Towards a Theory of Positive Governance: The Effects of ESG Disclosure, Shareholder Activism, and Research on Performance in Socially Responsible Mutual Funds

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Key trends

1. Increased transparency in firms → Increased transparency for funds

- *Past:* Increased voluntary financial disclosure (e.g. quarterly reports, management forecasts, press releases)
- *Present:* Increased voluntary non-financial (ESG) disclosure (e.g. sustainability reports, press releases on CSR issues, code of ethics)
- *Structured initiatives:*
  - Global Reporting Initiative
  - PRI Reporting Framework/ Eurosif transparency code
  - Novethic SRI Label in France
  - EU initiatives (pension funds)

- Considerations
  - Less and less discretion for managers: non-disclosure affects competitive position (e.g. securing RFPs)

Empirical question 1: Does ESG disclosure affect fund performance?

Key trends

2. Higher level of shareholder activism by institutional investors

- *Past:* institutional investors targetted mostly financial and governance issues while other issues (environmental and social) were left to unions and activists
- *Present:* Increasing role of institutional investors as advocates for ESG issues

- *Structured initiatives:*
  - PRI Clearinghouse
  - Interfaith Center on Corporate Responsibility
  - Institutional Investors' Group on Climate Change
  - Pharmaceutical Shareowner Group
  - In-house engagement teams (e.g. Hermes EOS (Equity Ownership Services))
- Considerations:
  - Institutional investors have discretion on level of engagement
  - Shareholder activism is still geographically (culturally) contingent

Empirical question 2: Does ESG shareholder activism affect fund performance?

Key trends

3. Better ESG research quality within both firms and funds

- *Past:* ESG research non-existent or fully outsourced
- *Present:* Formation of internal ESG/sustainability teams and structured positions (“Head of SRI research”; “SRI analyst”)

- Considerations:
  - Cost-benefit (“make-or-buy”) approach for ESG information is easier to comprehend (i.e. “Makes sense” to invest in ESG research if this information can be a competitive advantage and is value-relevant; otherwise outsource)

Empirical question 3: Does ESG research quality affect fund performance?

Theoretical background

CORPORATE GOVERNANCE: involves internal or external systems of laws, rules, and factors that control operations at a company (Gillan & Starks, 1998)

- Mainly stems from **agency theory:** control is required to prevent important conflicts of interests between the principal (the shareholder) and the agent (the manager). (Eisenhardt, 1989; Jensen & Meckling, 1976).
- Assumes:
  - The sole objective of the shareholder is to maximize financial returns
  - Managerial behavior will be negative unless controlled
- Hence, extant literature has focused on:
  - Board structures and managerial incentives
  - Share redemption, board structure, and fund management fees (Del Guercio, Dann, & Partch, 2003; Tufano & Sevick, 1997)

Less attention towards governance mechanisms which relate to non-financial issues.

Theoretical background

POSITIVE GOVERNANCE: examining non-financial yet potentially value-relevant governance issues (mostly relating to ESG issues).

1) **ESG disclosure:** disclosure of non-financial but potentially value-relevant information
2) **Shareholder activism:** using power as a shareholder to improve corporate sustainability practices
3) **ESG research:** having in-depth research practices on environmental, social, and governance issues

Theoretical question: How does positive governance affect financial performance?

Theoretical background

1. ESG DISCLOSURE AND PERFORMANCE

- Disclosure in empirical accounting literature is mostly related to **financial disclosure**
  - Regulated financial reports (e.g. financial statements)
  - Voluntary communication (e.g. management forecasts, press releases, internet sites, analysts' presentations)
  - Information intermediaries
- Motives for voluntarily financial disclosure:
  - Decreases cost of capital (e.g. Botosan & Plumlee, 2002)
  - Increases analyst followings and coverage (e.g. Lang & Lundholm, 1996)
  - Greater price informativeness (e.g. Gelb & Zarowin, 2002) and increases in stock performance (Healy, Hutton, & Palepu, 1999)
- Voluntary disclosure may also be **detrimental** to firm value
  - **Proprietary cost hypothesis**: firms are reluctant to disclose information due to a concern that such a decision may damage their competitive position in product markets (cf. Darrough, 1993; Gigler, 1994; Verrecchia, 1983)

Theoretical background

1. ESG DISCLOSURE AND PERFORMANCE (con't)

- **Non-financial disclosures are less studied**
  - Dhaliwal, Li, Tsang, and Yang (2011) examine motives for corporate social responsibility (CSR) reporting and find that CSR reporting reduces firms' cost of capital
  - Sustainability-related information is **value-relevant** (e.g. Margolis & Walsh, 2003; Orlitzky, Schmidt, & Rynes, 2003): is a proxy for corporate social performance which has a positive relationship to financial returns (i.e. Stakeholder Theory)
- Engaging in some form of non-financial voluntary disclosure – 'general' non-financial voluntary disclosure – may act as a signal of quality. However, 'specific' information disclosure relating to the firm's strategy implies a proprietary cost which damages its competitive position.

H1a: ESG disclosure related to 'general' information is positively related to financial performance.

H1b: ESG disclosure related to 'specific' information is negatively related to financial performance.

Theoretical background

2. SHAREHOLDER ACTIVISM AND PERFORMANCE

SHAREHOLDER ACTIVISM: shareholder responses to corporate performance; an investor who tries to change the status quo through 'voice' *without* a change in control of the firm (Gillan & Starks, 1998).

- Historically, primary emphasis was to focus on poorly performing firms in the portfolio
  - Changes in corporate governance structures, changes in voting rules, and increased board independence (Gillan & Starks, 2000)
- Reviews of empirical studies on the link between shareholder activism and performance have shown largely **conflicting results** (cf. Gillan & Starks, 1998; Karpoff, 2001).
  - 'Free-rider' problem (Becht, Franks, Mayer, & Rossi, 2010).
  - How to assess effectiveness
- Fund context:
  - Becht et al. (2010) find a 4.9% increased abnormal return per year due to shareholder activism
  - Renneboog, Terhorst, & Zhang (2008) do not find evidence of a positive nor negative impact of shareholder activism

Theoretical background

2. SHAREHOLDER ACTIVISM AND PERFORMANCE (con't)

- Less empirical evidence examining the effect of ESG engagement and performance.
- **Stakeholder theory** points towards a positive relationship between corporate social performance (CSP) and corporate financial performance (CFP) (cf. Donaldson & Preston, 1995; Freeman, 2010)
- Shareholder activism will be positive for performance only if it improves CSP in the long-term.
  - Shareholder activism is positive for financial performance after a point wherein it enables fundamental operational change.

H2: Shareholder activism has a curvilinear (U-shaped) relationship with financial performance.

Theoretical background

3. ESG RESEARCH AND PERFORMANCE

- **Information asymmetry problem** when information is outsourced
- May lose out on possible **externalities** produced by in-house research
- Increased amount of internal specialization, through the development of in-house research skills is likely to have a positive effect on performance.
  - Renneboog et al., 2008 find that funds which have an in-house ESG research team perform better than those who outsource

H3: ESG research conducted internally is positively related to financial performance.

Research Setting: Socially Responsible Mutual Funds

SOCIALLY RESPONSIBLE INVESTING (SRI): generic term covering any type of investment process that combines investors' financial objectives with their concerns about ESG issues (Eurosif, 2010).

