RESPONSIBILITY AND PROFIT: Hoje Jo and his colleagues have taken a new approach toward measuring the connection between corporate social responsibility, outside pressures and company financial performance.

The Value of Responsibility
New Way of Measuring Its Link to Company Performance

Corporate social responsibility (CSR) is a concept that has gained such traction in the business world that a recent survey by The Economist found that 53.5 percent of responding firms said it “is a necessary cost of doing business.” Yet for all its acceptance by large companies, there has been little hard evidence of its impacts and ramifications.

“The long-lasting question in this area is if a company engages in CSR, will it be rewarded?” says Hoje Jo, associate professor in the Finance Department.

“The research so far has been inconclusive: Some said yes, some said no, and some said it depends.”

Table of Contents

- The Value of Responsibility 1
- The Personalities of Investors 2
- Troubled Home Loans 4
- Big Spread in Performance 5
- Innovation, Risk, Ethics 6
- The Value of Values 8
A significant step toward answering that question was taken in a paper released earlier this year by David P. Baron of Stanford, Martino A. Harjoto of Pepperdine, and SCU’s Jo. Titled “The Economics and Politics of Corporate Social Performance,” the paper was awarded the 2009 Moskowitz Prize from the Center for Responsible Business in the Haas School of Business at UC-Berkeley in September.

In the paper, Jo and his colleagues focused on Corporate Social Performance (CSP), which is typically (though not necessarily) an outgrowth of CSR and more measurable by concrete standards, such as corporate policies and contributions.

Mining material from multiple sources, they looked at data covering more than 2,000 companies over an eight-year period that was evenly divided between Democratic (Bill Clinton) and Republican (George W. Bush) administrations.

Large firms, they said, are operating in three markets: a product market, a capital market, and a market for social pressure as generated by shareholders, government, non-governmental organizations (NGOs) and social activists.

CSP was defined as social activities that go beyond the requirements of law and regulation and that involve either the private provision of public goods or private redistribution.

To evaluate the relationships among these markets, they created a three-equation structural model that provided a measurement.

Viewed from this perspective, they found that there was no overall evidence of a connection between a company’s financial performance and social performance, but that social pressure had a significant impact on both. The more social pressure a company faces, the more it’s likely to feel the sting on the bottom line and also to step up its involvement in social performance activities.

Jo says that point can be illustrated by the automotive industry. “General Motors has problems with unions and with its management/shareholder relations. Toyota has few internal problems and has never had a strike.” The first is in trouble, and the second is thriving.

Although he and his colleagues found little or no overall connection between social and financial performance in companies, Jo says the matter is more complicated.

Industrial firms that primarily sell to other companies tend to be adversely affected by their CSR efforts, while companies that sell directly to consumers through known brands tend to see more of a connection. When CSR activity is geared toward appealing to consumers, investors are more likely to respect the effort, Jo says.

It also matters, the researchers found, whether CSR/CSP activity is strategic or responsive. When done proactively, with a certain goal in mind, the results tend to be more favorable; when done in response to attacks or outside influences, a less positive outcome is likely.

“If a company does CSR properly, it can improve financial performance,” Jo says. “If it’s used as an intelligent means of conflict resolutions, it can mitigate agency problems among the various stakeholders and raise up a company’s value.”

“What’s the reward for corporate social responsibility?”

Hoje Jo
Associate Professor
Dept. of Finance

The Personalities of Investors
Tailoring Portfolios to Suit Individual Propensities

When financial advisors meet investors, they typically discuss how much risk investors are willing to take in pursuit of potentially higher returns. The current financial crisis has tested the limits of those discussions, and two researchers at Santa Clara University’s Leavey School of Business say the crisis has exposed some shortcomings in the tools used in the assessment of risk tolerance. Investors who thought they could tolerate risk in late 2007 realized in early 2009 that they cannot.

