quite successful in financial terms. For example, research has found that this approach can lead to abnormal returns by going long in the top performing stocks regarding eco-efficiency, and shorting the inferior counterparts (Derwall et al., 2005).

Our paper will mostly review those studies investigating a particular sub-theme of CSR which is then applied to investigate its effect on the operational performance of a corporation, its cost of financing and its stock price performance. Where appropriate, we will also refer to studies investigating the exclusion method as a sustainable investment approach.

We will, however, not limit ourselves to merely investigating and reviewing existing studies on CSR. In the second half of the paper, we will show the extent to which the financial market is becoming more and more aware of CSR as extra-financial information used to price securities and we provide a third and alternative way to invest responsibly—this involves direct engagement with corporations that display an inferior CSR quality: We advocate an active ownership culture among shareholders in order to promote more sustainable and responsible business practices.

The remainder of the paper is structured as follows. Section II discusses the strategic management implications of CSR. In this section we discuss the strategic management perspective on CSR while Section III addresses the consequences of CSR for corporate costs of capital. Section IV continues with an overview of the performance debate: What are the implications of CSR for corporate performance? Section V covers research avenues we suggest to be undertaken in order to complete the discussion on CSR and its effects on corporations. In Section VI, we provide evidence on the learning effect in financial markets. In this section, we answer the question 'Are financial markets becoming aware of ESG information?'. In Section VII we conclude with our view of the future of sustainable investing.

2. CSR from a strategic management perspective

An obvious question which is relevant to corporate managers is whether CSR makes sense from a strategic management point of view. This perspective requires measuring the effects of CSR on corporations on additional dimensions other than financial impact. Several commentators have argued that a firm's social responsibility is highly important for its competitiveness and its relations with overall society (see Porter and Kramer, 2006). In particular, they claim that

CSR has to be "anchored" and completely integrated in a corporation's strategy in order to effectively create positive impact for its competitiveness. Similarly, Porter and Kramer (2011: 7) argue that corporations "can create economic value by creating societal value" alluding again to the importance of proper social responsibility as a competitive advantage.

In a similar vein, Hart (1995) introduces his "natural-resource-based view" of the firm. He argues that in order to sustain a competitive advantage in the future, firms have to take into account the natural environment they are operating in. In particular, he stresses three main dimensions of the natural environment that are of special relevance to firms: pollution prevention, product stewardship, and sustainable development. In his follow-up paper, Hart (1997) argues that it is of utmost importance for corporations to have a vision of sustainability in order to benefit from CSR in the long run by creating a competitive advantage. He also emphasizes the importance of today's powerful corporations in promoting sustainability in the overall economy around the globe.

Likewise, Eccles and Serafeim (2013) view the strategic importance of CSR as a dynamic process. In particular, they argue that good CSR practices can just survive in the long run if enough innovations within the firm take place in the firm of new products, business models, or processes (Eccles and Serafeim, 2013). For them it is of crucial relevance to quantify the materiality of each single CSR dimension – using for example the Sustainability Accounting Standards Board's (SASB) Materiality Map – in order to respond to upcoming challenges in an effective manner and to implement sustainable business strategies. In doing so, the authors claim that corporations can improve overall societal welfare and make society more sustainable (Eccles and Serafeim, 2013).

Overall, it seems as if the literature points to an important business case for corporate social responsibility. By introducing particular sustainable and responsible business practices, corporations can contribute to a more sustainable environment. However, what is important to stress is the fact that these sustainable business practices have to be deeply rooted in the corporation's business strategy, its supply chain, and in its corporate vision in order to effectively create impact for society. It is – also in our view – not sufficient to solely focus on the reduction of waste or pollution abatement; instead, more is needed for creating a more sustainable environment.

3. The effects of CSR on the costs of financing

The implementation of particular CSR policies also has directly quantifiable effects on corporations. It has been shown in the literature that a corporation's costs of financing are directly affected by the firm's quality of its CSR policies, its social policies, its environmental management practices and its corporate governance structures that are in place. Why is the CSR quality relevant to a firm's costs of financing? Why would investors care about a corporation's social responsibility in the first place?

The literature has shown that CSR can have direct impacts on a corporation's cost of debt and equity. In particular, it has been argued that environmental externalities impose particular risks on corporations, be it reputational, financial, or litigation risks (Bauer and Hann, 2010). The authors argue that "[f]irms that engage in environmental misconduct can incur costly penalties and evoke strong negative reactions from both financial and non-financial stakeholders, each of which affects their default risk […]" (Bauer and Hann, 2010: 2). This in turn implies that a firm's cost of debt is also affected. However, it is not only the corporation's debt financing costs which might be affected by CSR externalities, but also its cost of equity financing.

3.1 CSR and the cost of debt

Regarding the effects of CSR on a corporation's cost of financing the empirical evidence is very broad. To start with, Bauer and Hann (2010) investigate more than 2,200 bond issues in the U.S. regarding the effects of the corporate social responsibility quality and its effects on bond spreads. Relying on KLD scores as their main data source for CSR ratings, the authors document a significant and negative relationship between good environmental management practices and a firm's loan spread. Conversely, they document a significant and positive relationship between a company's environmental concerns and its loan spread. These results imply that companies which have better environmental management standards in place have lower loan spreads, and hence, exhibit lower costs of debt – after controlling for a variety of firm and industry characteristics. In numerical terms, the authors claim that a corporate's environmental management practices can have an effect of up to 64 basis points on the loan spread on an annual basis.

Several other studies also investigate the relation between the social responsibility of firms and its cost of financing. Chava (2011) arrives at similar conclusions as Bauer and Hann (2010) by investigating 5,879 loan facilities made to 1,341 US-based firms. He finds that corporations with several environmental concerns have to pay significantly higher interest rates on their loans. Likewise, Goss and Roberts (2011) report that firms with CSR concerns pay on average between 7 and 18 basis points more than firms with no CSR concerns. The authors claim that banks evaluate CSR concerns as risk factors and therefore offer those firms "less attractive loan contract terms" (Goss and Roberts, 2011: 1807). Another related study by Schneider (2011) investigates the effects of direct pollution on the loan spreads of firms operating in the US pulp and paper and chemicals industries. He shows that there is a significant and positive relationship between toxic emissions and corporate loan spreads and argues that "[p]oor environmental performance pre-

sents a significant downside risk in future cleanup and compliance costs. These costs can be so large to threaten the ability of polluting firms to meet their fixed payments to creditors" (Schneider, 2011: 1558).

3.1.1 The "G" dimension of cost of debt financing

The literature has not just focused on the environmental dimension of ESG when it comes to the impact of CSR on the cost of debt financing. It has also investigated the impact of corporate governance quality on the cost of debt financing, corporate credit ratings and yields.