- Number of signatories to the PRI is currently approaching 1,000 AM companies or USD30 trillion globally (PRI, 2011)
- In Europe, SRI currently covers c. 10% of total AUM or €5 trillion (Eurosif, 2010)

RATIONALE FOR RESEARCH SETTING:

- SRI funds having a unique **sustainability identity** in the asset management industry yet maintain a mandate for optimum financial performance
  - Legislative and client pressure for increased transparency on ESG criteria
  - "Role model" of institutional investor shareholder activism
  - Practical concerns about internal or outsourced research
- Research on the **governance of mutual funds** is limited. We extend extant literature on corporate governance and performance to a fund level of analysis

Methods and Data

- Primary list of 529 socially responsible mutual funds domiciled in Europe (Eurosif)
- Fund governance information provided by Vigeo (formerly Avanzi)
- Historical financial data provided by Morningstar
- Final unbalanced panel of 102 funds
- Period of interest: 2006 to 2010 (currently extending the data to 2011)
- Sample contains 6,120 (60 months x 102 funds) observations

Methods and Data

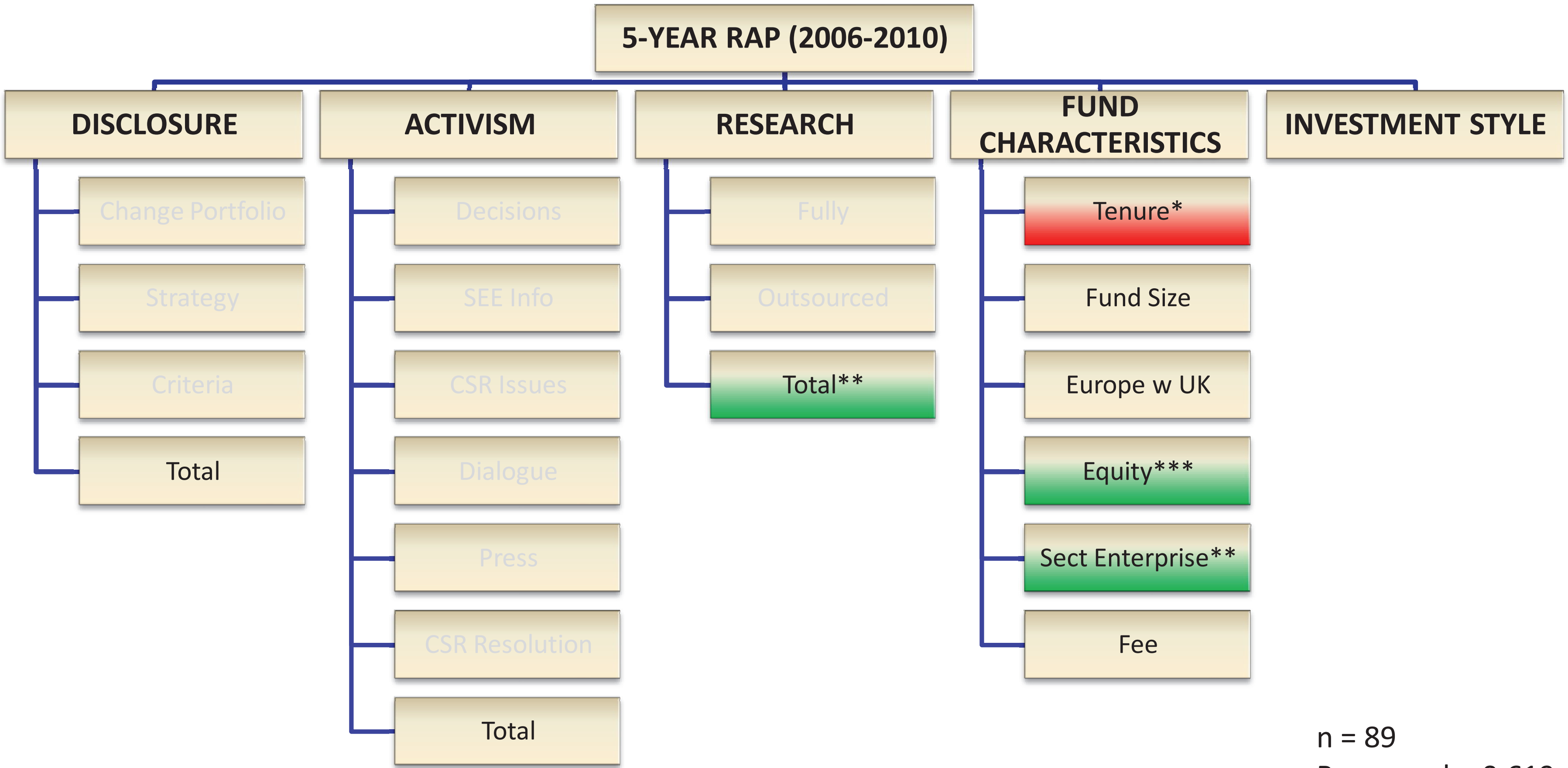
SRI FUNDS	MEAN	STD. DEV.	MIN	MAX
Total Asset (Million €)	142.82	216.43	3	1,531
Fund Age (years)	13.36	5.34	4	31
Management Fee (%)	1.50	0.38	0.5	2.5
Total Expense Ratio (%)	1.68	0.59	0.6	5.43
SRI PORTFOLIO	**MEAN (%)**		**STD. DEV. (%)**	
UK	22.32		28.32	
Europe (ex UK)	48.96		31.95	
Equity	85.49		25.32	
Manufacturing	45.00		12.44	
Service	37.40		11.38	
FUND DOMICILE	**FREQUENCY**		**PERCENTAGE**	
Austria	5		4.9	
Belgium	7		6.86	
France	10		9.8	
Germany	5		4.9	
Italy	6		5.88	
Luxembourg	24		23.53	
Netherlands	6		5.88	
Norway	1		0.98	
Spain	2		1.96	
Sweden	11		10.78	
Switzerland	4		3.92	
UK	21		20.59	

Methods and Data

CATEGORIES	CRITERIA	DEFINITION	FREQ.	%
Disclosure	DISC_CHANGEPORTFOLIO	Fund provides information about changes in its portfolio, explaining why companies have been admitted/excluded	69	67.65
	DISC_STRATEGY	Fund discloses sources and methods used to acquire information about the degree of sustainability	76	74.51
	DISC_CRITERIA			
	DISC_SRICRITERIA	Fund provides clients with details of SRI criteria used to select its portfolio	89	87.25
	DISC_CHANGECRITERIA	Fund informs clients about changes in SRI criteria	86	84.31
Shareholder Activism	ACT_DECISIONS	Companies are regularly informed about the fund's decisions	65	63.73
	ACT_SEEINFO	Ethical/Socio-environmental profiles sent to companies	62	60.78
	ACT_CSRISSUES	Fund manager/analysts include (CSR) issues in meetings	67	65.69
	ACT_DIALOGUE			
	ACT_WRITECONCERNS	Fund manager written to companies about issues in the last 12m	59	57.84
	ACT_SPECIALMEETINGS	Fund manager arranged special meetings with companies in the last 12m	60	58.82
	ACT_PRESS	Fund manager released press briefings and statements in the last 12m	48	47.06
	ACT_CSRRESOLUTION	Fund manager proposed CSR related resolution in the last 12m	15	14.71
Research	RES_ANALYSIS (fully)	Fund manager fully performs environmental and social analysis	33	32.35
	RES_ANALYSIS (partly)	Fund manager partly performs E&S analysis	40	39.22
	RES_ANALYSIS (outsourced)	Fund manager outsources E&S analysis	29	28.43

