

THROWING A CURVE AT SOCIALLY RESPONSIBLE INVESTING RESEARCH

A New Pitch at an Old Debate

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We agree with Entine's (2003 [this issue]) assertion that the personal histories of the investigators matter to academic research in general, and especially to social science. Our backgrounds influence the type of research that attracts our time and attention, affect the theories we draw on and the data we use, and although we less like to admit this, inevitably shade our interpretations of the results. But we disagree with Entine's assertion that this renders research on corporate social responsibility (CSP) and its relation to financial performance, or what is often referred to as socially responsible investing (SRI), a worthless and even harmful academic exercise.

Of course SRI research is imperfect. As with all social science research, the simplifications necessary in conducting SRI research make its mapping to a complex reality imperfect. As with all financial projections, the past is not a perfect indicator of future performance. As with all accounts of a firm's past activities and its intended future activities, public data may not accurately reflect reality, be it the result of fraud or error. As with the real world in general, self-interest exists, and it inevitably if not intentionally shades our interpretations of subjective data. However, these imperfections do not render SRI research useless. Even though the findings of SRI research have been mixed, often incomparable, and as a result, not entirely compelling, such studies have put firms and investors in a better position than they would be if there were no SRI research. More important, the state of the "art" is advancing.

In this article, we primarily focus on Entine's (2003) assertion that SRI research is "hopelessly flawed" (p. 352). We argue that although SRI researchers have primarily chosen to pluck the low-hanging fruit in this line of inquiry, it is possible to obtain unbiased higher level insight. In the following, we offer what we believe to be an agnostic approach to assessing SRI research. We have observed, through minimally biased academic eyes,¹ what we believe is the financial market's opinion of more fine-grained measures of CSP. Rather than exploring how SRI funds might further the agenda of *Shopping for a Better World* (CEP, 1990), as the Council on Economic Priorities suggests we do, we focused on a somewhat different topic, one

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that might better be titled *Measuring What Shoppers Are Willing to Pay For a Better World*.

Following, we first discuss the link between social responsibility and corporate financial performance. We then review how well SRI research has illuminated this link. Thereafter, we summarize a recent study we conducted. Finally, we propose productive new directions for SRI research. Counter to Entine's assertion, we believe that the future is bright, although not simple, for SRI research.

MORALITY AS A MEANS TO MONEY, NOT MONEY AS A MEANS TO MORALITY

In our agnostic tradition, we first proclaim that firms are neither inherently good nor evil. In theory, firms seek to maximize profit, and they will engage in whatever activities they believe will earn them the highest financial return. If a firm believes that being "good" pays, then it will engage in good behavior. On the other hand, if a firm believes that "bad" behavior is more profitable (net any expected penalties) it will engage in bad acts. The merit of an activity is judged by its financial reward; its morality is of secondary concern to the firm, at best.

This agnostic stance—where morality is estimated by financial returns—does not doom us to widespread corporate immorality. In fact, it is a good thing. Firms are not well qualified to judge morality, and are not the most efficient means of pursuing social goals. Firms are designed to judge what is and is not profitable. What is and is not moral is better debated in public forums, not corporate boardrooms. Firms should maximize returns to shareholders, and then allow these shareholders to spend the proceeds on whatever activities, moral or otherwise, they deem appropriate (Friedman, 1970).

However, this certainly does not mean that firms should not behave morally, and meet as well as exceed lawful requirements that govern a variety of social issues. Firms are open systems embedded in a social environment (Granovetter, 1985; Katz & Kahn, 1966; Scott, 1981). To maintain legitimacy and efficiently attract resources, firms must satisfy not only their stockholders, but also the stakeholders that compose their social environment (Donaldson & Preston, 1995; Freeman, 1984). CSP can improve relationships with key stakeholder groups and so increase a firm's ability to attract resources on favorable terms (Moskowitz, 1972). In short, stakeholder relations are instrumental to stockholder returns (Jones, 1995). For example, a firm that builds a reputation for maintaining a favorable work environment can decrease its hiring costs and increase its employee retention rate, decrease community opposition and legal costs when opening new factories, and may more easily lobby for tax breaks from local governments (Greening & Turban, 2000; Waddock & Graves, 1997). CSP builds valuable goodwill that can buffer a firm from unexpected problems, and even provide new business opportunities not available to less socially responsible firms (Fombrun, Gardberg, & Barnett, 2000). Conversely, socially irresponsible behavior, even though potentially improving profits in the near term, may substantially harm a firm's relationships with stakeholders and thereby increase its costs in the long run, diminish or destroy its market, or even lead to withdrawal of its license to operate.