Bhojraj and Sengupta (2003) are of the first to investigate the potential relationship between corporate governance mechanisms and bond ratings and yields. In particular, they study the effect of two main corporate governance mechanisms on bond ratings and yields: Institutional ownership and the percentage of outside directors on corporate boards. Their results indicate that these two mechanisms have a negative effect on bond yields and, conversely, a positive effect on bond ratings. We argue that these findings allude to a risk reduction role of shareholder governance mechanisms which are valued by bondholders but most likely not by shareholders. Likewise, Klock, Mansi and Maxwell (2005) show that the extent to which corporations have anti-takeover provisions in place – as measured by the well-known G-index as constructed by Gompers et al. (2003) – has a negative and significant influence on bond yield. Again, this points in our view to the fact that bondholders do like security and stability in corporate management. Ashbaugh-Skaife, Collins, and LaFond (2006) arrive at similar results with respect to the relationship between credit ratings and antitakeover provisions. They document that the number of anti-takeover provisions is positively related to bond ratings, implying lower bond yields for firms which are protected from the market for corporate control. However, and in contrast to

Bhojraj and Sengupta (2003), Ashbaugh-Skaife et al. (2006) find no relationship between institutional ownership and bond ratings. Rather, their results indicate that the number of blockholders is negatively and significantly related to bond ratings.

More recently, Cremers, Nair, and Wei (2007) also document that a particular shareholder governance mechanism, namely institutional ownership, has the potential to lower the yields on outstanding corporate bonds. However, this is just the case if and only if the company has several antitakeover measures in place which protects it from the market for corporate control. Likewise, but in a slightly different context, Chava, Livdan, and Purnaanandam (2009) investigate how shareholder rights – an important governance mechanism – influence the cost of bank loans of corporations. Their results show that firms which have fewer antitakeover devices in place pay on average significantly higher spreads on bank loans. In economic terms, Chava et al. (2009) report that three more antitakeover provisions in place will lead to an increase in the credit spread of about 12 basis points, which is in our view economically significant. On the other hand, there is an interesting study by Bradley, Chen, Dallas, and Snyderwine (2008) that documents there is no significant relationship between the G-index and credit ratings. However, the authors create another index which accounts for board stability and discretion. This index turns out to be positively influencing credit ratings which imply that bondholders value stable and persistent corporate management teams which is consistent with the findings by Cremers et al. (2007).

Overall, we believe that the literature on the relation between CSR and a corporation's cost of debt is indicating a negative relationship between CSR quality and cost of debt. In other words, a better CSR quality, and in particular better environmental management and corporate governance standards, can lead to lower cost of debt—be it in the form of lower bond spreads or

loan spreads of credit facilities. Corporate bond ratings generally tend to improve with better CSR standards. We believe that bondholders and banks are incorporating the extra-financial information on CSR quality in their pre-assessment and rating of potential borrowers. Creditors nowadays realize that firms with improper ESG standards in place might be prone to particular environmental, social, and governance risks which could have dramatic effects on a firm's reputation or financial position. Hence, lenders view proper CSR or ESG standards as risk-mitigating tools. These, if implemented correctly, can lead to more favourable lending conditions.

3.2 ESG characteristics and the cost of equity financing

In principle, the literature on CSR has not just concentrated on how it influences the cost of debt financing, but also on how the cost of equity financing are affected by CSR policies and ESG behaviour. Generally, we hypothesize that based on the findings regarding the cost of debt financing, one could expect that the risk-reduction characteristics of proper CSR standards also lowers the cost of equity financing because of a reduced firm-specific risk. The empirical findings from the literature on CSR and the cost of equity financing generally support our hypothesis.

Evidence that the cost of equity financing decreases with a corporation's corporate governance quality has been provided by Ashbaugh-Skaife, Collins, and LaFond (2004). The authors assess the economic effect of corporate governance attributes on the implied cost of equity of corporations and find that by just controlling for governance, well-governed firms exhibit a cost of equity financing which is 136 basis points lower compared to poorly-governed counterparts. Taking into account the commonly used risk factors of size, market-to-book and market risk, the effect difference between well- and poorly-governed firms is still at 88 basis points. We believe

that these findings indicate that good corporate governance standards lead to cheaper cost of equity financing. In a similar vein, Derwall and Verwijmeren (2007) also find that on average better corporate governance leads to lower cost of equity capital over the period from 2003 to 2005.

In contrast to the previous two studies that focus on the governance aspect of ESG, Ghoul, Guedhami, Kwok, and Mishra (2011) investigate the effects of overall CSR quality on the equity cost of equity capital in US publicly-traded companies over the period from 1992 to 2007. The authors find that on average firms with better CSR quality exhibit lower cost of equity financing. However, this result is driven by specific sub-categories of CSR, in particular by the corporation's quality of its employee relations, its environmental management quality, and its product quality. Furthermore, Ghoul et al. (2011) show that particular controversial businesses are mostly affected by the CSR quality: Firms operating in the nuclear power and tobacco industries exhibit a positive relation between their cost of equity capital and their CSR quality. In our view, this highlights the multi-dimensional character of CSR. What needs to be stressed is the fact that higher CSR quality apparently does not only translate into a lower cost of equity financing, but also in turn to a higher firm value (Ghoul et al., 2011; Derwall and Verwijmeren, 2007).

Additional supporting evidence for the claim that proper CSR standards lead to reduced cost of equity capital is provided by Sharfman and Fernando (2008). Focusing on one particular dimension of CSR, namely corporate environmental risk management practices, they find that firms with better environmental risk management exhibit significantly lower cost of equity capital. Sharfman and Fernando (2008) even document that the firm's overall weighted average cost of capital is significantly lower when it has proper environmental risk management measures in place. More recently, Albuquerque, Durnev, and Koskinen (2013) investigate both theoretically and empirically the indirect influence of CSR on the cost of equity through its beta. The authors

document that their self-constructed composite CSR index is significantly and negatively related to a firm's beta, which implies that it also reduces its cost of equity financing, all else equal.

Dhaliwal, Li, Tsang, and Yang (2011) show that the negative effect of CSR quality is biggest, when good CSR performers start to voluntarily disclose information on their CSR policies. In economic terms, Dhaliwal et al. (2011) report a reduction of 1.8 per cent in the cost of equity capital for first-time CSR disclosing firms with excellent CSR quality. Again, corporations tend to enjoy a benefit from good CSR policies – especially when they voluntarily report on their efforts to implement CSR standards.

The overall evidence provided by the academic literature on ESG and its relation to the costs of corporate finance alludes in our view to a negative effect of ESG on cost of debt and equity capital. That is to say, good corporate governance standards, as well as superior corporate social and environmental standards lower a firm's costs of financing significantly because those firms tend to exhibit lower risks, arising from reputational, financial or litigation concerns resulting from ESG scandals or issues. However, research in this field substantially lacks systematic evidence on the different effects of CSR on the costs of capital in different industries and also in different geographies.

4. The effects of CSR on corporate performance

The most intriguing question to investors and corporate managers is, of course, whether CSR also pays off in financial terms. The research on the relationship between CSR and firm performance goes back to the 1970s. However, we do not review the literature in a pure chronological fashion. Rather, we structure the literature along two dimensions. First, and also as explained in more detail below, we also structure this overview along the different aspects of CSR

and ESG in order to provide a complete picture on the effects of the different individual facets of CSR on corporate performance. Second, we make a distinction (where possible) between studies which look at operational corporate performance (accounting-based) and CFP (market-based). Even though the literature on single-industry sectors and geographical regions is relatively scarce, we do look at studies which make inferences about CSR in different industrial sectors and regions at the end of this section.