Results: Performance (Model 1)

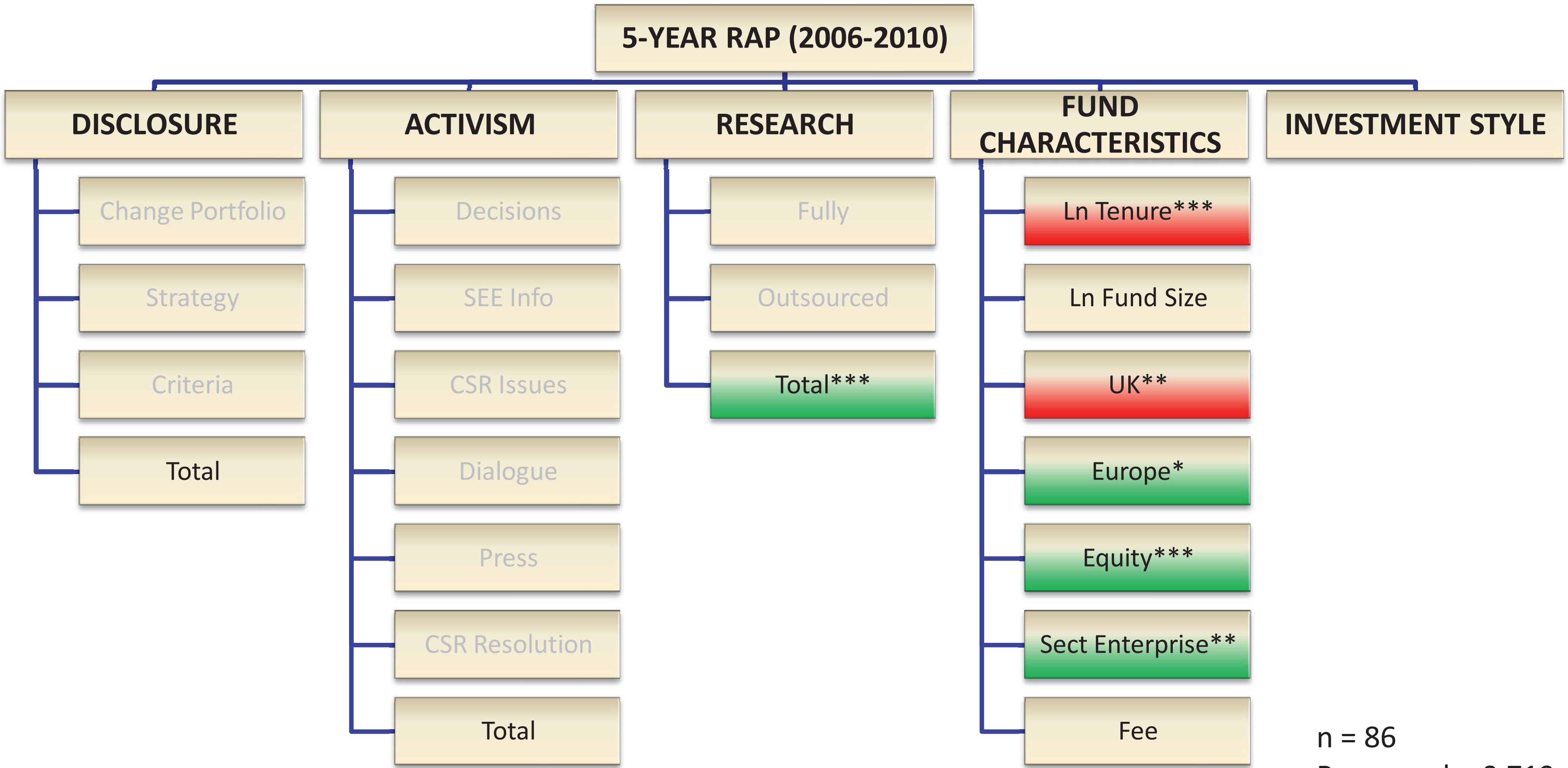
$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$



n = 89
R-squared = 0.619

Results: Performance (Model 2)

$$RAP_{i,t} = \gamma_0 + \gamma_1 \mathit{Positive\ Governance\ Criteria}_i + \gamma_2 \mathit{Fund\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$



n = 86
R-squared = 0.719

Results: Performance (Model 3)

$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$

5-YEAR RAP (2006-2010)

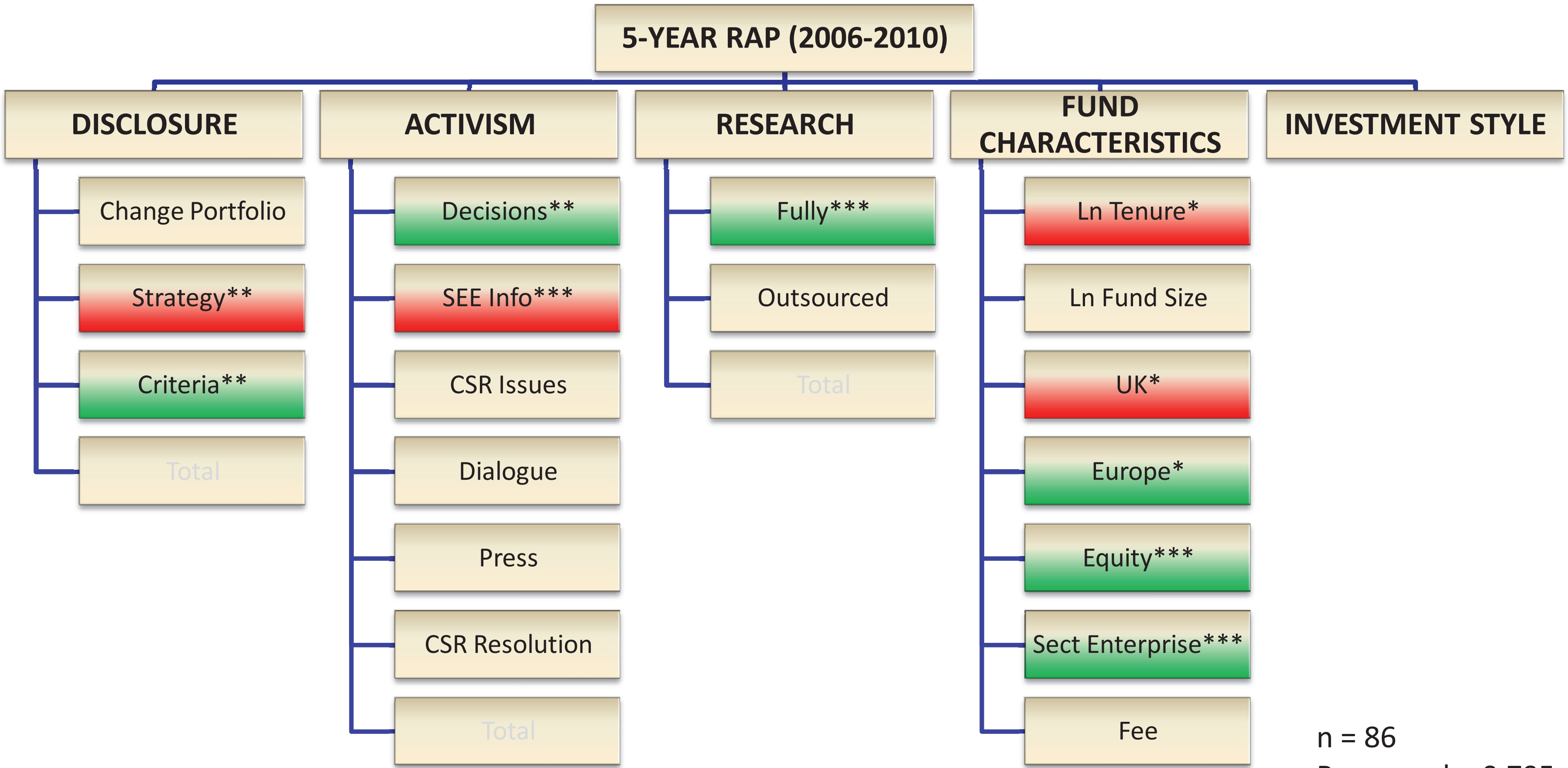
- **DISCLOSURE**
  - Change Portfolio
  - Strategy***
  - Criteria***
  - Total
- **ACTIVISM**
  - Decisions**
  - SEE Info***
  - CSR Issues
  - Dialogue
  - Press
  - CSR Resolution**
  - Total
- **RESEARCH**
  - Fully***
  - Outsourced
  - Total
- **FUND CHARACTERISTICS**
  - Tenure
  - Fund Size
  - Europe w UK
  - Equity***
  - Sect Enterprise***
  - Fee
- **INVESTMENT STYLE**

