Could Nice Guys (Companies) Actually Finish First? – Kirk Martin

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CHAPTER 1: INTRODUCTION

You have probably heard the saying, "you'll get what's coming to you," or "karma's a bitch." These sayings suggest good things happen to nice people, and the not-so-nice get their comeuppance. These are appealing viewpoints, but are they true, and more importantly, do they have a corollary in the business world? While research into the link between corporate stewardship and financial performance is almost two decades old (one of the first major studies being Waddock & Graves, 1997), the topic has come into prominence with the corporate scandals and market downturn in 2001. The results from Enron, WorldCom and Global Crossing show clearly that poor company ethics can be hazardous to one's finances (Barney, 2009). But is the reverse true? Is good stewardship by public corporations rewarded by above-market equity returns? If so, are these excess returns enough to overcome any necessary trading costs? In other words, can company ethics be a profitable way to find companies to invest in?

This project will explore the correlation between stewardship and equity returns and, if successful, to use this methodology as a tool for profitable stock selection. This method is intended for personal investors that buy and sell equities in smaller increments than professional investors do.

The topic has relevance personally and in the financial services industry. With Social Security under demographic pressure and fewer companies offering pensions to their employees, more investors have to self-finance retirement, thus the topic has wide appeal. From a personal perspective, any impact on my portfolio rate of return means I can retire earlier, have a higher standard of living, or both.

To keep the scope manageable, three limitations will be employed. The correlation between stewardship and equity returns will be examined in the technology industry, specifically the networking sub-sector. Secondly, the time period being studied will be from December 2004, through December, 2011 (corresponding to the introduction of Morningstar's® stewardship grades). Lastly, this research will not delve in causality, but only look at correlation (for the details of this decision, see Chapter 3: Research Methodology).

Definitions and Terms

Above-Market Returns – Stock price increases, plus dividends, which exceed the benchmark index (or decreases, plus dividends, that are less than the benchmark).

Board Quality – One of the components of stewardship (see below), board quality is measured subjectively using three criteria: Is the board independent (meaning, not connected or beholden to management in any way)? Do the independent directors have meaningful investments in the company? How has the board served shareholders in the past?

Corporate Culture – This measurement, also a component of stewardship, evaluates the accounting practices, transparency of communications, and shareholder friendliness of company structure and practices.

Efficient Markets Theory – This economic theory proposes that markets price all known information into securities almost immediately, thus picking individual equities is ultimately fruitless; and the most efficient form of investing is to purchase index mutual funds (see below) in order to get average market returns at very low costs.

Equity Returns (Investment Returns) (Stock Market Returns) (Shareholder Value Creation) – The share price increase or decrease, plus dividends paid to the investor of an investment.

Financial Incentives of Management – Part of stewardship (see below), this assesses whether management's incentives are aligned with shareholder interests.

Financial Performance (Economic Performance) – These are the financial measures of a company other than the equity return of its stock. Examples would be earnings per share, leverage, or return on assets.

Governance – Exercising control or authority, referring in this paper to the control of investors' capital.

Index Mutual Funds (Passive Investing) – An index mutual fund seeks to own the same securities, in exactly the same proportion as the underlying index, getting as close to the performance of that index as possible (less trading costs). This is called passive investing (as opposed to active investing, which strives to beat the index).

KLD Index – An index developed by MSCI to give investors access to listed companies whose activities exhibit high levels of social, environmental and governance engagement.

Market Impact – This represents the hidden cost of large buyers or sellers actually moving the price of a security simply by their orders (as they buy a stock, it tends to drive up the price as they accumulate more shares, while a seller does the opposite).

Mutual Funds – A basket of holdings managed professionally, giving smaller investors diversification and lower costs.

Opportunity Costs – The hidden cost of choosing one investment over another. For example, purchasing a Treasury bond has the opportunity cost of losing the (possibly) higher returns of the stock market.

Public Corporations (Corporations) – Companies owned by shareholders, whose stock is traded on an exchange open to all investors.