The topic of CSR and its effects on CFP has been investigated by researchers as early as the 1970s and 1980s. Arlow and Gannon (1982) conclude that back then, half of all published studies on this topic find a positive relation between CSR and performance, while the other half of the literature shows that there is a negative relationship present. Arlow and Gannon (1982) conclude that there is not that strong evidence in favour of the positive relationship between CSR and performance. Over the years, many meta-studies and review papers have attempted to provide a more complete picture of the relationship between CSR and CFP (see, for example, Orlitzky, Schmidt, and Rynes, 2003, Margolis and Walsh, 2003, and McWilliams, Siegel, and Wright, 2006). These meta- and review studies have in common that they do not find very strong and significant evidence in favour of a positive or negative relationship between CSR and corporate financial performance. However, the general conclusion we draw from these meta- and review studies is that there is at least some positive correlation between CSR and CFP.

To start with, Orlitzky et al. (2003) conducted a meta-study and focused on the question whether CSR affects CFP in any way. In their analysis, they mainly concentrate on management-related studies and disregarded financial studies. This is in our view due to the fact that back then not many financial journals published studies on sustainable investing and CSR. Overall, Orlitzky et al. (2003) conclude that both social and environmental responsibility pay off in financial

terms. Furthermore, the authors argue that CSR seems to be more strongly related to accounting-based performance measures than market- based performance proxies.

Margolis and Walsh (2003) come to a stronger conclusion after having reviewed 127 studies on CSR. In their quite comprehensive review, they conclude that "[a] simple compilation of the findings suggests there is a positive association, and certainly very little evidence of a negative association, between a company's social performance and its financial performance" (Margolis and Walsh, 2003: 277). In their reviews, Orlitzky et al. (2003) and Margolis and Walsh (2003) discuss papers which find significant and positive relations between certain measures of CSR and corporate financial performance, but also papers which provide evidence on a negative relation between the two constructs. McWilliams, Siegel, and Wright (2006) broach the issue of contradicting evidence in the CSR-financial performance literature. They address the problems which have to be resolved by researchers in order to arrive at robust conclusions about the relation between CSR and CFP. The authors state that both theoretical and empirical problems have to be resolved in order to arrive at a definite conclusion. In particular, they point out that there is no single definition of CSR and that research in this field still suffers from measurement inconsistencies of CSR (see also Beurden and Gossling, 2008). Consistent with this view, the measures of CSR used in the literature have also evolved over time. Orlitzky et al. (2003), e.g. point out that earlier research papers take "environmental performance as a proxy for social responsibility" (p. 412). Therefore, earlier studies are actually in their nature and their measurement of CSR completely different than more recent studies which may take employee well-being (Edmans, 2011, 2012) or corporate eco-efficiency (Derwall et al., 2005) as CSR measures.

Because of these inconsistencies in measurement of CSR and CFP, we do not adopt a pure meta-study approach in this section. In our view, comparing studies on CSR is difficult because

there are many different CSR measures and CSR consists of many different facets and dimensions—it is almost impossible to reach a consensus on a proper CSR measure or definition. As in the earlier sections, we will take account of the fact that CSR consists of different dimensions (e.g., environmental, social, and governance dimensions and respective sub-topics in each dimension) and we will describe ways and opportunities how the debate on the effects of CSR on CFP could be resolved.

We start with a review of the studies which use aggregated CSR scores in one or the other way in order to study the effect of CSR on CFP.

4.1 CSR and performance: Evidence from aggregated CSR measures

Even though the literature has become more and more aware of measurement problems and other inconsistencies of using aggregate CSR scores, there is evidence provided by studies testing for a relationship between CSR and financial performance using aggregated CSR scores. In the 1990s a new stream of papers emerged using a – back then – new data source for testing the hypothesis that CSR has an effect on corporate social performance, namely the Kinder, Lydenberg, and Domini (KLD) data. This data provide social ratings on a wide range of environmental, social, and governance sub-themes for a large number of publicly listed firms. The sub-themes range from human rights, worker safety standards, governance practices, to the presence of particular environmental management qualities. The data evaluates firms based on their 'strengths' and 'concerns' in each dimension — researchers most of the time construct their own aggregate indices of sub-themes which take account of corporations' ESG 'strengths' and 'concerns' in certain sub-CSR themes. The seminal paper by Waddock and Graves (1997) represents the start of that emerging literature strand. Based on the KLD data, the authors then construct an aggre-

gate CSR index and test the effect of that index on corporate operational performance measures such as return-on-equity, return-on-assets, and return-on-sales. Waddock and Graves (1997) arrive at a two-folded conclusion. First, the quality of a corporation's social responsibility depends on past financial performance which is, according to the authors, consistent with the "slack resource view" which states that stronger financial performance in the past makes it more likely that corporations spend on CSR in the future. This evidence is also consistent with Hong, Kubik, and Scheinkman (2012). Second, Waddock and Graves (1997) also show that future financial performance also significantly depends on good CSR which they attribute to the "good management hypothesis".

Related is another early paper by Hillman and Keim (2001) that relies on an aggregate index as CSR measure. They study S&P500 firms regarding their stakeholder management practices. To do so, they create two separate CSR constructs. The first is a so-called "stakeholder management" variable that takes account of all primary stakeholders such as employees, customers, and shareholders. Second, they construct a "social issue participation" variable based on particular social issues such as exclusionary screens (such as alcohol, tobacco, and gambling firms; or even nuclear power exclusions). In their empirical analysis, Hillman and Keim (2001) find that stakeholder management quality is positively related to CFP. Furthermore, their results indicate that social issue participation is negatively associated with shareholder value. They conclude that primary stakeholders are apparently more important than social issue participation for shareholder value creation. Similar results are documented by Baron, Harjoto, and Jo (2011). By investigating over 1,600 firms they find that social pressure (measured by KLD concerns) is negatively correlated with financial performance (Tobin's Q). However, Baron et al. (2011) show that CFP is not correlated with CSR (measured by an index comprised of KLD indicators). In sum, the pa-

per makes an important contribution to the whole CSR literature by concluding that "greater social pressure is associated with worse [CFP], which could reflect the effects of social pressure on firms' reputations, brand equities, or productivities" (p. 38).

More evidence in favour of a positive relationship between CSR and financial performance is provided by Servaes and Tamayo (2013). By relying on different aggregated CSR indices; they conclude that CSR has a positive effect on financial performance, especially when the advertising intensity of a corporation is high: Firms benefit most from CSR if they also pro-actively advertise. Next to advertising intensity, there is also evidence on other moderating effects affecting the relation of CSR and financial performance. For example, McWilliams and Siegel (2000) show that the widely documented positive and significant effect of aggregated CSR scores on financial performance is driven R&D expenditures. Using data for 524 firms for the period 1991 to 1996, McWilliams and Siegel (2000) find that the generally large and positive influence of CSR on financial performance becomes neutral and small, once the model accounts for R&D expenditures. We would like to stress, however, that the authors' measure for CSR is just a binary variable – indicating whether a firm is member of a particular social stock market index – to account for CSR which might not be the best way to measure CSR. Cheung (2011) in fact even proves that there is no strong evidence that the announcement of inclusion or exclusion from a sustainability index has any significant impact on stock return and risk. More specifically, upon the day of the inclusion (exclusion), the author finds a ***temporary*** positive (negative) stock market reaction. We would like to emphasize that this study is in its nature slightly different from the other papers reviewed in this report. It takes the inclusion in a social index as a proxy for a corporation's CSR quality. Interestingly, the author documents that most of the sample firms are

operating in the manufacturing industry, implying that also more CSR-sensitive industries frequently become a member of a sustainability index.