n = 89

R-squared = 0.734

Results: Performance (Model 4)

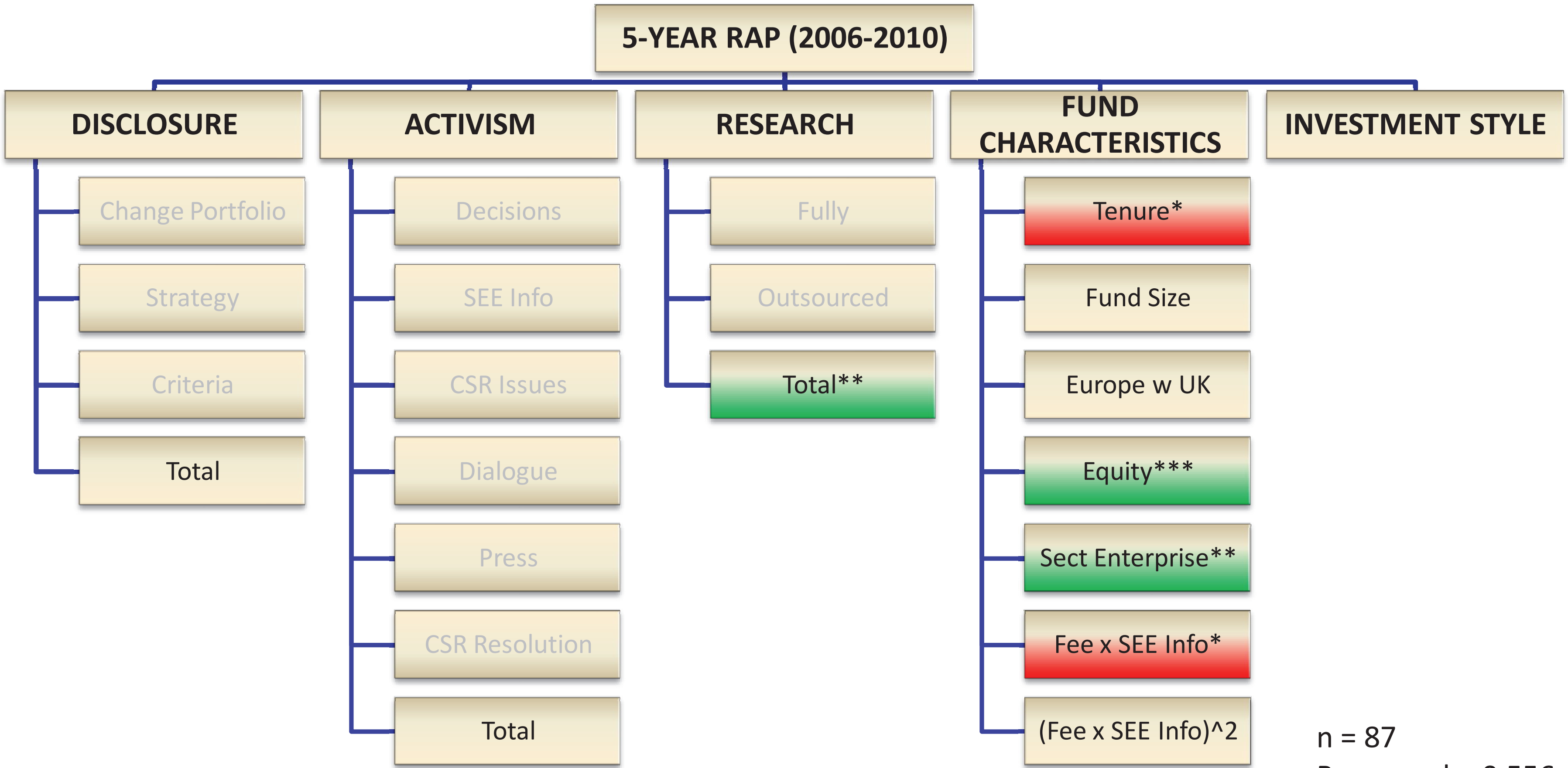
$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$



n = 86
R-squared = 0.795

Results: Activism & Performance (Model 1)