“Risk tolerance is not the only question,” says Meir Statman, the Glenn Klimek Professor of Finance in the business school. “People have different notions, propensities and personality traits. The conversation an investor has with an advisor should be structured and wide-ranging, like what you’d have with a caring physician.”

To help identify the outlines of that structure, Statman and Assistant Professor Carrie Pan have written a paper titled “Beyond Risk-Tolerance: Overconfidence, Regret, Personality, and Other Investor Characteristics,” which is about to be submitted for publication in a leading journal for financial advisors.
In the paper, they cover a range of propensities and personality traits that can help advisors determine how to guide investors. “We found that there were differences of risk-tolerance depending on the situation,” Statman says. “For instance, young people are more willing to take risks with their portfolios, but less willing to take risks with their jobs. When you’re young, your serious money is in your paycheck. When you’re old, the serious money is in your portfolio.”

The data for the paper was obtained from Keirsey.com, which offers a widely used personality test on its web site. Statman persuaded them to offer an optional supplemental questionnaire he and Pan devised on risk-tolerance and other investor propensities. These include:

- Propensity for overconfidence, reflected in answers to a question about abilities to pick stocks with above average returns;
- Propensity for maximization, reflected in agreement with a statement that second best is not good enough;
- Propensity for regret, reflected in agreement with a statement about regretting choices that did not turn out well, and;
- Propensity for trust, reflected in answers to a question about whether people can be trusted, or whether one always has to be on guard dealing with people.

Statman and Pan linked these investor propensities to personality traits such as extraversion, conscientiousness, openness and agreeableness. For example, extraverts are generally willing to take risks, but conscientious people are not. Trusting people are willing to take risk and so are overconfident ones, but propensity for regret neither adds nor detracts from the willingness to take risk.

As an example of how these factors can come into play, Statman points to the question of propensity for regret. “When investments go badly, some people look back in anguish. Others just say, ‘That’s life; stuff happens.’ If someone is very much prone to regret, an advisor should prepare for it ahead of time rather than be shocked when it happens.

“The results answer questions asked by financial economists, and by financial advisors. Questions and answers can help financial advisors guide investors.”

As one of the pioneers in the field of behavioral finance, Statman sees how money and personality interact. “You can’t disconnect issues of money from issues of life,” he says. “After all, what’s money for?”
Troubled Home Loans
What’s The Most Effective Way to Modify Them?

Following the recent crash of the housing market, lenders have actively been restructuring and modifying home loans to avoid foreclosures as much as possible. Professor Sanjiv R. Das, chair of the Finance Department in the Leavey School of Business, has looked at the way they’re doing it and concluded that the current approach may be suboptimal.

“In an attempt to make loan service affordable for a borrower, lenders are usually reducing monthly payments by reducing interest rates, extending the term of the loan, or some combination of the two,” Das says. “The subsequent re-default rate is very high, ranging from one-third to two-thirds of modified loans, depending on how you look at it. Lenders may be doing exactly the opposite of what’s theoretically indicated.”

Lenders, he says, may not have properly accounted for the willingness to pay. Simply put, a borrower in trouble, particularly a borrower with negative equity, has the option of turning over the keys and walking away from the home and the loan. A loan modification that doesn’t provide some incentive not to do that carries a higher risk of re-default.

Das says that earlier this year a student put him in touch with a man who was making that argument, and Das decided to create a mathematical model to test that hypothesis. The result of his research is contained in a paper, “Saving Homes and Banks: Optimal Modification of Distressed Home Loans,” that is about ready to be submitted for publication.

What would make far more sense than cutting interest rates or extending the term of the loan, he found, would be writing down the principal on the loan. That immediately gives the borrower more equity and a greater incentive to remain in the home and continue to pay off the loan.

“Lenders may be doing the opposite of what’s optimal.”

Sanjiv R. Das, Chair, Department of Finance

Banks and other lenders are reluctant to do that, Das says, because of the initial financial hit they have to take. Yet if they end up foreclosing on a house and reselling it, they’re likely to lose about 30 percent of the property’s value and create a ripple effect that adversely affects the value of neighboring properties on which they’ve loaned money.