In a corporate finance context, the effects of an aggregated CSR measure have also been investigated. Deng, Kang, and Low (2013) study 1,556 completed US mergers between 1992 and 2007 to address the key question whether CSR creates value for acquiring firms' shareholders. They find that superior acquirer CSR quality creates value for both the acquiring shareholders and the target shareholders. In our view, even more important, is the finding by Deng et al. (2013) that CSR has a significant and positive effect on long-term stock return. This adds to the discussion that CSR is able to create long-term value. In economic terms, Deng et al. (2013) find that by going long in high CSR acquirers and going short in low CSR acquirers, investors are actually able to realize an annual risk-adjusted abnormal return of 4.8 per cent, 3.6 per cent, and 3.6 per cent over a one-, two- and three-year holding period, respectively. Also, Deng et al. (2013) document that bondholders' CARs (cumulative abnormal returns) are generally negative upon the announcement of the merger, but they are less negative for those mergers in which a high CSR acquirer is involved which adds to the evidence provided by Cremers et al. (2007). One of the benefits of the study by Deng et al. (2013) is the fact that CSR in the context of corporate mergers could attenuate the reverse causality concerns inherent in studies on the effects of CSR on CFP.

In a recent working paper, Eccles et al. (2013) study the performance differential between high- and low-sustainability firms. They classify the sustainability quality of firms based on a kind of a sustainability index which evaluates whether corporations adopt several different kinds of CSR policies (e.g., human rights, environmental issues, waste reduction, product safety, etc.). They also primarily investigate the stock market performance of both groups of firms and there-

fore circumvent any reverse causality issues. Their empirical analysis reveals that a portfolio consisting of low-sustainability firms exhibits significantly positive abnormal returns. Further, also the high-sustainability portfolio displays positive and significant abnormal returns over the sample period. However, the performance differential between the two portfolios is economically substantial and statistically significant. Specifically, a high-sustainability portfolio "outperforms" the low-sustainability portfolio by 4.8 per cent on an annual basis. Even when using a value-weighted portfolio, the results indicate an annual outperformance of 2.3 per cent. Eccles et al. (2013) also find that the high-sustainability portfolio outperforms the low-sustainability portfolio in eleven out of the 18 years of the sample period. Overall, the authors' findings allude to the possibility to earn a risk-adjusted abnormal return by investing in superior CSR firms.

In an interesting study by Hawn and Ioannou (2013), the authors investigate whether just symbolic CSR actions affect firm values or whether corporations have to undertake real, "substantive" CSR actions, in order to affect firm value. To answer these questions, the authors use a composite CSR index based on the data provided by ASSET4 and which consists of sub-ratings regarding corporate environmental, social, and governance performance. Hawn and Ioannou (2013) examine 2,261 firms between 2002 and 2008. Their results indicate that symbolic changes significantly increase Tobin's Q, while substantive CSR action do not have any significant effect on firm performance. "This paper suggests that firms with an established base of CSR resources might undertake symbolic actions largely because it is relatively less costly for them to do so, and also because such firms enjoy sufficient credibility with social actors to get away with it" (p. 23). Hence, we conclude as well, that it may be also the corporation's past CSR reputation which matters for future financial performance effects of newly introduced CSR actions. This argument is also in line with Bauer, Moers, and Viehs (2013) who show that CSR resolutions at

annual general meetings are more often withdrawn than corporate governance resolutions. The authors argue that it is much easier for corporations to change CSR practices; or in the words of Hawn and Ioannou (2013): to undertake symbolic CSR actions.

This section provides an overview of studies which use an aggregate CSR measure in order to test the relationship between CSR and CFP. The review provides mixed findings, although the evidence points towards a positive relationship between CSR and performance. However, we would like to emphasize that these ambiguous findings are a result of the use of aggregate CSR measures which do not account for differences in importance of particular CSR topics. The effects of some CSR sub-topics may offset the effects of others, implying that the results are deemed to find less significant (or even neutral) effects from composite CSR measures on financial performance. Hence, we strongly advocate the analysis of particular CSR sub-categories, in order to indicate the effects of ESG on CFP.

As we have shown in the previous paragraph, still many studies use aggregate CSR scores. However, there is also some evidence on the effects of particular fine-grained CSR classification on CFP. In the section that follows, we review papers which merely look at particular sub-topics of CSR.

4.2 The financial performance effects of the "E" dimension

Several studies investigate the effect of corporate environmental performance on the financial performance of corporations. In an attempt to investigate whether environmental ratings of corporations affect CFP, Russo and Fouts (1997) find a positive and significant relation between environmental and corporate operational performance as measured by the firm's return-on-assets ratio. Going one step further and investigating the effect the growth of the corporation's industry

has on this relationship they conclude, that the positive relation between environmental and financial performance is even stronger in high-growth industries. Likewise, Hart and Ahuja (1996) find that it pays to be green: using cross sectional yearly regressions, the operating performance is significantly improved in the year following the reduction in emissions. The authors also find that "the biggest bottom line benefits accrue to the high-polluting companies where there are plenty of low-cost improvements to be made" (Hart and Ahuja, 1996: 36). This is an interesting argument implying that the highest polluting firms can benefit most in terms of financial performance, though the low-polluting firms might have had pollution prevention schemes in place for years. Hart and Ahuja (1996) argue that the environmentally-best-performing firms have to invest more in order to even further lower emissions. An obvious question arises out of this finding: In how far does the stock market pick up this asymmetric relationship between high- and low-polluting companies? First indicative evidence regarding this question is provided by Klassen and McLaughlin (1996) who document significant abnormal returns following positive environmental events. Apparently the market values positive environmental news.

Relatedly, the seminal work by Derwall et al. (2005) investigates the stock market performance of eco-efficient and non-eco-efficient firms with a focus on the concept of "eco-efficiency" as a measure of corporate environmental performance. They define it as the economic value that the company generates relative to the waste it produces in the process of generating this value (p. 52). Over the period from 1995 to 2003, Derwall et al. (2005) find that the most eco-efficient firms deliver significantly higher returns than the poorly performing firms. Even after accounting for transaction costs, market risk, investment style, and industries, this result persists. King and Lennox (2002) obtain similar results and claim that proper waste prevention

causes better financial performance. We argue that this important finding points to a positive relationship between corporate environmental performance and financial performance.

In direct relation to Derwall et al. (2005), Galema, Plantinga, and Scholtens (2008) investigate the financial performance of SRI and non-SRI stocks. Using data from KLD, they argue that the generally found positive and significant alpha of SRI stocks/portfolios is actually due to the fact that CSR and non-CSR stocks differ in their book-to-market ratios. And indeed, Galema et al. (2008) document that amongst other factors, corporate environmental performance significantly lowers the book-to-market ratios, implying that the return differences between high CSR and low CSR stocks is created through the book-to-market channel because "SRI results in lower book-to-market ratios, and as a result, the alphas do not capture SRI effects" (Galema et al., 2008: 2653).