Why do firms do what they do? Because they think there is profit in it. By this logic, firms engage in CSP because they think it will improve their bottom line. Of course, CSP is costly. Corporate philanthropy, employee day care, paid parental leave, pollution prevention, and other such socially responsible practices entail significant expenditures. Such costs can place a firm at an economic disadvantage rel-

ative to less responsible rivals (Aupperle, Carroll, & Hatfield, 1985; McGuire, Sundgren, & Schneeweis, 1988; Ullman, 1985; Vance, 1975). In a highly competitive marketplace, such practices may even threaten a firm's survival. Thus, there is an inherent cost-benefit analysis involved with CSP, as with any other strategic investment.

From the perspective of firms and investors, CSP is simply strategic action taken to pursue profit. However, the costs and benefits of this strategy are hard to measure. Proponents of SRI sometimes overemphasize the benefits and underemphasize the costs, whereas critics are sometimes guilty of the reverse. The role of SRI research is to conduct this cost-benefit analysis as objectively and accurately as possible, and so help firms and investors determine whether there is, in fact, money in morality.

THE MARKET VALUE OF CORPORATE SOCIAL RESPONSIBILITY (CSP)

Do the benefits of CSP outweigh the costs, do the costs outweigh the benefits, or are they more or less equal? Common sense, theory, and a growing body of empirics have supported all of the above contradictory positions. SRI researchers have long sought to resolve this debate. However, the end result thus far has been more than "25 years of incomparable research" (Griffin & Mahon, 1997, p. 5). Researchers have employed varying theoretical perspectives and conflicting data sources to arrive at different answers to incompatible questions, generally categorized under the framework of the search for a link between "people and profits" (Margolis & Walsh, 2001) or "money and morality" (Lowry, 1991). Despite the intensity of study directed at it, the relationship between CSP and corporate financial performance (CFP) remains in dispute.

The solid financial performance of the most prominent SRI indicator, the Domini Social Index (DSI), has strengthened proponents' argument that CSP and CFP are positively related. DiBartolomeo and Kurtz (1999) showed that the DSI substantially outperformed the S&P 500, earning a total return of 470% from its inception in May 1990 through March 1999, as compared to 389% for the S&P 500. Nonetheless, critics of SRI were not swayed. As Entine (2003 [this issue]) duly notes, although standard measures of a public firm's financial performance are readily available, standard measures of a public firm's social performance are not. SRI critics argued that improvements in financial performance have come about at the expense of social performance. If one observes the holdings of the DSI, one will see that its portfolio is quite similar to that of the S&P 500 (Glassman, 1999). In other words, SRI funds have turned from being "the butt of Wall Street jokes" (Glassman, 1999, p. 4) into competitive financial performers only because many SRI funds' "once-strict screening criteria have turned porous" (Goetz, 1997, p. 43).

SRI studies are vulnerable to this critique. SRI researchers have primarily focused on comparing the financial performance of SRI funds versus funds that do not screen based on social criteria. Yet, within SRI funds, there is significant difference in the degree of social responsibility. Some funds are much more stringent in their selection of firms than others. By pooling all SRI funds into the same general category, the link between CSP and CFP is muddled. To test the validity of this claim, researchers need to move beyond the standard comparison of SRI versus non-SRI funds. Instead, we must look within SRI funds and measure relative social responsibility.

SRI VS. SRI: BEYOND DICHOTOMY

We analyzed the social and financial performance of 63 socially responsible mutual funds from their inception through the year 2000 (see Barnett & Salomon, 2002). Our main measure of social performance was the total number of social screens used by a mutual fund, as reported in the *Social Investment Forum*. According to this data source, there are 12 possible social screens associated with socially responsible mutual funds: alcohol, tobacco, gambling, weapons, animal testing, products or services, environment, human rights, labor relations, equal employment, community services, and community relations. We related a fund's financial performance to the total number and types of social screens it employed over its lifetime. Controlling for a variety of factors, we found the relationship between social and financial performance to be curvilinear. That is, financial performance declined as the number of social screens increased, until it reached a low point around 6 (of 12) screens, then turned back up, increasing as the number of screens increased.

This curvilinear finding suggests that two long competing viewpoints in the SRI literature may, in fact, be complementary. Proponents of socially responsible investing maintain that screening benefits mutual funds because in so doing, fund managers eliminate poor performing firms from their portfolios. It is argued that what remains after applying such screens is a portfolio of financially superior firms. Conversely, critics have argued that by screening out firms, mutual fund managers handicap their portfolios because they limit the universe of firms in which they can invest. This constrains their ability to diversify away non-systematic risk. Our finding suggests that both may be right to varying degrees. That is, funds that employ many social screens (those that screen intensively) may effectively weed out "bad" firms from their portfolios, thereby improving financial performance. On the other hand, SRI funds that employ few social screens (e.g., employing only 1 or 2) improve financial performance through the diversification benefits that such porous criteria allow.