Regulatory History – An element of stewardship (see below), this quantifies whether the company has been accused of wrongdoing, or been subject to penalties from a securities regulatory body.

Return on Assets – Net income divided by the cost of assets, this measures the efficient (or inefficient) use of equipment and facilities.

Return on Equity – Net income divided by capital invested (both debt and equity), this gives an idea how effectively a company uses capital (does it take large amounts of cash to grow?).

Return on Sales – Net income divided by twelve months of sales, this indicates whether a firm has pricing power, or sells products that are lower-margin commodities.

Shareholders – The owners of a publicly held corporation (the providers of capital).

Social Performance – A non-financial measurement of how a company deals with its employees, unions, the community, shareholders, and management. It includes stewardship (see below) as well as environmental and community-service aspects.

The Spread between Bid and Ask Prices – The spread between what you can buy and sell a security for, normally a few pennies (however, with large transactions this can add up significantly).

Stakeholders – The different groups a company has a relationship with: employees, labor unions, the community, the environment, shareholders, management, and government entities.

Stewardship – In this paper, this term covers shareholders' rights. Specifically: board quality, corporate culture, the financial incentives given to management, and regulatory history.

Stock (Security) (Equity) (Holding) (Investment) – In this research these terms are synonymous and all refer to ownership in a publicly-held corporation.

Trading Costs (Expenses) (Transaction Costs) – The cost of acquiring and disposing of a security, both explicit (the commission) and implicit (the hidden costs, such as market impact – see above).

CHAPTER 2: REVIEW OF THE LITERATURE

As more of the retirement burden is shifting from employers to employees - from 1993 to 2005, the number of private-industry participants in a defined benefit pension dropped from 32% to 21% (Costo, 2006), the importance of selecting suitable investments is increasing in importance. If good stewardship can predict financial performance beyond investment returns, it also becomes a useful decision point for job-seekers when comparing potential employers.

This literature review will cover the current research into the link between stewardship and financial performance; look briefly at the costs of trading that would need to be overcome for ethics to be a profitable investment criterion; then summarize the existing literature, providing conclusions and suggestions for future studies.

What is Good Stewardship?

Basic economic theory assumes rational decision-makers (Mankiw, 2007). Rewarding a company through higher stock market returns because of social performance (a corporation doing environmental or social good works) seems to contradict that principle. Investors, however, aren't as rational as economic theory predicts. Given a choice, they will forego returns up to a certain point to seek opportunities consistent with their values (Pasewark & Riley, 2010). It is also true that management incentives are a key governance consideration (limiting the conflict of interest between owners and management) which can affect economic performance (Chen, Conover & Kensinger, 2002). If it is possible social performance impacts financial results and equity rates of return, is there evidence it actually does so?

On the surface, the support for a link between social and financial performance is mixed. Several studies found little correlation between the two (Bhagat & Black, 2002; Brammer, Brooks & Pavelin, 2009; and Makni & Bellavance, 2009), however a number of authors came up with different

findings (Waddock & Graves, 1997; Hillman & Kelm, 2001; Gompers, Ishii & Metrick, 2003; Cremers & Nair, 2005; Wellman & Zhou, 2007; and Lutton, Rushkewicz, Liu & Ling, 2011).

The first step in sorting through these different conclusions is determining what is meant by good stewardship. Two studies used the KLD Index (Waddock & Graves, 1997; Heyes-Liston & Ceton, 2009) to measure what they term "corporate social performance," while another (Brammer, Brooks, et al, 2009) used the *Business Ethics* survey of America's 100 Best Corporate Citizens as their metric. Both of these sources measure a wide variety of data points, covering environmental, social and governance criteria. Hillman & Kelm (2001) took the rather unique step of dividing corporate social performance into two parameters: stakeholder management and social issue participation. They found stakeholder management to have a strong impact on shareholder value creation; while social issue participation had a neutral or slightly negative effect on financial performance. This literature review, while including studies that look at social factors, focuses on the impact of corporate governance (which includes stakeholder management as a sub-set).