More recently, Guenster, Derwall, Bauer, and Koedijk (2011) examine the relationship between eco-efficiency and financial performance of corporations between 1997 and 2004. The results of this paper indicate that better eco-efficiency significantly increases corporations' operating performance, measured by their return-on-assets. Similarly, the results also indicate that a firm's Tobin's Q is positively and significantly influenced by its eco-efficiency, even after controlling for firm characteristics. In sum, the authors conclude that the positive relationship between eco-efficiency and corporate performance is persistent over time. In a similar vein, Tobin's Q seems to be affected by the release of toxic chemicals and environmental lawsuits against the firm (Konar and Cohen, 2001). More specifically, Konar and Cohen (2001) show that both the release of toxic chemicals and the number of environmental lawsuits are significantly and negatively related to Tobin's Q. Based on their sample and statistical results, they conclude that a 10 per cent reduction in chemicals released leads to an increase in the firm's intangible as-

set value of more than $34 million. The author's industry analysis reveals that manufacturing companies suffer most in economic terms when they have a poor environmental performance. Likewise, Jiao (2010) argues that corporate environmental performance is the driving force behind the positive relation between stakeholder welfare and CFP (measured by Tobin's Q) which he documents in his paper.

In addition to those studies which take environmental ratings as the main measure, other studies use different proxies for corporate environmental performance and responsibility. Amongst other things, the literature investigates the effects of voluntary environmental reporting and environmental performance certification by third-party organizations on CFP. Recently, Fisher-Vanden and Thorburn (2011) study whether shareholder wealth is affected by voluntary participation in corporate environmental initiatives. The authors study 117 firms over the period 1993 to 2008 and examine shareholder-wealth effects resulting from participation in the voluntary environmental programmes using event study methodology. Overall and across several empirical specifications, Fisher-Vanden and Thorburn (2011) document a significant and negative stock market reaction upon the announcement of joining the voluntary environmental performance initiatives. Shareholder value is therefore destroyed by voluntarily joining these programmes. Hence, the authors conclude that "corporate commitments to reduce GHG emissions appear to conflict with firm value maximization". The wealth destroying effects are in fact even larger for corporations with weaker corporate governance structures. Consistent with the previous evidence, Jacobs, Singhal, and Subramanian (2010) also find a negative market reaction to the announcement of voluntary emission reduction initiatives participation. To make their point, the authors use two different categories of environmental performance. The first one includes the Corporate Environmental Initiatives (CEIs) "that provide information about self-reported corpo-

rate efforts to avoid, mitigate, or offset the environmental impacts of the firm's products, services, or processes" (Jacobs et al., 2010: 430). The second category includes information on "Environmental Awards and Certifications (EACs)" that provide info about third-party recognition of corporate environmental performance (p.430). The authors find that the market does not react to announcements in the aggregate categories of the CEI and the EAI. Therefore, the authors also investigate topical sub-categories of environmental performance, for example "environmental business strategies", "eco-friendly products", "recycling". For some of those categories they find significant abnormal stock price changes around the announcement of the participation in the environmental initiatives. For example, philanthropic gifts for environmental causes result in a statistically significant and positive mean abnormal return. In contrast, announcements of voluntary emissions reductions result in a statistically significant and negative abnormal return.

Thus, there seems to be a persistent negative market evaluation of voluntary environmental management programmes causing stock prices to fall on the announcement date of participation. But why do companies still participate in these kinds of initiatives? Fisher-Vanden and Thorburn (2011) argue that these companies may feel pressure from shareholders to do so. In our view, especially large institutional shareholders could play a role in pressuring corporations to participate in these voluntary initiatives.

Other studies provide evidence for a negative relationship between corporate environmental and financial performance. E.g., Brammer, Brooks, and Pavelin (2006) demonstrate that for UK companies, firms with good CSR ratings tend to underperform in relation to their poor CSR counterparts and they attribute this finding to the environmental indicators driving this finding. The authors conclude that "various aspects of corporate social behaviour must be examined sepa-

rately in order to achieve an accurate picture of their impacts on returns" (Brammer et al. 2006: 114). This argument is taken up by Jayachandran, Kalaignanam, and Eilert (2013) who claim that CSR should not be measured on an aggregate basis. They investigate specific dimensions of CSR: Product social performance and environmental social performance. By analysing 518 firms and 3,701 corresponding firm-years, and find that a firm's environmental performance does not significantly relate to Tobin's Q (Jayachandran et al., 2013). Hence, we believe the conclusions of this study allude to the important fact that researchers need to investigate separate dimensions of CSR in order to establish robust relationships between CSR and financial performance. Often, aggregated CSR scores include sub-scores (e.g. community, environmental, and human rights scores) which offset each other or which lead to opposing results causing the overall relationship between aggregate CSR scores and CFP to be insignificant or even negative.

To conclude this section on the effect of corporate environmental on CFP, we claim that the majority of studies which take real environmental ratings, carbon emissions, or eco-efficiency as proxies for corporate environmental performance finds that the better a corporation's environmental performance, the better its financial performance – however measured. Whether the studies always observe a causal relation between the two constructs (environmental and financial performance) or whether financial markets are not able to price proper environmental policies yet, still remains an open question.

4.3 The "social" dimension of CSR and its relation to financial performance

The literature also investigates the effect of particular social issues on CFP. The social domain of CSR also consists of sub-categories. Some researchers subsume employee relations (Edmans, 2011), or charitable giving (Brammer and Millington, 2008) as corporate social issues.

However, in comparison to the literature on corporate environmental performance in relation to financial performance, the evidence on corporate social performance and its effect on financial performance is not that broad.

The most prominent research study on the social dimension of ESG and its effect on CFP is by Edmans (2011). He investigates the "100 Best Companies to Work For" to assess whether there is a relationship between employee well-being and stock returns of the respective companies. The results of Edmans (2011) indicate that a portfolio of the "100 Best Companies to Work for" earned a risk-adjusted abnormal return of 3.5 per cent annually in excess of the risk-free rate from 1984 to 2009 and 2.1 per cent above industry benchmarks. Edmans (2011) argues that the stock market obviously does not fully value intangibles in the form of employee relations. In his follow-up paper which appeared in the Academy of Management Perspectives, Edmans (2012) extends the sample period until 2011 and tests for any abnormal returns over the new sample period from 1984 to 2011. Consistent with his earlier findings, the results indicate an abnormal profit of 3.8 per cent annually in excess of the risk-free rate. Likewise, the abnormal returns adjusting for industries are higher than in the shorter sample period with 2.3 per cent annually (Edmans, 2012). Since the abnormal returns seem to survive over the longer term, the market has still not yet priced in all the information regarding employee satisfaction.

This evidence points in our opinion to a significant causal relationship between employee satisfaction on one side and CFP on the other side. As Edmans (2011, 2012) correctly argues, his approach of using stock returns as a financial performance measure reduces concerns regarding reverse causality. We believe that these findings clearly show that proper corporate social behaviour of firms (in this case, employee satisfaction) causes better financial performance.

