

Valuing ESG: *Doing Good or Sounding Good?*

BRADFORD CORNELL AND ASWATH DAMODARAN

BRADFORD CORNELL
is an emeritus professor of finance in the Anderson Graduate School of Management at UCLA in Westwood, CA.
bcornell@ad.ucla.edu or
bradfordcornell@gmail.com

ASWATH DAMODARAN
is a profesor of finance in the Stern School of Business at NYU in New York, NY.
adamodar@stern.nyu.edu

KEY FINDINGS

- For ESG to increase company value, actions taken to improve ESG ratings have to result in either higher cash flows or lower risk, and there is the very real possibility that being good can lower value for some firms.
- The evidence that being good improves a company's operating performance (increases cashflows) is weak but there is more solid backing for the proposition that being bad can make funding more expensive (higher costs of equity and debt).
- Investing in companies that are recognized by the market as good companies is likely to decrease, rather than increase, investor returns, but investing in companies that are good, before the market recognizes and prices in the goodness, has a much better chance of success.

ABSTRACT: *In the last decade, companies have come under pressure to be socially conscious and environmentally responsible, with the pressure coming sometimes from politicians, regulators, and interest groups, and sometimes from investors. The argument that corporate managers should replace their singular focus on shareholders with a broader vision, where they also serve other stakeholders, including customers, employees, and society, has found a receptive audience with corporate CEOs and institutional investors. The pitch that companies should focus on doing good is sweetened with the promise that it will also be good for their bottom line and for shareholders. In this article, we build a framework for value that will allow us to examine how being socially responsible can manifest in the tangible ingredients of value and look at the evidence for whether being socially responsible is creating value for companies and for investors.*

TOPIC: ESG investing*

*All articles are now categorized by topics and subtopics. [View at PM-Research.com](#).

Using criteria based on environmental, social, and governance (ESG) considerations has become an increasingly important aspect of investment decision making, particularly for high-profile institutional investors. Bloomberg reported on February 8, 2019 that Europe alone has “some \$12 trillion committed to sustainable investing.” Fish et al. (2019) state that sustainable assets under management worldwide were approximately \$30 trillion by 2019. On the corporate side, there has been a growing awareness of the need to be, or at least appear to be, socially responsible, either to fend off pressure from interest groups and media or to market themselves to customers. A statement published by the Business Roundtable (2019), and signed by CEOs of major companies, announced that, “While each of our individual companies

serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders.” In a follow-up letter to CEOs, Lawrence Fink, the CEO of Blackrock, stressed that a company’s prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders.

In this article, we investigate the interaction between ESG-related investment criteria and value, both from the perspective of investors wondering whether and how to incorporate social issues into investment choices, as well as from the perspective of companies considering the value effects of being more socially responsible. We begin by looking at how corporate social standing is measured, and then develop a simple valuation framework to examine how and where ESG choices made by firms play out in value. Specifically, we look at how being a good company can make it more valuable, and the drivers of that higher value, and also how being a good company can make it less valuable, casting doubt on the sales pitch of ESG’s most ardent promoters, which is that good corporate behavior will always be rewarded with higher value.

We examine the evidence with the intent of trying to evaluate the link between corporate social responsibility and value. We begin by looking at how good companies perform on growth and profitability measures, relative to bad companies, and find that the research here is thinner and the overall evidence remains mixed. We then look at the extant research on how corporate social responsibility and investment returns are related and find the results to be inconclusive on the central question of whether higher ESG ratings are associated with greater risk-adjusted returns. Although there are some studies that find that companies that score high on the corporate responsibility scale reward investors with greater risk-adjusted returns, there is little consistent evidence that socially responsible funds that invest in these companies deliver excess returns. In this regard, we note that much of the ESG literature conflates value changes and investor returns and we argue that positive returns to investors in companies that score highly on ESG are murky indicators of whether ESG is value-creating. Finally, we address the question as to what decisions regarding ESG considerations should be made by corporate executives and what decisions should be the province of public policy determined through the political process.