$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$

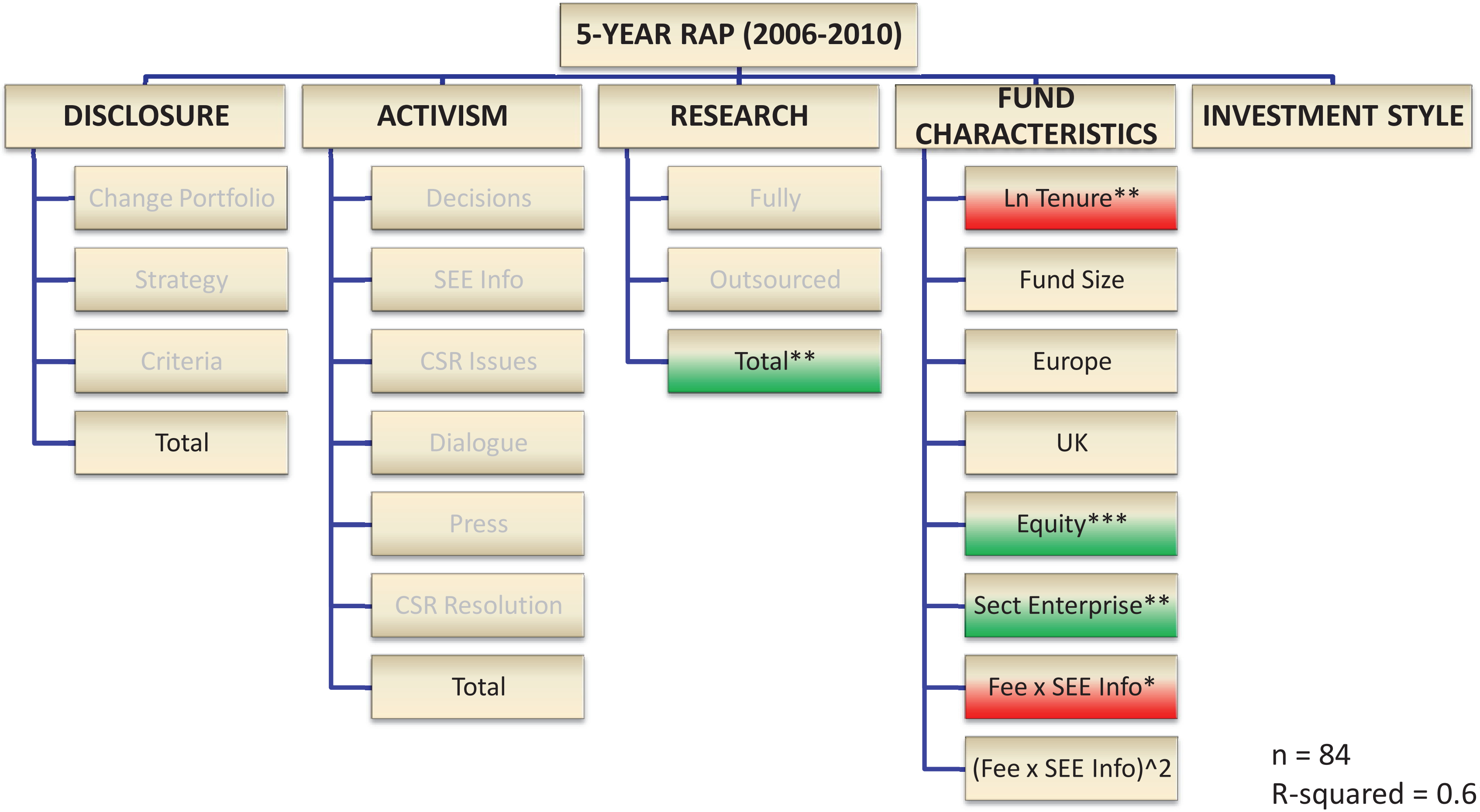


n = 87

R-squared = 0.556

Results: Activism & Performance (Model 2)

$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$



n = 84
R-squared = 0.610

Results: Activism & Performance (Model 3)

$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$

5-YEAR RAP (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy
  - Criteria***
  - Total
- **ACTIVISM**
  - Decisions***
  - SEE Info
  - CSR Issues
  - Dialogue
  - Press*
  - CSR Resolution**
  - Total
- **RESEARCH**
  - Fully**
  - Outsourced
  - Total
- **FUND CHARACTERISTICS**
  - Tenure*
  - Fund Size
  - Europe w UK
  - Equity***
  - Sect Enterprise***
  - Fee x SEE Info***
  - (Fee x SEE Info)^2
- **INVESTMENT STYLE**

n = 87

R-squared = 0.691

Results: Activism & Performance (Model 4)

$$RAP_{i,t} = \gamma_0 + \gamma_1 Positive\ Governance\ Criteria_i + \gamma_2 Fund\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$

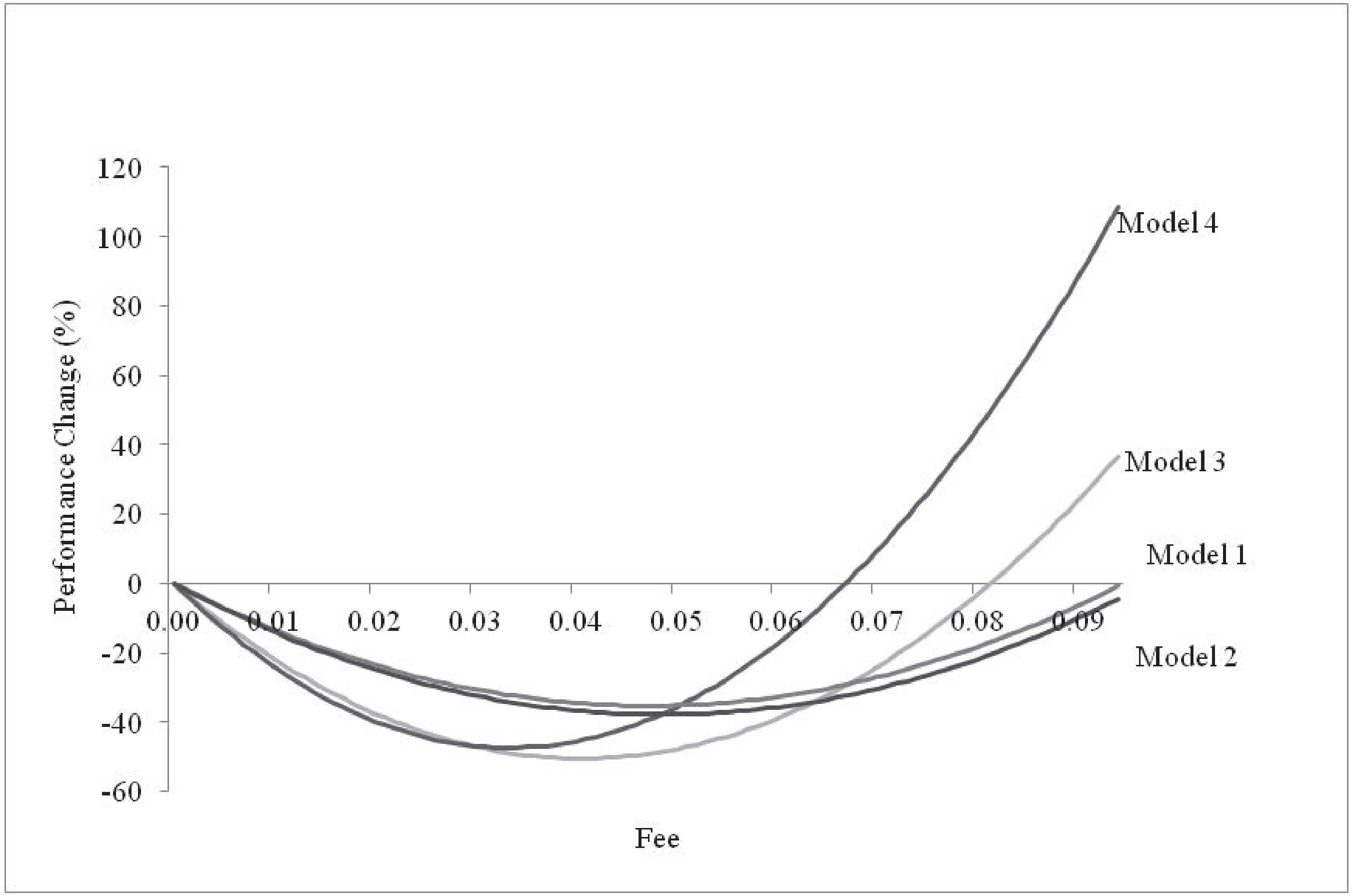
5-YEAR RAP (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy**
  - Criteria***
  - Total
- **ACTIVISM**
  - Decisions***
  - SEE Info
  - CSR Issues
  - Dialogue
  - Press*
  - CSR Resolution**
  - Total
- **RESEARCH**
  - Fully**
  - Outsourced
  - Total
- **FUND CHARACTERISTICS**
  - Ln Tenure**
  - Ln Fund Size
  - Europe
  - UK
  - Equity***
  - Sect Enterprise***
  - Fee x SEE Info***
  - (Fee x SEE Info)^2*
- **INVESTMENT STYLE**

n = 84
R-squared = 0.723

Results: Activism & Performance

SHAREHOLDER ACTIVISM AND PERFORMANCE



Results: Beta (Model 1)

$$\beta_{i,t} = \gamma_0 + \gamma_1 Fund\ Governance\ Criteria_i + \gamma_2 Funds'\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$