After considering the effect of screening intensity on financial performance, we subsequently analyzed how particular screens influence mutual fund performance to gauge how financial markets react to, and evaluate, such screens. We found that mutual funds that actively screened out tobacco stocks performed better than the baseline fund (about 7.4% better on average). This result is consistent with the poor performance of tobacco firms due to intense legislative pressures placed upon them in the 1980s and 1990s. Similarly, the results imply that funds that screened out firms with poor community relations records performed better. Otherwise stated, mutual funds that included firms that fostered positive relationships within their local community, and actively participated in charitable giving within that community, performed about 4% better than the average fund without such screens. Taken together, these results show that the market positively values certain screens and that eliminating certain types of firms from one's portfolio can provide financial performance benefits.

However, not all social agendas were rewarded in the financial market. Contrary to the positive findings for tobacco and community relation's screens, screening on the basis of environmental criteria and labor relations was negatively related with financial performance. All else equal, SRI funds that culled environmentally poor performers out of their holdings performed about 4.2% worse on average than the baseline SRI fund. Mutual funds that screened on the basis of labor relations suffered financial performance decrements of 3.3% per annum. The results on envi-

ronmental screens suggest that the cost of such procedures and policies exceed the benefit for the implementing firm. Likewise, the findings for labor relations imply that firms that provided excellent workplaces and numerous benefits for their employees raised their costs to the detriment of the bottom line. Taken together, the market perceived that the costs of implementing these policies outweighed their gains relative to other possible means of being socially responsible.

BETTER GAUGING MORAL SENTIMENT: THE FUTURE OF SRI RESEARCH

Entine (2003 [this issue]) notes that the criteria used by fund managers to screen firms out of portfolios are poorly defined, inconsistently applied, and impossible to verify. As a result, he argues that any research using these measures must be invalid. In our study, we relied in part on data provided by *Social Investment Forum*, a source whose accuracy Entine directly questions. We would certainly like to have better, if not complete and perfectly consistent information on firms and their socially oriented behaviors. The current data from *Social Investment Forum* are not perfect, but they bring us closer to understanding the market's opinion of CSP than we would be with no data on a firm's social performance. It is a beginning in what should be a strong push toward more fine-grained measures of social performance that get us beyond the usual SRI versus non-SRI dichotomy.

Using imperfect measures, however, does not necessarily make the results of such research invalid. It is important to recognize that perfect information in most any domain of science, and particularly in social science, is almost impossible to obtain. Social scientists are forced to make due with imperfect measures of their constructs. Ultimately, we must work with the information that we have available. So long as there is some consistency in the way measures are defined and employed (no matter in which direction they are biased), the results will not be invalid. We have the statistical and methodological toolkit to control for some of the potential biases that may be induced by using blunt and dirty instruments. We have ways to control for idiosyncrasies in the ways that individual fund managers apply screens. We can make inferences about whether results attained are a result of the underlying phenomenon in question (in this case, the financial performance associated with a particular screen) or the measurement itself. From this we may, with better precision and accuracy, assess whether there are empirical regularities associated with particular screens and minimize bias (for an overview of such econometric and statistical techniques see Greene, 2000; Kennedy, 1998).

Entine (2003 [this issue]) and others have also argued that SRI research lacks theoretical underpinnings. Waddock (2003 [this issue]) points out, though, that this argument is premised on dated studies. Early SRI research developed in a somewhat ad hoc fashion and boiled down to fairly simple logic, but it is no longer fair to categorize it as atheoretical (Donaldson & Preston, 1995; Jones, 1995). As Jones (1995, p. 422) concluded, "firms that contract with their stakeholders on the basis of mutual trust and cooperation will have a competitive advantage over firms that do not." This advantage comes from "reduced agency costs, transaction costs, and costs associated with team production. More specifically, monitoring costs, bonding costs, search costs, warranty costs, and residual losses will be reduced" (Jones, 1995, p. 422). In short, CSP builds trust, and trust facilitates favorable exchanges with resource holders. Others have phrased it differently, but the logic is similar. For example, Fombrun et al. (2000) described CSP as building up reputational capital

and therein facilitating favorable exchanges with resource holders. Thus, there are theoretical underpinnings to the SRI literature.