Stakeholder management is comprised of shareholders' rights (Gompers, et al, 2003), corporate culture and an independent board of directors (Lutton, et al, 2011), governance mechanisms (Cremers & Nair, 2005), and the extent to which management fulfills the pledges made to stakeholders (Atkinson, Waterhouse & Wells, 1997). It is research using these factors that will be analyzed. There were several different approaches to organizing this qualitative data: Gompers, et al. (2003) used 24 governance provisions; Cremers & Nair (2005) used change of control to determine governance; and Lutton, et al (2011) looked at four different areas to compile a single stewardship grade.

The other consideration is how each study defined financial performance. Bhagat & Black (2002) use company profitability; while Waddock & Graves (1997) analyzed return on assets, return on equity and return on sales as their benchmarks. Investors are primarily concerned with equity returns; therefore this review will use that as the basis for financial performance.

When looking at studies that analyzed the intersection of the two criteria: using stakeholder management as the definition of social performance; and equity returns as the measure of financial performance, a clearer picture emerges. This limits the field to six major studies; and a further distinction is made by looking at those studies analyzing a longer timeframe (three years or longer). This distinction is important because the average holding period for an individual investor is just under four years (Bogle, 2008). Four of the six employed such a time horizon (Gompers, et al, 2003; Cremers & Nair, 2005; Wellman & Zhou, 2007; and Lutton, et al, 2011), all of which conclude that good stewardship is linked with increased financial performance (as measured by equity returns).

Can The Effects of Good Stewardship Overcome Trading Costs?

With the link between good stewardship and financial performance supported by these four studies, the next question is that of causality. Only two of the articles listed in the bibliography examined causality. In one, the authors noted the possibility "that the results are driven by some unobservable firm characteristic." (Gompers, Ishii & Metrick, 2003, pg 142). In the other, Waddock & Graves (1997) found causality may run in both directions. Do companies with good stewardship practices get rewarded by investors, or do successful companies have more resources available to create good stewardship?

Investors are less concerned with causality than with demonstrable investment returns. It would be ideal to identify the root cause of a corporation's success in the equity markets, but this tends to be more of a cerebral exercise. Even if a parameter such as good stewardship is simply a proxy for another measurement that causes the outperformance, in the end, the investor is really only after that performance.

While causality might not be a real-world issue for investors, expenses associated with buying and selling securities certainly are. None of the research that compared social and financial

performance took trading costs into account. It is not enough that good stewardship rewards shareholders, but it must do so at a rate that overcomes the friction costs of expenses.

According to French (2008), individual investors overwhelmingly hold mutual funds, rather than direct ownership in companies (only 21.5% of equities were owned by individuals – the majority held by mutual funds). The average cost investors paid to invest in those mutual funds was 0.87% per year (Bogle, 2008). While not a perfect comparison to directly holding a portfolio filled with stocks identified as good stewards, it is a reasonable approximation of the ownership costs. French (2008) estimates the cost as 0.67%, but using the higher hurdle is appropriate, since neither number includes taxes, the spread between bid and ask prices, market impact or opportunity costs (Karz, 2010).

What Does All This Mean?

According to the parameters laid out above – using stakeholder management to measure social performance and equity returns as financial performance – the current research supports the thesis that these factors are linked. Good corporate stewardship correlates with higher investment returns. Data on whether this outperformance overcomes the hurdle of expenses is non-existent, which will be included in this study. Further research is necessary to determine whether bad corporate stewardship is punished by the equities market. Anecdotal evidence from the corporate scandals of the early 2000's would indicate this is so, but this is an area still to be explored.

If good corporate stewardship is compensated with above-market equity returns (even after accounting for the trading costs), this gives individual investors a powerful tool to use in screening possible investments. The literature, as discussed above, indicate this. Whether these results are magnified by the ethics crisis in the early 2000's, or have always been in place, is unknown and is a possible area for future research.