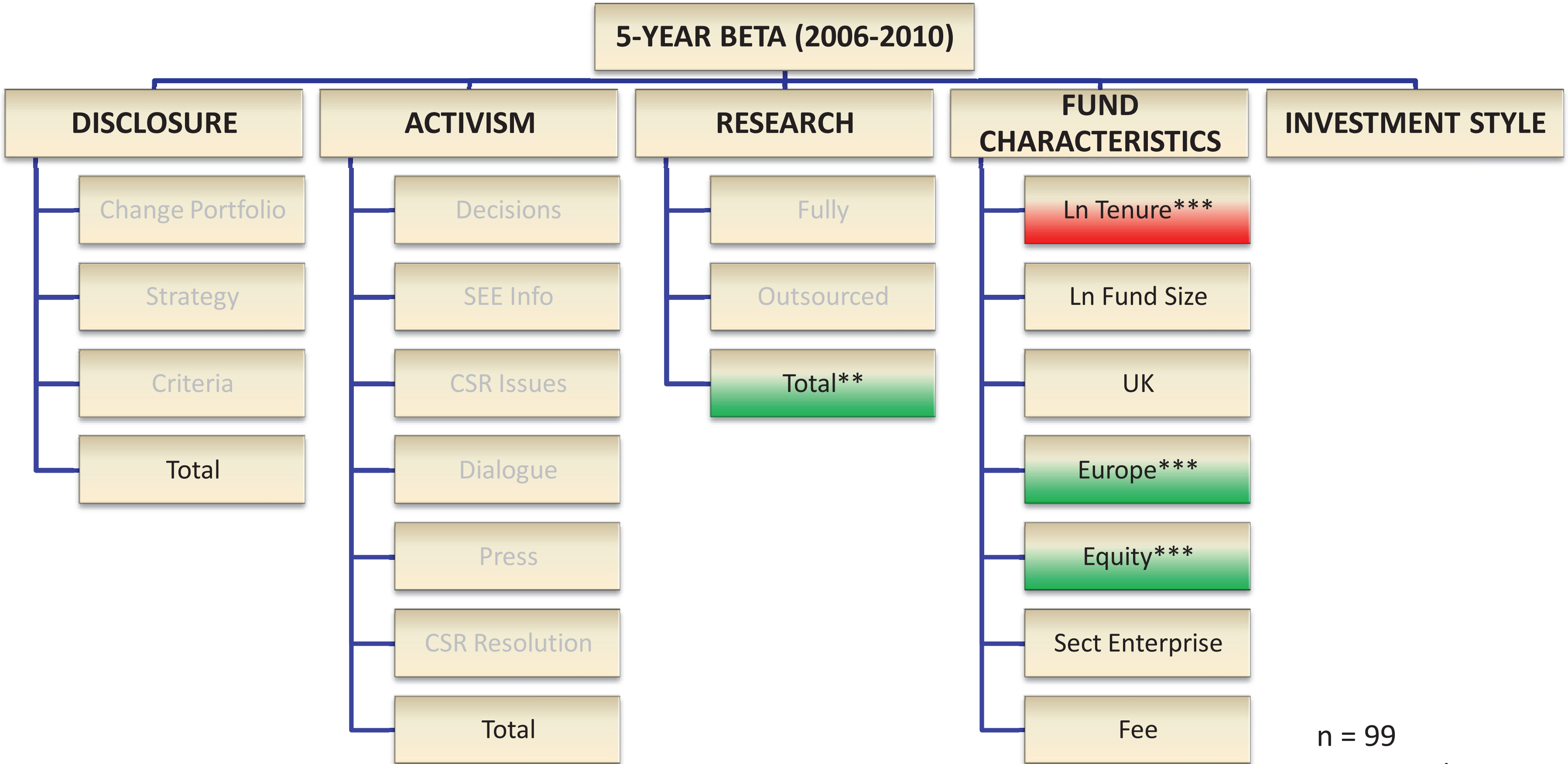
5-YEAR BETA (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy
  - Criteria
  - Total
- **ACTIVISM**
  - Decisions
  - SEE Info
  - CSR Issues
  - Dialogue
  - Press
  - CSR Resolution
  - Total
- **RESEARCH**
  - Fully
  - Outsourced
  - Total**
- **FUND CHARACTERISTICS**
  - Tenure***
  - Fund Size
  - Europe w UK***
  - Equity***
  - Sect Enterprise
  - Fee
- **INVESTMENT STYLE**

n = 102
R-squared = 0.840

Results: Beta (Model 2)