Brammer and Millington (2008) also focus on one specific dimension of CSR to test whether it pays off for companies "to be different", namely corporate philanthropic donations. Brammer and Millington (2008) find that firms that made either unexpectedly very high or very low CSR charitable donations have higher financial performance than other firms and conclude that good social performers do best in financial terms over longer time horizons. It is, however, important to note, that they focus exclusively on UK firms and acknowledge this may bias the results in one or the other direction, because in the UK the majority of donations are made directly by corporations. Relatedly, we question whether charitable donations are a real measure for CSR or if donations are just seen as a "symbolic action" as pointed out by Hawn and Ioannou (2013).

Research on the banking industry also revealed a positive link between CSR and financial performance. Simpson and Kohers (2002) show that banks that have better ratings with respect to the "Community Reinvestment Act Ratings" exhibit better financial performance. Contrarily, the corporate reputation itself matters as well: McGuire, Sundgren, and Schneeweis (1988) show that future financial performance is not as strongly related to CSR as past financial performance. The authors attribute this finding to the fact that a "lack of social responsibility may expose a firm to significant additional risk from lawsuits and fines and may limit its strategic options" (p. 868)

Given the reviewed evidence, we conclude that the social dimension of the ESG universe generally has a positive influence on CFP. This conclusion is based upon the vast majority of studies that focus on a social sub-topic of CSR were able to find a positive link between the quality of the social dimension of CSR and financial performance. What is missing in this research strand is more direct evidence on other corporate social behaviours, for example, worker safety

standards of corporations in emerging markets, the respect of human rights, or socially responsible advertising campaigns — this evidence is still clearly missing in the existing literature.

4.4 Governance and financial performance

The financial economics literature in general and the corporate finance literature in particular clearly focus more on research which relates the corporate governance quality to CFP. It is often claimed that (1) corporate governance quality is easier to quantify than environmental or social performance and (2) the consequences are much easier to measure.

The corporate governance literature has focused on particular features of a corporation's governance structure to investigate effects on profitability and financial performance. Most studies focus on external governance mechanisms like the market for corporate control (e.g., Gompers et al, 2003) or the level of industry competition (e.g., Giroud and Mueller, 2010, 2011), or on internal mechanisms like the board of directors (e.g., Bebchuk and Cohen, 2005, or Yermack, 1996), executive compensation practices (e.g., Core, Holthausen, and Larcker, 1999) and the ownership structure (e.g., Gompers, Ishii, and Metrick, 2010). In contrast to the environmental or social dimension of ESG, we can draw a very definite conclusion from the corporate governance literature: Superior governance quality leads to better financial performance because shareholders do value good corporate governance. This is the case because proper corporate governance structures limit managerial entrenchment.

Probably the most well-known confirmation that good corporate governance pays off is by Gompers et al. (2003). They investigate the performance implications of the exposure of corporations towards the market for corporate control. Gompers et al. (2003) construct a governance index which consists of 24 unique antitakeover devices. Higher values of this index imply many

antitakeover mechanisms in place (≥ 14), or a low level of shareholder rights ('dictatorship' or poorly-governed firms). Contrarily, well-governed firms display very low levels (≤ 5) of the governance index (the 'democracy' firms). The empirical analysis of Gompers et al. (2003) reveals that a long-short portfolio of well-governed and poorly-governed firms leads to a risk-adjusted annual abnormal return of 8.5 per cent over the period 1990 to 1999. That is to say, well-governed firms significantly outperform poorly-governed firms (measured by their protection from the takeover market) by 8.5 per cent annually. A long-short strategy, hence delivers a significant alpha over the investigated sample and time period. Cremers and Nair (2005) provide similar evidence by studying the effects of both the takeover vulnerability and the strength of internal corporate governance mechanism. The authors find that a portfolio that goes long in firms with well-governed firms (low takeover vulnerability) and short in poorly-governed firms (high takeover vulnerability) creates an abnormal return of 10 per cent to 15 per cent annually. This result, however, only holds when internal governance is also strong, that is, only if there is high institutional ownership. More recently, Cremers and Ferrell (2009) provide additional supporting evidence for the valuation effects of superior corporate governance structures. By investigating thirty years of data from 1978 to 2007, they document that an investment strategy which involves taking long positions in well-governed firms while shorting the poorly-governed counterparts at the same time, delivers consistently significant alphas. Taken together, these findings reinforce our claim that superior governance quality is valued by the financial market.

The governance index constructed by Gompers et al. (2003) comprises 24 different governance provisions; mostly related to takeovers, while Bebchuk, Cohen, and Ferrell (2009) focus on a subset of the governance index., They specifically construct a so-called "entrenchment index" which is based on only six governance provisions. Bebchuk et al. argue that these six provisions

can have particular managerial entrenchment effects (2009, p. 788). The authors find that their entrenchment index is negatively related to firm value as measured by Tobin's Q. Hence, their findings support the results obtained by Gompers et al. (2003) as well as those of Cremers and Ferrell (2009) in that they document the importance of corporate governance for firm value and financial performance.

International evidence on the effects of corporate governance on financial performance is provided by Ammann, Oesch, and Schmid (2011). The authors examine 6,663 firm-year observations from 22 developed capital markets over the period 2003 to 2007. Consistently across all their models, the authors find a significant relationship between their measures of corporate governance quality and Tobin's Q. However, we suggest future studies should also control for shareholder and/or creditor rights and jurisdiction more explicitly.

Other studies support the results reviewed thus far. E.g., Bebchuk and Cohen (2005) find that firms with staggered boards suffer in terms of lower valuations (measured by Tobin's Q). Also, Yermack (1996) shows that more properly governed firms (i.e. smaller boards) perform better. Mehran (1995) finds that firm performance is directly affected by executive compensation practices. Likewise, Core, Holthausen, and Larcker (1999) document that poorly-governed firms pay their executives more than their well-governed counterparts, resulting in poorer firm performance. Recently, it has also been shown that the industry competitiveness level also exerts governance over corporations. In particular, Giroud and Mueller (2010) show that firms perform worse when the likelihood of a corporate takeover is reduced through the introduction of new antitakeover legislation. Furthermore, Giroud and Mueller (2011) document that industry competition has a moderating effect on the relationship between governance quality and financial performance. In particular, they show that poorly-governed firms perform worse than well-governed

firms only if industry competition is low. Otherwise, industry competition acts as a governance mechanism. The corporate governance quality also has effects on corporate environmental and social behaviours. Jo and Harjoto (2011) document that well-governed firms (those that are more exposed to the takeover market) undertake more CSR activities than their poorly-governed counterparts and CSR is also positively related to financial performance

It appears that there is a clear positive effect of corporate governance on the future profitability of firms and their corresponding performance on the stock market. The literature tackles many different facets of corporate governance and relates those to CFP measures. The picture that emerges from the literature is that well-governed corporations perform – at least on average – better than poorly-governed firms. The reason why the literature generally observes a positive relationship between governance and financial performance is that corporate governance deals with the way in which corporations are managed. Properly-installed governance devices ensure that capital providers get a return on their investment (Shleifer and Vishny, 1997). This is indeed the case: Good governance pays off for capital providers in that equity investors achieve superior stock returns. However, from the bondholders' perspective it is important to also understand that not all corporate governance devices are meant to benefit debt capital providers as well (see, e.g., Cremers et al. 2007).