CHAPTER 3: RESEARCH METHODOLOGY

To answer these questions, this research project will use two data sources. The first is stock market return from Standard & Poor's®, both for the individual companies in the technology industry and the index. As a control, the results will be compared to the Standard and Poor's 1500 composite index, which is a proxy for the stock market in its entirety. All of these data points are readily available from Thomson ONE Banker through the DePaul University Library.

The second source of information will come from Morningstar® in the form of stewardship grades for the companies within the networking sub-sector of the technology industry. This data can be accessed from the Morningstar® website with a premium membership at minimal cost.

Using a coefficient of correlation, the data between those companies with a high stewardship grade will be compared to those with a low stewardship grade, market rate of return being the dependent variable. The companies with the highest stewardship grades will also be compared to the market as a whole, using the S&P 1500 index as the control group.

This is a simple Ex Post Facto design, using a time-series. Historical return data will be compared against to the stewardship grades across time, within a single industry. This research will use a mixed methods approach, employing both quantitative and qualitative data. What, in essence, is being answered is the question of whether a qualitative source of information (the stewardship grades) has a statistically significant effect on quantitative data (the individual company stock returns).

The qualitative method of determining stewardship grades is done by the Morningstar® research staff, though these stewardship grades are composed themselves of both qualitative and quantitative data. These grades are composed of four aspects: corporate culture, board quality, the financial incentives of management, and regulatory history. Each of these broad categories covers sub-categories, some of which are more subjective in nature (much of corporate culture), while others are of a quantitative nature (all of the financial incentives category). This mixture of data types gives strength

to the overall stewardship weightings – there is certainly the specificity of raw numerical data to give preciseness; while the subjectivity of the feel of whether a company is a good "steward" of others' capital is also present. The drawback to this type of design, however, is the difficulty in combining the two forms. Does qualitative data get more, less or the same prominence as quantitative? There is also the impression of complete objectivity that a singular grade bestows, despite the fact that significant interpretations are involved. Lastly, Morningstar's® stewardship grades are relatively new, being initiated in 2004, so their history is limited. This could bring confounding variables into play (that market environment could be responsible for outperformance of this industry, rather than stewardship). This research seeks to eliminate that confounding variable by using the index as a control.

On the other hand, equity rates of return are completely quantitative, historical data. This is the dependent variable, so there is merit in the exactitude of having an abundance of objective data to use. Although the cause of stock price variance is murky, the actual price itself has no qualitative features whatsoever. The price of a share of stock on a given date is very precise quantitative data. The weakness in this form of information is the difficulty in assigning causality to price changes and the variation in rates of return over time. Correlation (or lack) between our two variables can be established, but causality cannot – it is not possible to dig back into historical trades and interview the participants to determine whether they took stewardship of the company into account. Even if it was possible to determine who was involved in the millions of trades on a given day, it would not be logistically feasible to do such interviews. Causality between our dependent and independent variable will not be explored in this research.

Since this study is seeking to ascertain the correlation between two variables, one being completely quantitative and the other mostly qualitative, a mixed methods design will be employed. Using solely quantitative data wouldn't lend as much judgment to the stewardship grades, which this research relies heavily upon. There are purely quantitative parallels to the data chosen here, but they

are not as relevant with the research questions we are trying to answer. It would not be possible to depend on purely qualitative information for rates of return.

This research involves no human subjects, so does not face most ethical challenges. The data to be used is longitudinal stock market returns compared against subjective stewardship grades. Neither of these involves human subjects, but rather public information. The only ethical dilemma to be considered is a possible conflict of interest.

This might arise due to the author's employment in the financial services industry. Even if a real conflict of interest does not exist, the mere appearance of a conflict could taint the results of the study, such that it would not enjoy the credibility it should.

To avoid this prospect, the study will focus on a very narrow industry segment the author's employer is not involved with. By using stewardship data from a respected organization such as Morningstar® the appearance of a conflict should be much diminished.

The research questions being asked have four built-in assumptions. According to the Efficient Markets Theory (Malkiel, 1973), stock market pricing reflects all known information. This theory speculates that picking individual equities is not consistently profitable and will ultimately lose to an index. This research seeks to contradict the Efficient Markets Theory. To counter any personal bias, this research will analyze a long timeframe that includes up, down and sideways trending market environments. This should present a balanced investing environment.

