The Stocks at Stake: Return and Risk in Socially Responsible Investment

Rients Galema, Auke Plantinga, and Bert Scholtens

*Journal of Banking & Finance*

vol. 32, no. 12 (December 2008):2646–2654

The authors investigate the relationship between socially responsible investing (SRI) and stock returns. They conclude that SRI affects stock returns by lowering book-to-market ratios and not by generating positive alphas. The authors suggest that this result helps explain why so few studies establish a link between alphas and SRI. Also, the authors point out that the findings are consistent with theoretical models that predict lower expected returns for SRI stocks as a result of excess demand for this rather small universe of stocks.

Socially responsible investing (SRI) has gained popularity in recent years, and empirical studies examining SRI stocks have found no significant relationship between SRI and returns. Theoretical models, however, predict a relationship between SRI and returns, and the results are generally based on the mismatch of supply and demand for SRI and non-SRI stocks. Excess demand for the rather small universe of SRI stocks and a shortage of demand for the large universe of non-SRI stocks predict overpricing in SRI stocks and underpricing in non-SRI stocks. The implication is that expected returns of SRI stocks should be lower than those of non-SRI stocks.

The authors attempt to resolve this contradiction between theoretical predictions and empirical findings by further examining the effect of SRI on stock returns. In short, the authors conclude that SRI affects stock returns; specifically, SRI affects stock returns by lowering book-to-market ratios and not by generating significant alphas.

Each year, KLD Research & Analytics (KLD) assigns corporate social responsibility scores on various dimensions of social responsibility to a large group of stocks. The authors examine the effect of SRI on stock returns of these companies.
returns by conducting three analyses using the KLD scores from the period of 1992 to 2006. Relevant return and accounting data for these stocks are from Datastream.

First, the authors examine the risk-adjusted performance of 12 equally weighted portfolios formed on the basis of KLD scores for six SRI dimensions. The SRI dimensions are community involvement, corporate governance, diversity, employee relations, environment, and product quality, and the authors construct “strength” and “concern” portfolios for each dimension. Consistent with previous studies, regression results from a four-factor model (i.e., the Fama–French three-factor model augmented with the Carhart momentum factor) indicate that SRI stocks do not generate risk-adjusted excess returns.

Second, the authors examine whether the KLD scores help predict excess returns by using cross-sectional regressions. Specifically, the authors run Fama–McBeth regressions of monthly excess stock returns on the six lagged KLD dimension scores and a host of control variables. The authors find employee relations to be the only SRI dimension that has a significant positive effect on monthly excess returns.

Third, the authors investigate the KLD scores’ effect on company value by running annual pooled regressions of the logarithm of the book-to-market ratio on the six KLD dimension scores and a host of control variables. The authors point out that SRI and non-SRI stocks of equal risk may have different book-to-market ratios as a result of the excess demand for SRI stocks. The implication is that SRI stocks should have lower book-to-market ratios than non-SRI stocks. Consistent with this prediction, the authors find that the dimensions of diversity, environment, and product quality have a negative effect on book-to-market ratios; however, corporate governance has a positive effect. The dimensions of community and employee relations do not significantly affect book-to-market ratios. Ultimately, the authors conclude that SRI affects stock returns by lowering book-to-market ratios and not by generating positive alphas.

**Keywords:** Corporate Governance; Portfolio Management: equity strategies; Investment Theory: CAPM, APT, and other pricing theories