SOCIAL RESPONSIBILITY AND ENVIRONMENTAL AWARENESS

Much of the debate around ESG and corporate social responsibility starts with the premise that we can differentiate clearly between good and bad companies, but that is clearly not the case. Unlike profitability and returns, where there are accepted measures of both, and numbers to back them up, social responsibility is often in the eyes of the beholder. It should come as no surprise that a ranking of companies from good to bad by Greenpeace bears little resemblance to a listing of good and bad companies by a group focused on labor rights.

There are numerous reasons to interpret results regarding the impact of ESG ratings screens on portfolio performance, ambiguous as they are, with particular care. The first problem that arises when attempting to assess the impact of ESG information on investment performance is defining what is meant by “ESG information.” It turns out there are a large number of organizations attempting to answer that question. Li and Polychronopoulos (2020) report that, as of year-end 2019, they had identified 70 different firms that provide some sort of ESG rating. Furthermore, they note that this does not include the multitude of investment banks, government organizations, and research organizations that conduct ESG-related research that can be used to create customized ratings. Fish et al. (2019) document that more than 600 ESG ratings were produced in 2018.

This problem would not be so bad if all the ratings were effectively similar, but this is not the case. There is a substantial literature documenting the divergence of ESG ratings for the same firms, which includes Berg et al. (2019), Chatterji et al. (2016), Dörfler et al. (2015), Semenova and Hassel (2015), and Li and Polychronopoulos (2020). Dimson et al. (2020) look at ESG ratings for companies from three providers, FTSE Russell, Sustainalytics and MSCI, and note not only that the correlations on measures is low across the services, but also that they disagree on high profile companies. Facebook, for instance, is ranked at the 1st percentile (among the worst) by Sustainalytics on environment and at the 96th percentile (among the best) by MSCI. The rating organizations differ not only in how to measure the various ESG criteria, but also with respect to what criteria are deemed worthy of measurement. In some cases, the criteria are so numerous that it is difficult to separate those that are germane from those

that are not. For instance, Bloomberg's ESG data covers 120 environmental, social, and governance indicators. Nonetheless, virtually all the raters include the most highly publicized indicators in their ratings. These include carbon emissions, climate change effect, pollution, waste disposal, renewable energy, discrimination, diversity, community relations, human rights, and independent directors. But they still fail to agree on how these indicators are to be measured.

Finally, we question why governance, a measure that has historically been defined in research in terms of responsiveness of managers at publicly traded companies to their shareholders, is bundled with environmental responsiveness and social consciousness, two concepts that often require managers to put the interests of other stakeholder groups ahead of shareholders. It may be that the governance that is incorporated in the ESG concept is different from the conventional governance measures, but if it is, any references to the payoff to good corporate governance should be not be part of the ESG sales pitch, because it represents a mindset diametrically opposed to the stakeholder value mindset that underlies ESG. The stakeholder wealth maximization objective, floated as an alternative to stockholder centrality, is a concept that has acquired followers, many of whom are also in the ESG camp, but Bechtel et al. (2020) discuss its limits.

In summary, classifying firms into good and bad firms, from an ESG perspective, is not only difficult to do, but subjective. Although we continue to use the terminology of *good* and *bad* firms for the rest of this article, we do so with the recognition that goodness (or badness) exists not only as a continuum, but also that the classification depends on the dimension used to measure company performance.

VALUE AND SOCIAL RESPONSIBILITY

Before looking at the existing research on the relationship between social responsibility and value, we need a value framework. That framework will allow us to identify key value drivers, and then assess how these drivers are affected, in positive or negative ways, by attempts by companies to be more socially responsible and environmentally conscious. In this section, we first develop that framework and then apply it to assess the valuation implications of ESG related actions.