An investor can greatly decrease transactions costs by merely investing in a modest index mutual fund (Malkiel, 1973). If this research supports the thesis that good stewardship is economically advantaged and that these excess returns overcome trading costs, there exists still the question of whether the effort is worth those excess returns. The stock screening and selection necessary to implement this as a trading strategy would require a significant time investment. This time value will be ignored in this research.

In order to narrow the focus of the study, a sub-sector of the technology industry was chosen as a test-bed. While it seems likely that results from this segment of the market can be generalized across industries, that is an assumption made as part of this research and will not be explored to any depth.

Using historical stock pricing, correlation (or a lack of correlation) will be determined, however causality cannot be judged by this data. The choice was made to disregard causality – if some unknown factor is causing a correlation between the two variables, this research assumes correlation is stable and will continue into the future. Analysis of causality will be left to future research efforts.

CHAPTER 4: RESULTS AND DISCUSSION

It is presumed this research will support the hypothesis that good stewards of capital outperform their less ethical peers. The anecdotal evidence seems to lend credence to this theory; it makes logical sense; and is supported by the available literature (see Chapter 2: Review of the Literature). If this turns out to not be the case, further research on a wider range of corporations may be in order before abandoning this hypothesis. Even if the premise is supported, further study of other industry groups should be undertaken to allow for wider generalization. Research to encompass a longer time horizon would also be appropriate in the future. If this project successfully demonstrates correlation between stewardship and equity returns, the next step would be to build a model portfolio using stewardship as a selection criterion under real-world conditions.

The equity markets have a tendency to quickly arbitrage away economic advantage once it becomes widely known, so this method of stock-picking may have a limited length of usefulness. Nonetheless, results supporting the idea that stewardship can predict above average rates of return would allow investors to wield a powerful instrument in stock selection.

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Bhagat, S. & Black, B. (2002). The non-correlation between board independence and long-term firm performance. *Journal of Corporate Law, 27,*(2), 231-273.

Bogle, J. (2008). A question so important that it should be hard to think about anything else. Journal of Portfolio Management, 24,(2), 95-102.

Brammer, S., Brooks, C. & Pavelin, S. (2009). The stock performance of America's 100 best corporate citizens. *Quarterly Review of Economics & Finance, 49,*(3), 1065-1080.

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COMPOSITE DATA COLLECTION INSTRUMENT

				Compounded Internal Rate of Retu			
		Stewardship Grade		From January 1, 2005			From Janu
	Networki	t Dec, 200	t Dec, 200	1-year IRR	3-year IRR	5-year IRR	1-year IRR
BRCM	Broadcom						
CSCO	Cisco Systems						
FFIV	F5 Networks						
HPQ	Hewlett-Packard						
JDSU	JDS Uniphase						
JNPR	Juniper Networks						
LSI	LSI						
^IXS	**S&P Technology Sector Index**						
ADBE	Adobe Systems						
AMD	Advanced Micro Devices						
A	Agilent Technologies						
AKAM	Akamai Technologies						
ALTR	Altera						
ADI	Analog Devices						
AAPL	Apple						
AMAT	Applied Materials						
ADSK	Autodesk						
ADP	Automated Data Processing						
BMC	BMC Software						
BRCM	Broadcom						
CA	CA						
CSCO	Cisco Systems						
CTXS	Citrix Systems						
CTSH	Cognizant Tech Solution						
CSC	Computer Sciences						
CPWR	Compuware						
DELL	Dell						
EBAY	Ebay						

(Click on the spreadsheet to open the Data Collection Instrument in Microsoft Excel)

APPENDIX B: ANNOTATED BIBLIOGRAPHY

Atkinson, A., Waterhouse, J. & Wells, R. (1997). A stakeholder approach to strategic performance management. *Sloan Management Review, 38*, 25-37.