5. What has to be investigated in more depth?

We have ascertained that the literature on CSR in relation to CFP, corporate cost of financing, and other firm characteristics is still incomplete.

5.1 Sector-specific evidence

E.g., there is a need for a much deeper analysis of industrial sectors with respect to ESG and CSR. Different industries are exposed to different CSR factors: e.g., the chemicals industry might be much more exposed to environmental management issues than a financial institution which would probably more likely be exposed to some governance issues. There is not enough evidence on the cross sectional variation of CSR in different industries. As documented here, some tentative evidence has been provided for the banking industry (Simpson and Kohers, 2002), manufacturing corporations (Konar and Cohen, 2001), chemicals (Griffin and Mahon, 1997), pulp and paper industry (Cormier and Magnan, 1997, and Clarkson, Li, and Richardson, 2004), and for the so-called "vice industries" (Jo and Na, 2012).

However, the research questions of these existing studies address different issues and no clear picture emerges regarding the effects of CSR on firms in particular industries. E.g., Jo and Na (2012) study the risk implications of CSR in sin industries and find that CSR spending in these industries is negatively related to risk. Clarkson et al. (2004) investigate the value of corporate pollution in the pulp and paper industry and are able to quantify the liabilities of pollution for firms operating in this industry. Similar evidence is provided by Corman and Magnan (1997) who show that corporate pollution reduces the market value of corporations. They show that this effect is particularly pronounced for firms operating in the steel, metals, and mining industry. Other studies are more case-study like and investigate a very small number of corporations from, e.g., the chemicals industry (Griffin and Mahon, 1997).

We advocate more research on whole stock market indices with respect to the financial performance implications of eco-efficiency or employee relations. A per industry analysis would help to identify the materiality of different CSR factors within different industries.

5.2 The geography of ESG

There is also a substantial lack of evidence on what we call 'the geography of ESG'. The vast majority of evidence discussed in this report focuses on the United States and United Kingdom. Much less evidence exists on other developed capital markets, such as Continental Europe. Hardly any evidence on CSR and its direct effects on corporations exist for emerging or developing countries. Kitzmueller and Shimshack (2012) even claim that the international CSR literature is "underdeveloped" (p.76). They see a need for evidence, especially related to the globalized economy: multinational corporations with production facilities around the world, but nationwide regulation on ESG and where restrictions are investigated in order to evaluate the effects for the CSR quality of multinational corporations.

Kitzmueller and Shimshack (2012) argue that most of the international evidence on CSR focuses on regulation and politically motivated introduction of minimum CSR standards. They also refer to obstacles which hinder proper research to emerge for these countries, namely data quality and also availability. Reliable data on CSR for corporations from emerging markets is very scarce and it may take some time until ESG rating agencies also provide data on more firms from developing and emerging markets.

Assuming that enough data is available at some point in time, key research questions which could be addressed are:

- How do nationwide standards on environmental, social, and governance issues affect the overall CSR quality of multinational corporations from developed countries? Is there an effect in the first place? Do they affect a firm's general CSR policy in an adverse way?
- Can international corporations promote better ESG standards in developing countries and if so, how?
- How are manufacturing or production plants of international corporations in developing countries affected by the ESG standards in these emerging markets? This question calls for a detailed plant-level analysis: Is a plant's profitability significantly affected by the national ESG standards?
- How does the performance of an investment portfolio containing just corporations with operations in developing countries with inferior ESG regulation compare with a portfolio of firms operating in developed countries with better ESG standards? Are there any performance implications?
- Do operations in developing countries affect the volatility and sensitivity of cash flows?

These and other questions should be tackled by the literature in order to draw much more complete conclusions regarding the effects of CSR on several corporate characteristics.

6. Learning by doing: Is extra-financial information priced?

Having reviewed the literature on the linkages between CSR and several firm characteristics like cost of equity capital, cost of debt financing, operational and financial performance, and leverage effects, one question ultimately remains: Will this extra-financial information on CSR be eventually priced in security prices? As documented here, trading strategies do exist which incorporate information on the corporate governance quality of firms which will lead to abnormal

risk-adjusted returns. This important finding triggered research which investigates whether the observed relations between ESG in general, and governance in particular, and financial performance persists over time and/or whether the market subsequently incorporates this into stock prices.

The seminal paper by Gompers et al. (2003) has in fact triggered more research on the relationship between governance quality and financial performance. Three years after these path breaking findings, Core, Guay, and Rusticus (2006) pose the question "are the findings period-specific?" (p. 681). They then conduct an analysis to test for differences in returns of well- and poorly-governed firms over the period 2000 to 2003, which reflect the four years subsequent to Gompers et al.'s (2003) sample period. Core et al. (2006) show that between 2000 and 2003 *no* abnormal returns were realizable by going long in well-governed stocks and short in poorly-governed ones. They also show that by combining the period from 2000 to 2003 with the Gompers et al.'s (2003) original sample period of 1990 to 1999, all significant abnormal returns from a trading strategy on governance information disappears.

Bebchuk, Cohen, and Wang (2013) conduct similar analyses for the period 2000 to 2008. They hypothesize that financial markets learn to price the extra-financial information so that the positive relation between governance and financial performance eventually disappears. To test this hypothesis, they construct different indicators of "governance attention" for the period from 1990 to 2008. These indicators measure the markets' awareness of corporate governance information as a stock pricing factor over time. And in fact, Bebchuk et al.'s (2013) results indicate that the interest in corporate governance information by market participants has increased over time. All four applied measures, the (1) number of newspaper articles referring to corporate governance, (2) NBER working papers on corporate governance, (3) shareholder resolutions by in-

stitutional investors, and (4) self-constructed governance attention index, show a strong surge over the sample period. Even though the interest in some of the indicators has decreased in the latter two years of the sample period, Bebchuk and his co-authors conceptually show that the financial market becomes more and more aware of extra-financial information regarding corporate governance. Empirically, they show that over the entire sample period 1990 to 2008 a portfolio long in well-governed firms and short in poorly-governed firms is not able to yield a statistically significant alpha. In fact, such a trading strategy leads to a return of just 18 basis points (risk-adjusted). Bebchuk et al. (2013) are also able to show that while the results of Gompers et al. (2003) indeed hold over 1990 to 1999, the abnormal returns diminish dramatically over the period, 2000 to 2008. In this period, a value-weighted stock portfolio of poorly-governed firms (measured by the governance index) even outperforms a portfolio of well-governed firms by about 30 basis points.

Hence, the positive relationship between governance and stock returns disappears over time, which is consistent with the learning hypothesis. Under the assumption that markets are efficient, we believe this result points to the fact that the financial market is becoming more and more aware of other extra-financial information which is not related to governance. For example, the market's attention might also shift towards social and environmental factors when pricing stocks. However, the lack of research in these particular fields makes it impossible to draw strong conclusions. In an attempt to shed light on the effect of corporations' stakeholder relations on stock price performance, Borgers, Derwall, Koedijk, and ter Horst (2013) investigate whether the stock market performance of corporations with good stakeholder relations is significantly different from firms with poor stakeholder relations over the period 1992 to 2009. Hence, in comparison to the studies reviewed before, Borgers et al. (2013) investigate in how far the market views ESG

information and whether trading strategies based on overall ESG performance (i.e. stakeholder relations) are profitable and whether there is any learning effects observable over time by market participants. The authors' empirical results indicate that from 1992 to 2004 trading strategies, based on the quality of stakeholder relations, delivered statistically and economically significant abnormal returns. Over the subsequent period 2004 to 2009, however, the abnormal returns from such a trading strategy cease to exist because of an increased attention of financial market participants to stakeholder-related issues (Borgers et al. 2013: 175).