That “deadweight loss” is something banks and other lenders want to avoid, and one way of doing it would be to write down the loan in stages so the lender doesn’t take the full force of the financial hit up front.

Interestingly, Das says, while most lenders have so far been reluctant to adopt this approach, a number of hedge funds that buy securitized mortgages have done so.

THE PRIVATE EYE: With a wealth of new information available, Robert Hendershott is studying the performance of private equity firms and finding there are clear winners and losers.
For years, private equity funds have raised capital by pooling a group of limited partners to invest in privately held companies — either startups or non-public firms needing capital for specific reasons. The pitch to investors is that the risks are greater, but so are the potential rewards.

Recently Das was on the East Coast presenting his model to banks and regulators who are receptive to his ideas. “They recognize that the lowest economic loss over the remaining life of the loan is likely to occur if they write down some of the principal,” he says.

Borrowers are increasingly aware that they have a valuable option to default and are less reluctant to walk away from a loan that no longer works for them.

“There are two factors that come into play in restructuring a loan,” Das says, “the ability to pay and the willingness to pay. The social stigma of foreclosure has all but gone because there have been so many foreclosures that no one cares any more. What was not recognized by lenders in the past was the value of the borrower’s option to walk away from the loan.”

Robert Hendershott, associate professor of Finance, has been mining the data and already sees some surprising trends.

“With private equity funds, you’re locking up your investment for a long time, usually five to eight years, with no liquidity,” he says, explaining the rationale for his study. “The only reason to do that is if you’re getting really high returns.”

Using the Private Equity Intelligence (PEI) database, which goes back to 1969, as well as more recently available information, Hendershott has looked at more than 3,400 private equity firms. He hasn’t yet reached the point of writing a paper, but some things have jumped out.

“One thing that surprised me is how many poorly performing funds there are,” he said. “A lot of funds are losing money. Before, you never heard about the real losers, but they’re out there.”

Because of the long time that private equity funds hold investors’ money, the effects of a loss can be significant.

**THE FREEDOM TO WALK:** Sanjiv Das’ research shows that lenders should correctly account for the borrower’s option to default when they restructure distressed home loans.
big spread in performance

For Sharath M. Sury, the turbulence in the financial markets over the past two years has created a “perfect storm”: a condition that almost demands the establishment of an organization that looks at financial innovation and risk management from an ethical point of view.

Sury, the Dean’s Executive Professor in the Finance Department, is acting on that belief to take the lead in launching the Sury Initiative for Financial Innovation and Risk Management (SIFIRM). By involving academics, students, and representatives of the private sector, it aims to become a magnet for innovative thinking in these areas.

“Wall Street isn’t what it used to be,” Sury says. “The case for applied studies that combine ethics, social justice and innovation is compelling, and students and companies have latched on to it in a very big way.”

Coming into academia from the private sector (he was CEO of S4 Capital, the top-ranked wealth manager in the U.S. in 2006 and 2007), Sury has the connections to get the initiative off to a fast start and has provided much of the seed money for its inception.

The Sury Initiative will sponsor a conference in the spring of 2010 that will focus on social investing. “The theme will be the value of values in the investment world,” Sury says. The steering committee is planning a more formal event later next year that will serve as a forum for top practitioners and also help raise funds for SIFIRM.

As the SIFIRM grows, Sury hopes it will generate a portfolio of work that will advance knowledge in the public domain on the subject of ethical innovation and risk management.

Innovation, Risk, Ethics
Initiative Weaves Study of the Three Together

Hendershott points out that if an investor were to put money into a private fund that lost 30 percent over five years, as opposed to a safe bond that returned 30 percent over the same period, that investor would end up with half as much money as if he’d taken the conservative approach with the bond.