Location: OmniFile Full Text Select (H.W. Wilson)

Atkinson and Wells researched using a stakeholder approach to management measurement that focuses on strategic planning, specifically, the contracts, explicit and implicit, management makes with all of its stakeholders. This examination is useful in my particular research questions because it attempts to quantify qualitative data to come up with a measure performance metric, which I can adapt for my own research. The authors make no attempt to quantify the results of using this performance measurement, which complicates my own use of the tool.

Barney, J. (2009). Corporate scandals, executive compensation, and international corporate governance convergence: a U.S.-Australia case study. *Temple International & Comparative Law Journal, 23,(*2), 231-267.

Location: OmniFile Full Text Select (H.W. Wilson)

This case study looks at the recent corporate scandals, and how may have been caused by poor corporate governance, especially bad management incentives (compensation strategies that didn't align the interests of management with those of shareholders). I agree with many of Barney's conclusion, however, in this research, I will only explore the correlation between poor stewardship and below-average equity returns in a superficial and anecdotal manner.

Bhagat, S. & Black, B. (2002). The non-correlation between board independence and long-term firm performance. Journal of Corporate Law, 27,(2), 231-273.

Location: Business Source Complete

This research asks three questions: does greater board independence affect financial performance; does financial performance impact board composition; and does the size of a board

directors influence the performance of a company. Using quantitative data and a long time-horizon, the authors find little correlation between board independence or board size and financial performance. This study, however, defines financial performance as profitability of the company, rather than equity returns. While a company might not improve profitability under these parameters, it could be perceived to be more valuable in the stock market. Despite that, this study tends not to support my hypothesis that stewardship (as defined by board independence) is ultimately rewarded by the market.

Bogle, J. (2008). A question so important that it should be hard to think about anything else. Journal of Portfolio Management, 24,(2), 95-102.

Location: OmniFile Full Text Select (H.W. Wilson)

This article examines the trend of costs in financial intermediation, and only touches upon my research questions in the area of average investor holding periods and trading costs, both of which were supported by other sources.

Brammer, S., Brooks, C. & Pavelin, S. (2009). The stock performance of America's 100 best corporate citizens. Quarterly Review of Economics & Finance, 49,(3), 1065-1080.

Location: Business Source Complete

Using the *Business Ethics* survey of America's 100 Best Corporate Citizens as a proxy for social responsibility, the authors quantitatively compare the performance of those 100 companies to the S&P 500 index, adjusting for size, value, momentum and sector. They find a statistically insignificant correlation between stewardship (as defined by *Business Ethics*) and rate of return. The study looked at two measures: a 21-day window after it was announced a company would be joining the rankings; and for one year afterward. I find this one-year timeframe to be much too short to analyze whether a portfolio of "best corporate citizens" would outperform the broader market. Thus, while the results on the surface don't support my thesis, I think longer-term analysis is in order.

Chen, A., Conover, J. & Kensinger, J. (2002). Proven ways to increase share value. Journal of Applied Finance, 12,(1), 89-97.

Location: Business Source Complete

The authors set out to identify the key drivers of stock market performance for an individual company and how an incentive system for company management could be implemented to take advantage of those drivers. Taking into account the inherent conflict of interest between owners (shareholders) and management, the study identifies "handles" (Chen, Conover & Kensinger, 2002, pg 96) that could be used to link incentives with those key performance drivers. While this research doesn't directly reflect my own research questions, it does contribute several ways to measure whether a target companies' incentive pay plan would contribute to above-average stock market returns.

Costo, S., (2006). Trends in retirement plan coverage over the last decade. Monthly Labor Review, 129,(2),58-64.

Location: OmniFile Full Text Select (H.W. Wilson)

This study looked at trends in worker coverage, specifically relating to both defined contribution and defined benefit type plans. I used it simply for the BLS data contained within that compared the percentage of private-industry employees covered by defined benefit plans from 1993 to 2005.

Cremers, K. & Nair, V. (2005). Governance mechanisms and equity prices. The Journal of Finance, 60,(6), 2859-2894.