Altogether, these findings indicate that the financial market is subsequently pricing in the extra-financial information contained in ESG ratings or indices. As all groups of investors and also corporate executives (Accenture, 2013) are more and more looking for sustainable and responsible investments, financial markets apparently also have taken up this development by pricing also extra-financial information into stock prices. However, this has important implications for investors, corporations, and governments, because one ultimate question remains: If markets properly incorporate extra-financial information in the pricing process, what needs to be done with those firms that still score relatively poorly on environmental, social, and governance issues? Stated differently, what needs to be done by investors to motivate or force also those "laggards" to be more sustainable and responsible? In the next section we outline an agenda for investors sketching our vision for the future of the sustainable investment profession.

7. The future of sustainable investing: Active ownership

As we outlined in the introduction, the financial industry posits several ways of sustainable and/or responsible investing. It has become more or less the industry standard to offer sustainable investment products (mainly equities) which are constructed on the basis of either (1) exclu-

sion or (2) inclusion strategies. Simple exclusion strategies are executed by simply shunning all positions in firms which are operating in any of the so-called "sin industries" such as tobacco, alcohol, gaming, adult entertainment, or weapons (Hong and Kacperczyk, 2009). However, empirical research has shown that this approach has several caveats and eventually will result in a "neglect effect" which drives up the expected rates of return for the shunned stocks (Hong and Kacperczyk, 2009). Earlier evidence, however, has shown that a portfolio which excludes firms which conduct business in South Africa outperforms the overall NYSE (Grossman and Sharpe, 1986). Teoh, Welch, and Wazzan (1999) found that politically-imposed boycotts do not affect corporations or financial institutions with links to South Africa in a negative way. Even though there seems to be contradicting evidence on the financial performance implications of exclusion strategies, it remains a question what happens to those firms that do not score particularly well in the environment, social, or governance domains? Simply excluding them from a portfolio will not make them more sustainable and responsible.

This also holds for so-called "best-in-class" or inclusion approaches. Adopting these approaches implies that particular screens are applied selecting those firms – maybe within certain industries – that perform best regarding environmental, social, and governance criteria. However, this approach also leaves aside those firms that score relatively worse on these criteria. Several studies reviewed in this report investigate the profitability of such inclusion strategies by constructing hypothetical investment portfolios which go long in the good- and short in the poorly performing ESG firms (see, e.g., Derwall et al., 2005 and Gompers et al., 2003).

We argue that these approaches will not make corporations more responsible and more sustainable. We claim that investors have to become active owners of corporations in order to promote better CSR practices and ESG standards. Most institutional investors (i.e. large asset man-

agers, pension funds, or insurance companies) adopt such an active way of investing responsibly already: The active use of proxy voting rights at annual general meetings. Proxy voting is often seen as a responsible and sustainable investment strategy because it supports exclusion and inclusion investment strategies and it provides a low-cost tool to engage with firms for better ESG standards. However, the literature thus far only provides limited evidence that proxy voting is an effective tool to promote proper ESG standards or that it is helpful in creating superior financial performance at investee firms (see, e.g., Gillan and Starks, 2000, 2007). At the centre of the discussion whether proxy voting is an effective engagement tool is the fact that – at least in the United States – the voting outcomes of resolutions at the annual general meeting are not binding for managers. That is, they can forego the implementation of a certain resolution even if this resolution received more than 50 per cent of the votes (Bauer, Moers, and Viehs, 2013).

We suggest that institutional investors can do even more in order to promote proper and sustainable ESG standards at investee firms which lag behind the best performing ones. Eurosif (2013) recently reported that over the last couple of years, institutional investors became more and more actively engaging with firms to promote better ESG practices. In particular, we advocate – next to the adoption of inclusion or exclusion strategies and proxy voting – that institutional investors should file own shareholder resolutions in order to influence the agenda at annual general meetings. Doing so creates a platform for discussion with other investors. Even if the resulting vote does not exceed 50 per cent or if the resolution is not implemented by the management, the mere filing already creates publicity (Bauer, Braun, and Viehs, 2012, and Bauer, Moers, and Viehs, 2013).

In a recent survey, McCahery, Sautner, and Starks (2013) find that institutional investors are indeed very eager about adopting certain engagement means in order to influence corporate envi-

ronmental, social, or governance behaviours. Amongst others, institutional investors reported that they also undertake (or plan to undertake in the future) private engagements in the form of private dialogues with management teams. As Bauer, Clark, and Viehs (2013) argue, these private engagements usually take place behind the scenes and can be quite successful in promoting change. Private engagements are a relatively new research field as more and more investors are moving into that direction. Dimson, Karakas, and Li (2013) study the private engagement activities of a large institutional investor in its US-investee firms. They report that successful private engagement lead to an abnormal return of – on average – 4 per cent annually subsequent to successful engagements. Bauer, Clark, and Viehs (2013) also investigate the engagement activities of a large UK-based institutional investor. In comparison, however, to Dimson et al. (2013), Bauer, Clark, and Viehs (2013) investigate a global sample of target firms and examine why firms become targets and whether the investor can really promote change regarding ESG practices. Their conclusions are as follows. First, more and more shareholder engagement is being observed over time. The engagement does take place within all three dimensions of ESG, and in some years, the number of environmental and social engagements exceeds the number of governance engagements indicating a growing awareness of environmental and social issues (Bauer, Clark, and Viehs, 2013). Second, the authors show that private engagements suffer from a home bias effect: UK firms are significantly more targeted than firms originating from other countries. And third, the institutional investor is relatively successful in promoting better ESG standards, with an average success rate 8.7 per cent which is very conservatively measured.

Therefore, we claim in this report that institutional investors should go beyond simple exclusion and inclusion strategies when they want to invest in a responsible and sustainable way. To sum up, they could start filing own shareholder resolutions and also privately engage with

investee firms on ESG issues in order to make them aware of certain firms which are lagging behind commonly perceived standards. In five years from now, the financial institutions can no longer claim to be responsible and sustainable investors by simply applying certain inclusionary and exclusionary screens for selecting portfolio firms. The future of sustainable investing is active ownership. Institutional investors should become aware that they also have a responsibility when they invest large amounts in corporations. As the owners of corporations they not only have the power, but also the incentives to promote better ESG standards (Viehs, 2013). However, claiming that especially the shareholders of corporations have an important responsibility in promoting proper ESG standards does not imply that we suggest that philanthropic or pure social ideas should be pursued by shareholders. The overall goal of corporations and also financial institutions should be value maximization, as in the spirit of Jensen (2002). Rather, we argue that institutional investors can use their economic power of investments to make firms more sustainable and responsible leading in turn also to sustainably-generated returns for investors. Institutional investors cannot and also do not have the responsibility to change the world. But they can make a difference where no proper ESG standards are in place.

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