The theoretical links, as with most theory, could, however, be strengthened and made more explicit. If we treat CSP as an investment in trust, we need to concern ourselves with optimal levels of such investment (Wicks, Berman, & Jones, 1999). In our study, we found that the maximum investment in CSP had maximum payoff, but our measures of CSP were themselves not very fine grained. Future research needs to dig deeper in this direction to better determine when being good becomes a financial vice. Included in this vein is the need, as objectionable as this may seem to some, to determine the relative importance of constituent groups. In the face of near infinite and often conflicting constituent demands, firms must make concrete decisions about where to allocate finite resources. Some offer better returns than others. For example, Berman, Wicks, Kotha, & Jones (1999) found that investments in employee and customer relations offer better payoffs than do investments in the environment, diversity, or the community. We found that screening out tobacco firms, including firms with positive community relations, improved SRI fund performance, whereas environmental and labor relations screens decreased SRI fund performance. As measures of both the specific type of CSP investment and the payoff improve, SRI research will help firms to better allocate their limited resources.

Of course, this goal is complicated by the fact that SRI findings are historical. No matter how fine-grained and accurate our measures of CSP become, they provide no guarantee about a firm's future CSP. Moreover, prior findings about the link between certain types of CSP and CFP, no matter how strong, provide no guarantee that such linkages will remain in the future. The social preferences of constituents change. Issues unheard of today can become serious causes tomorrow, and the serious causes of today may be irrelevant to the market tomorrow. Moreover, as an issue ages, so, too, may its link to financial performance. For example, whereas divestment from South Africa might have once provided a firm with an ability to distinguish itself, as more and more firms joined in, it become more of an expectation, and therein may have begun to lose its strategic value.

SRI research will at best serve as an effective lagging indicator of what the market demands, but it is not likely to indicate what the market will want very far into the future. Of course, if this were not the case, profit would be eliminated. Were all the rules of the game clear and constant, managers would have no discretion and all firms in competitive industries would earn normal returns. SRI research can, when conducted in an unbiased manner, point out where profit was made in the past, and through extrapolation, provide some sense of where it is likely to be made in the future. However, firms will still have to take a chance. Realistically, this is all we can ask of any strategic tool, whether it be mired in the murky world of morals or the more seemingly objective world of high finance.

CONCLUSION

As mentioned earlier, our view is that firms are not inherently good or bad. Rather, they are profit seeking, and will engage in those behaviors that they expect to make money for them. SRI research best functions as a means of helping firms and investors identify what the market wants. As Entine (2003 [this issue]) points out, and we agree, the definition of what is and is not moral behavior for a firm is a quagmire, and our ability to measure whether socially responsible investors have forced firms to become moral is suspect. We also agree with Waddock (2003 [this issue]) that socially responsible investors have caused firms to take certain actions

that, without such pressure, they would have taken much later or not at all. However, whether these actions have made firms moral is not a debate that SRI researchers should enter, or that we are certain can be resolved in the social sciences. Certainly, events of late would suggest that although firms, by and large, are now more responsive to a variety of social issues, they are not moral entities, and should not be viewed as such.

Rather, the focus of SRI research should be to determine whether particular CSP activities are good investments for firms, and by implication, for investors. We think the market should answer such questions. The market largely determines which social criteria (however applied by a particular fund) will be met with reward, indifference, or loss. If we can isolate how the market reacts to particular social criteria, then we may gain a better understanding of which socially responsible issues are worthwhile from a financial standpoint, and which do not pay off. Based on the findings of our recent empirical study, we believe that funds that use many social screens may effectively weed out “bad” firms from their portfolio and hence, improve financial performance. On the other hand, funds that employ few social screens improve financial performance through increased diversification. That is, they resemble more broadly diversified mutual funds. Those funds that are “stuck in the middle” may not be able to either effectively diversify away unsystematic risk, or eliminate enough “bad” firms from their portfolios to experience financial performance benefits. These results imply that researchers should begin to look at differences within socially responsible funds, and that socially responsible mutual fund managers should pursue a social investment strategy fully, or not at all.

Entine (2003 [this issue]) has a blanket objection to SRI research because he claims that the ideological bents of SRI researchers predetermine their findings. We took an agnostic approach to allow the market to speak for itself. We found that the market did value social responsibility in some cases, although not in others. By declaring what the market values, to the extent such research is believed, SRI studies are likely to foster changes in firm and investor behavior. However, although SRI research may drive social behavior, research findings themselves need not be ideologically tainted. Clearly, the better SRI researchers become at measuring the market’s opinion, and not their own, the more valuable SRI research will become. Paradoxically, lack of a social agenda makes SRI studies believable, and so will drive the future social agendas of firms. Through this role, SRI research is an indirect agent of social change.²

NOTE

1. We believe it is quite possible to perform objective social science research even while personally favoring a particular political or social agenda, but for sake of argument, we point out that neither of us “cut our eyeteeth” in the midst of “Sixties activist ideology,” neither of us is fervently pursuing a conservative religious mandate to wipe out all sin, great and small, and furthermore, neither of us has been affiliated with the Council on Economic Priorities.

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