Location: Business Source Complete

This study asks three questions: do external and internal governance affect equity prices; does this depend on the size or leverage of the company; and what implications this might have for structuring corporate governance. Internal governance is the degree of public pension fund ownership (high internal governance has large block ownership); external governance is the ease with which control can change (the company has low anti-takeover provisions). When both of these measures

intersect (large shareowners and low anti-takeover provisions), the authors found excess returns of 10-15%. I find this quantitative study to be strong – it analyzes equity returns and company profitability and it supports my hypothesis of a correlation between good stewardship and positive equity returns.

French, K. (2008). Presidential address: the cost of active investing. The Journal of Finance, 63,(4), 1537-1573.

Location: Business Source Complete

The author calculates the total cost investors pay in trying to actively beat the market, comparing it to the cost of passive investing, where the investor accepts the index return, and it was this data I utilized in this project.

Gompers, P., Ishii, J. & Metrick, A. (2003). Corporate governance and equity prices. Quarterly Journal of Economics, 118 ,(1), 107-155.

Location: Business Source Complete

The authors created an index of shareholders' rights and, using a long time-horizon, studied the correlation between those rights and company performance for an entire decade. Using 24 corporate governance provisions for a sample of 1500 companies, this quantitative study found that stronger shareholders' rights correlated strongly with stock returns, profits, sales growth and firm value. This study supports my hypothesis and provides a ready template for further empirical research. The main drawback of this research is the possible lack of causality. The authors considered the possibility "that the results are driven by some unobservable firm characteristic." (Gompers, Ishii & Metrick, 2003).

Heyes-Liston, C. & Ceton, G. (2009). An investigation of real versus perceived CSP in S&P-500 firms. Journal of Business Ethics, 89, 283-296.

Location: Philosopher's Index

Heyes-Liston and Ceton conclude a discrepancy exists between perceived and actual corporate social performance (CSP) and attempted to determine causes for this divergence. This difference

between actual and perceived CSP affects investment, spending and employment decisions, causing economic inefficiency. Using quantitative research, the authors examine eight hypotheses they pose to explain the CSP gap. By comparing Fortune magazine's "America's Most Admired Companies" survey (used as a proxy for perceived CSP) to the KLD index (representing actual CSP), the gap between the two is verified and causes are tested for statistical significance. Six of their eight conclusions were found to be supported by the data. Although they make some rather large assumptions (for instance, that the Fortune survey acts as "perceived CSP" and the KLD index is relatively unknown), this article did show one reasonable way to measure the business ethics of corporations (Heyes-Liston & Ceton, 2009).

Hillman, A. & Keim, G. (2001). Shareholder value, stakeholder management, and social issues: What's the bottom line? Strategic Management Journal, 22,(2), 125-139.

Location: Telecom

This study takes a rather unique look at the connection between social and financial performance. They divide corporate social performance into two components: stakeholder management and social issue participation. They find that stakeholder management has a positive impact on shareholder value creation; while social issue participation has a neutral or slightly negative effect on financial performance. Using annual changes in market value added (MVA – which is market value less capital invested), this research, though still using a short (one year) timeframe, appears solid otherwise. It further helped me clarify my own research questions.

Karz, G. (2010). Trading Costs. Investor Home website. Accessed on February 3rd, 2012.

Location: http://www.investorhome.com/tc.htm

Karz postulated a trading cost of owning mutual funds that closely approximately the figures from the Bogle article, giving me confirmation both were fairly represented transaction costs.

Lutton, L., Rushkewicz, K., Liu, K. & Ling, X. (2011). 2011 Mutual fund stewardship grade research paper. Morningstar, Inc., April 13, 2011.