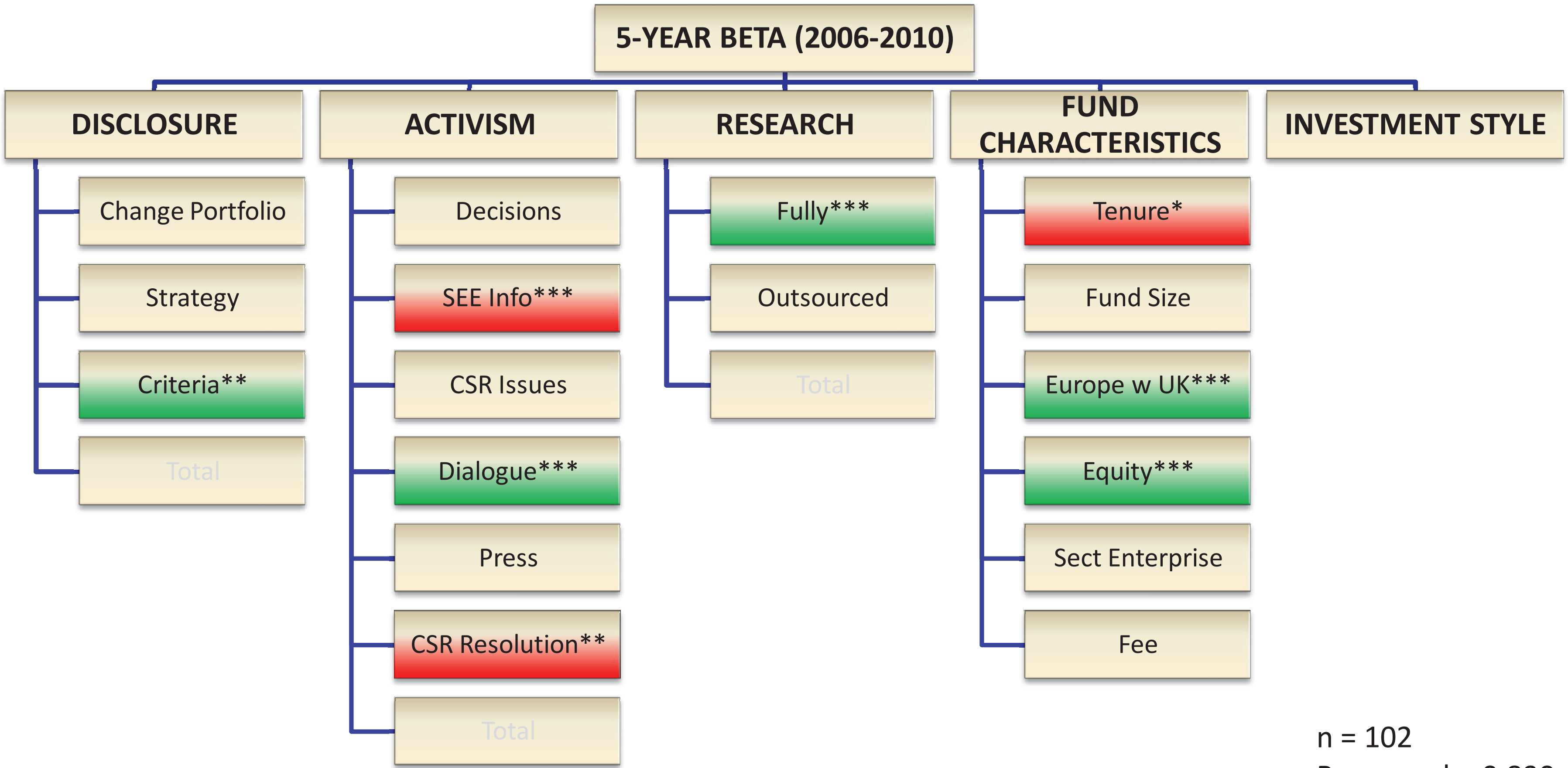
$$\beta_{i,t} = \gamma_0 + \gamma_1 Fund\ Governance\ Criteria_i + \gamma_2 Funds'\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$



n = 99
R-squared = 0.851

Results: Beta (Model 3)

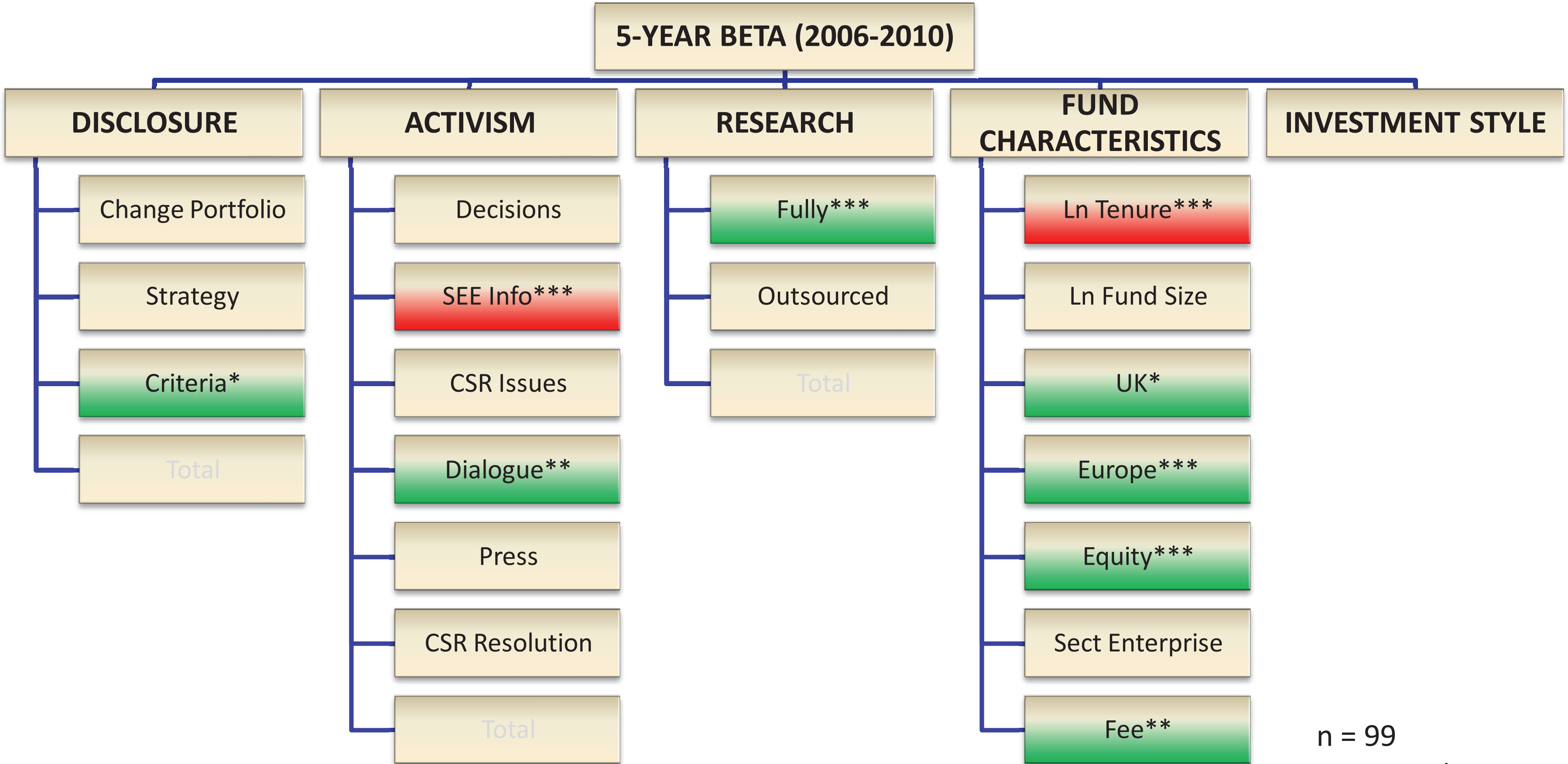
$$\beta_{i,t} = \gamma_0 + \gamma_1 Fund\ Governance\ Criteria_i + \gamma_2 Funds'\ Characteristics_i + \gamma_3 Investment\ Style_i + u_i$$



n = 102
R-squared = 0.890

Results: Beta (Model 4)