Another trend he’s observing is that, unlike mutual funds and other investors in public stocks and bonds, private equity funds do continue to do better or worse over the long haul. In the stock market, results tend to even out over a ten-year period, as most investors feel the impact of good and bad times. In private equity, funds that start out poorly tend to continue to do poorly.

Of course luck and general market trends also play a role. “In 2004-06, almost everyone was making money,” Hendershott says. “Now, it’s hard to make money. Even Warren Buffett didn’t do well in 2008.”

With private equity funds, it can take time to sort out the winners and losers. If a fund, for example, invests in a startup business, the result of the investment may not be known until that business goes public or goes broke.

“It’s clear that some funds consistently do better than others.”

Robert Hendershott
Associate Professor
Department of Finance

But with the wealth of data now available, Hendershott says it’s clear that some equity funds consistently do better than others.

That’s critical information for investors, because private equity funds typically raise capital for a new fund, investing in new ventures, every few years. While past performance is no guarantee of future results, it’s a better indicator with private equity funds than it is with mutual funds.

One of Hendershott’s findings is that the return on a private fund whose previous fund was in the top quartile in performance is up to double the return of a fund that was in the third quartile.

The tendencies Hendershott is finding in the data should be of interest both to academics and investors, he says. For the latter, there’s a clear message:

“Investors who have to make these decisions should be careful and selective and rarely go against what past performance suggests,” he says. “You’d have to be really smart at seeing the exceptions to bet against that performance.”
expose Santa Clara students and financial firms to each other, and provide an umbrella for grants leading to specific research in these fields.

Already the Sury Initiative is on the verge of engaging in a joint venture with a well-known European financial firm to study effects of the Basel II accords regulating international banking capital requirements and the adoption of International Financial Reporting Standards by U.S. companies.

For now, much of Sury’s work with SIFIRM is organizational, primarily lining up a board and getting students interested. Things are going well in both areas.

“Our biggest strength so far is our board,” he says. “Everybody on it has been hand-picked, and it’s a board designed for active participation and for its unique experience and insights which aren’t purely theoretical. This will be a board we can rely on for its opinions, guidance and direction.”

Two of the board members are Nobel laureates in economics: Harry Markowitz, founder of modern portfolio theory, and Robert Merton, honored for his theory on options pricing. SCU professors Meir Statman and Hersh Shefrin will bring to the board a background in behavioral finance as internationally recognized pioneers in that field.

When he put out a query earlier this year to students at Leavey, more than 100 students said they would be eager to volunteer “in any capacity” to be involved in the Initiative. Among graduate students, many of whom are already in professional positions, the rate of student interest was a strikingly high 70 percent. The student interest coupled with an active, blue-chip board, Sury says, has put SIFIRM on a strong footing at the beginning.

“I’ve been a student of risk all my life, and my own firms have had a focus on risk management throughout. You might say it’s in my DNA,” he says. “I feel that this Initiative can help find the silver lining in the financial cloud of the last two years, and because of Santa Clara’s strong commitment to values and educating the whole person in the Jesuit tradition, it made sense to house it here. When it comes to financial innovation, having a moral compass or the ethical grounding that a Jesuit education provides is a real benefit. It can lead you away from the excesses of runaway capitalism.”

SIFIRM develops applied research combining ethics, social justice, and innovation.
The Value of Values  May 14–15, 2010 — Santa Clara University

A unique opportunity to meet leading academics and practitioners and examine social investing and corporate social responsibility.

Why should you attend this conference?

• Unique participants
  Leading scholars from North America and Europe

• Groundbreaking scholarship
  Concentration of ‘hard data’ reports for you to explore

• Diversity of thought
  Academics representing divergent views of market behavior

• Applied theory
  Examining practical implications of this research

Conference Registration

$300 General admission
(includes all meals and materials)

$100 Students/Academic Faculty

For more about the conference and online registration, visit

www.scu.edu/business/sifirm/conference.cfm