Location:http://corporate.morningstar.com/us/documents/methodologydocuments/MethodologyPapers/StewardshipGradeMethodology.pdf

Morningstar began publishing stewardship grades for mutual funds shortly after the 2003/2004 industry scandal as a way to identify funds that would treat shareholders fairly. This study looked at the correlation between that stewardship and fund performance. The methodology looks at five areas to determine the stewardship grade: (1) corporate culture; (2) board of directors; (3) financial incentives; (4) fees; and (5) the firm's regulatory history. Using quantitative performance data, the authors compared both the overall stewardship grade, and the individual components of that grade, to risk-adjusted returns from 2004 to 2010. Although the timeframe was both short and somewhat anomalous (the authors looked at start dates of 2004 and 2007, along with three-year return data, the second period including two unusually deep down years), there was indeed correlation between stewardship grades and mutual fund performance and longevity of the mutual fund. Though this methodology is applied to mutual funds, I believe the same type of grade could be used with corporations.

Makni, R., Francoeur, C. & Bellavance, F. (2009). Causality between corporate social performance and financial performance: evidence from Canadian firms. Journal of Business Ethics, 89,(3), 409-422.

Location: Business Source Complete

This study sets out to assess the causal relationship between corporate social performance and financial performance, looking specifically at Canadian firms. Contrary to a study of American companies (Waddock & Graves, 1997), the authors find no statistically significant correlation between the two measures; in fact, they find a negative relationship between environmental efforts and financial rewards. Perhaps other factors are at work here, since Canadian companies are typically smaller and

environmental regulations differ. This research, however, refutes my hypothesis that superior stewardship contributes to market-beating rates of return.

Malkiel, B. (1973). *A random walk down wall street*. New York: W.W. Norton and Company.

Location: Book from personal collection

This is a well-received financial theory that this research seeks to contradict; that markets are efficient and can't consistently be predicted, making individual stock selection fruitless. Extensive experience with the markets leads me to believe this theory does not always operate exactly as stated.

Mankiw, G. (2007). *Essentials of economics (4th ed.).* Mason, OH: South-Western Cengage Learning.

Location: Textbook

This is an economics textbook used as a source for basic economic theory, specifically that investors (economic participants) are rational decision-makers. My thesis contradicts this theory, so it was necessary to include this basic framework.

Pasewark, W. & Riley, M. (2010). It's a matter of principle: the role of personal values in investment decisions. Journal of Business Ethics 93,(2), 237-253.

Location: Business Source Complete

This research looks at whether personal values play a role in investment decisions, and how big that role might be. Contrary to traditional theory that investors always act to maximize profits, the authors found that investors will seek opportunities consistent with their values up to a certain point. Using a tobacco and non-tobacco company and varying the return differential in an experimental study, the participants would choose the non-tobacco company until the rate of return of the tobacco company exceeded it (at a 1% greater return, social concerns began to be replaced with economic ones). While this study simplified things to isolate key variables, the possibility exists that participants would react in unanticipated ways once "real" money was involved in a real investment. Nonetheless, it does point out that social values could impact financial performance.

Waddock, S. & Graves, S. (1997). The corporate social performance-financial performance link. Strategic Management Journal, 18,(4), 303-319.

Location: ABI/Inform Complete

This is one of the first studies to look at the possible linkage between corporate social performance (CSP) and financial performance (FP). Using the KLD index, the authors attempted to determine if a connection exists, and in which direction causality operated (does higher CSP cause better FP, or do companies with stronger financial performance have resources to devote to CSP?). They found a correlation between the two indicators and, surprisingly, found that causality may run in both directions. While supportive to my own thinking, the authors used return on assets, return on equity and return on sales as their financial performance measures, rather than stock price valuation.

Wellman, J. & Zhou, J. (2007). Corporate governance and mutual fund performance: A first look at the Morningstar stewardship grades. Binghamton University School of Management.

Location: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=714303

Wellman and Zhou compared Morningstar's stewardship grades to mutual fund performance for two periods: 2001-2004 and 2004-2007. Their quantitative findings were that those mutual funds given an "A" or "B" stewardship grade outperformed those given a "D" or "F" by a statistically significant margin (between 1.20 and 1.92 percent per year). They further analyzed the five different components of the Morningstar stewardship grades against fund performance, documenting that board quality was better at predicting rate of return than other variables. Though this study analyzed mutual funds rather than public corporations, the findings were significant in that board quality was a strong determiner of financial performance.