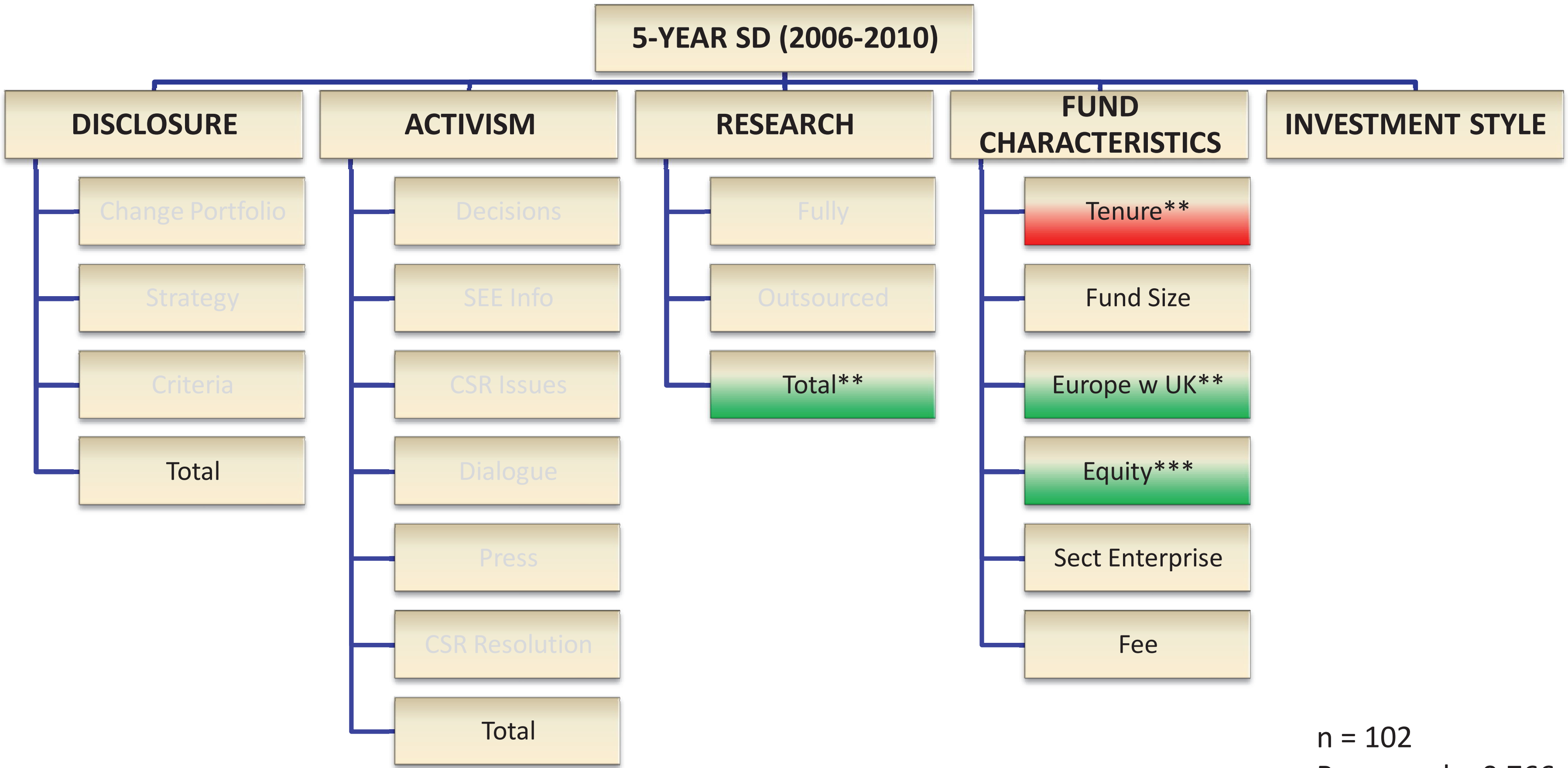
$$\beta_{i,t} = \gamma_0 + \gamma_1 \mathit{Fund\ Governance\ Criteria}_i + \gamma_2 \mathit{Funds'\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$



n = 99
R-squared = 0.899

Results: SD (Model 1)

$$\sigma_{i,t} = \gamma_0 + \gamma_1 \mathit{Fund\ Governance\ Criteria}_i + \gamma_2 \mathit{Funds'\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$



n = 102
R-squared = 0.766

Results: SD (Model 2)

$$\sigma_{i,t} = \gamma_0 + \gamma_1 \mathit{Fund\ Governance\ Criteria}_i + \gamma_2 \mathit{Funds'\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$

5-YEAR SD (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy
  - Criteria
  - Total
- **ACTIVISM**
  - Decisions
  - SEE Info
  - CSR Issues
  - Dialogue
  - Press
  - CSR Resolution
  - Total
- **RESEARCH**
  - Fully
  - Outsourced
  - Total**
- **FUND CHARACTERISTICS**
  - Ln Tenure***
  - Ln Fund Size*
  - UK
  - Europe**
  - Equity***
  - Sect Enterprise
  - Fee*
- **INVESTMENT STYLE**

n = 99

R-squared = 0.779

Results: SD (Model 3)

$$\sigma_{i,t} = \gamma_0 + \gamma_1 \mathit{Fund\ Governance\ Criteria}_i + \gamma_2 \mathit{Funds'\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$

5-YEAR SD (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy
  - Criteria*
  - Total
- **ACTIVISM**
  - Decisions
  - SEE Info***
  - CSR Issues
  - Dialogue**
  - Press
  - CSR Resolution*
  - Total
- **RESEARCH**
  - Fully**
  - Outsourced
  - Total
- **FUND CHARACTERISTICS**
  - Tenure**
  - Fund Size
  - Europe w UK**
  - Equity***
  - Sect Enterprise
  - Fee
- **INVESTMENT STYLE**

n = 102

R-squared = 0.833

Results: SD (Model 4)

$$\sigma_{i,t} = \gamma_0 + \gamma_1 \mathit{Fund\ Governance\ Criteria}_i + \gamma_2 \mathit{Funds'\ Characteristics}_i + \gamma_3 \mathit{Investment\ Style}_i + u_i$$

5-YEAR SD (2006-2010)

- **DISCLOSURE**
  - Change Portfolio
  - Strategy
  - Criteria
  - Total
- **ACTIVISM**
  - Decisions
  - SEE Info***
  - CSR Issues
  - Dialogue*
  - Press
  - CSR Resolution*
  - Total
- **RESEARCH**
  - Fully**
  - Outsourced
  - Total
- **FUND CHARACTERISTICS**
  - Ln Tenure***
  - Ln Fund Size**
  - UK
  - Europe***
  - Equity***
  - Sect Enterprise
  - Fee**
- **INVESTMENT STYLE**

n = 99
R-squared = 0.845

Discussion

- Provision of details about the SRI criteria used to select the portfolio and the provision of information relating to changes in the criteria is significantly positively related to performance. However, the disclosure of the sources and methods used to acquire information about the degree of sustainability is significantly negatively related to performance.
  - **ACCEPT** *H1a: Non-financial voluntary disclosure related to 'general' information is positively related to financial performance.*
  - **ACCEPT** *H1b: Non-financial voluntary disclosure related to 'specific' information is negatively related to financial performance.*
- Deep commitment towards shareholder activism and fundamentally changing a firm's operating performance is positively related to performance.
  - **PARTIALLY ACCEPT** *H2: Shareholder activism has a curvilinear (U-shaped) relationship with financial performance.*
- SRI research produces value-relevant information. Most robust finding.
  - **ACCEPT** *H3: Non-financial research conducted internally is positively related to financial performance*

Discussion

- **ADDITIONAL INTERESTING FINDINGS:**
  - Disclosing ‘general information’ while having a positive effect on performance also has a positive effect on risk.
  - Disclosing ‘specific information’ while having a negative effect on performance, however does not have an effect on risk.
  - Engaging in ‘deep activism’ while negative for performance, also has a negative effect on risk.
  - Engaging in dialogue with firms has no effect on performance but increases the risk.
  - Having an internal research team significantly increases both performance and risk.
  - Fund manager tenure decreases both performance and risk.

Our findings support the argument that positive governance practices are value-relevant.

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