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The impact of ethical ratings on Canadian security performance: Portfolio management and corporate governance implications

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Abstract

One approach that is gaining in popularity among portfolio managers uses ethical ratings, published by specialized research organizations, to screen securities for portfolio selection. Portfolio managers can thus gain a better understanding of the phenomenon and adopt a better and more consistent approach to ethical investment. By the same token, board of directors can measure the impact of their ethical policies on the market performance of the stock of their company. This paper provides new evidence about the impact of ethical ratings published in Canada on the risk-adjusted returns of the securities concerned, within the framework of a multi-factor Capital Asset Pricing Model, and gives an interpretation of the results from the perspective of portfolio composition and of corporate governance.

JEL classification: G11

Keywords: Ethical ratings; Security performance

Ethical screening of securities for portfolio composition has received considerable attention in recent years, particularly from institutional investors and corporate managers. The major preoccupation of investors, in this regard, is their ability to achieve the same or even a better risk/return tradeoff from portfolios restricted to securities of socially responsible companies as from portfolios without such constraints. For corporate managers, the question is whether ethical

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screening will affect the market evaluation of the securities of their companies. Either way, this new attention to the ethical behavior of companies can have an impact on business policies and practices particularly as regards the choice of operating procedures, products mix, sector diversification, and the relationship with stakeholders. It can also have an impact on the extent to which investors may make ethical concerns a corporate governance issue in an effort to protect the value of their investment.

Various approaches can be followed by investors in order to construct a universe of investment opportunities on an ethical basis. One approach that is gaining in popularity among portfolio managers uses ethical ratings, published by specialized research organizations, to screen securities for portfolio selection. These ratings are usually built around a number of criteria pertaining to ethical behavior and lines of business. As more investors adopt this framework to define their universe of eligible securities, it becomes important to clarify the range of criteria included in these ratings, and to measure their impact on security risk-adjusted returns. By analyzing the influence of these criteria, portfolio managers can gain a better understanding of the phenomenon and adopt a better and more consistent approach to ethical investment. By the same token, boards of directors can measure the impact of their ethical policies on the market performance of the stock of their company. As seen in this way, investors' perceptions of ethical business behavior become a corporate governance issue. Ignoring ethical concerns may result in discount on the price of stock, as investors defect to firms that display higher ethical standards. While adopting strict ethical standards may increase operating costs, if they are priced by the market ignoring them could result in a loss of wealth to shareholders that may exceed those costs. This could result in ethical issues becoming a concern for corporate governance that may be impossible to ignore by firm managers and directors without penalty, since investors concerned about their wealth are likely to increase the pressure on directors to adopt sound ethical standards to avoid discount by the market.

So far, no study has addressed this issue in a market equilibrium framework. To be sure, a number of event studies have examined the impact of specific ethical news or specific ethical policies on security returns. For example, Gunthorpe (1997) examined whether the financial markets penalize public corporations at the announcement of unethical business behavior. His study uses a sample of 69 US corporations that were involved in some form of alleged illegal activity over the period 1988–1992. He uses the Market Model to estimate for each firm the average and cumulative average abnormal return 5 days before and 5 days after the announcement of the alleged unethical event. His results show that public announcements of unethical behavior carry a statistically significant penalty for stock prices of the firms concerned of about 1.3% over a day and 2.3% over a week. Klassen and McLaughlin (1996) also used the Market Model approach and found a significant relationship between positive and negative environmental event announcements affecting companies and abnormal returns for their stocks. Their study covers a sample of 96 publicly traded US firms for which a positive public announcement was made in regard to strong environmental performance, and 16 firms for which a negative public announcement was made thus signalling weak environmental performance over the period 1985–1991. They report a positive cumulative average abnormal return of 0.82% following positive environmental events and a negative cumulative average abnormal return of 1.5% following negative environmental events. In the same vein, Feldman, Soyka, and Ameer (1997) using the CAPM methodology found that improving both the environmental management system and environmental performance can reduce firms' perceived risk in the market place and increase their stock price by as much as 5%.

Other studies have also examined the impact of ethical constraints from the perspective of portfolio performance. Thus, Guerard (1997) compared the average monthly return of 950