EXHIBIT 1

Expected Cashflows and Adjusted Discount Rate

Expected Cashflows in Time Period
$\text{Value} = \frac{E(CF_1)}{(1+r)^1} + \frac{E(CF_2)}{(1+r)^2} + \dots + \frac{E(CF_n)}{(1+r)^n}$
Risk-adjusted Discount Rate

The Drivers of Value

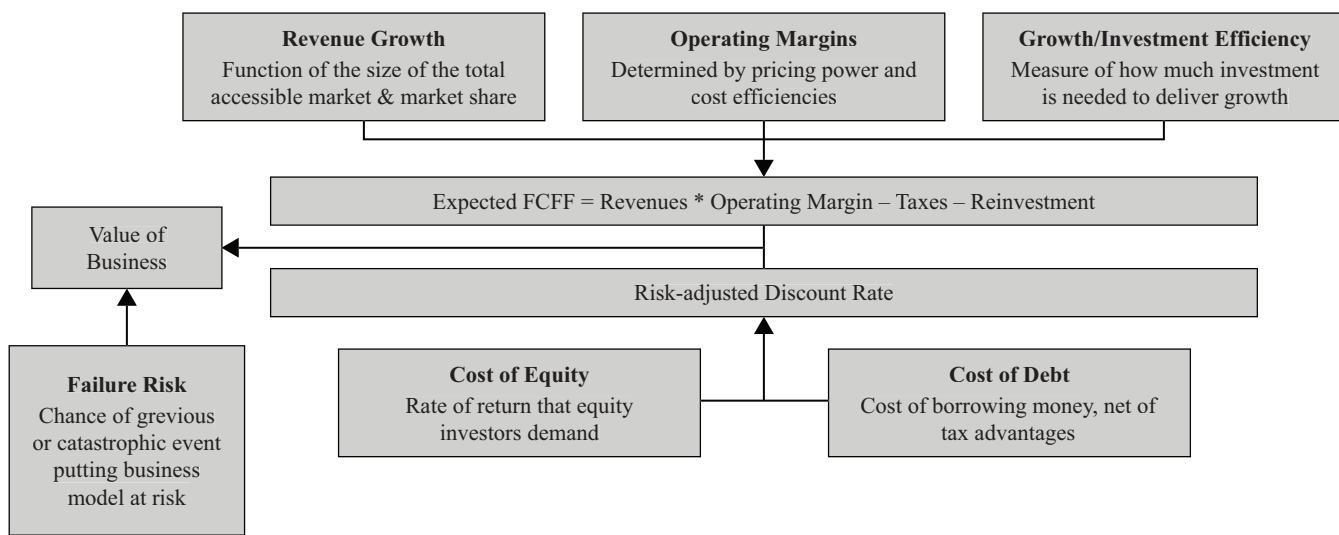
There is no mystery as to what determines the value of a business. In its simplest form, the value of a business comes from the expected cash flows it can generate over time, discounted back at a "risk adjusted" discount rate (see Exhibit 1).

Note that there is nothing in this structure that pushes a company toward short-term profitability, because it allows that company to trade off lower profits (and cash flows) in the near term for higher profits and cash flows in the future. Taking a deeper dive into the value equation (see Damodaran 2013 or McKinsey 2018 on Valuation) highlights four drivers:

1. *The growth lever:* Most companies and investors view growth favorably, because it allows companies to scale up and, in the process, make small operating numbers into bigger ones. We focus on *growth in revenues*, rather than growth in operating or net income, as the cleanest measure of this scaling up, because it requires that companies sell more of their products and services. (In contrast, earnings can grow because of margin improvements, arising out of economies of scale and cost cutting). The revenue growth can come from a market that is growing or from increased market share.
2. *The profitability lever:* Ultimately, there is no benefit to scaling up for a business, if it never makes money. We measure the profitability of a business by its *operating profit margin*, calculated as operating income after taxes divided by revenues. We focus on operating, rather than net profit, margin because the latter is not only affected by business profitability but also by financial leverage.

EXHIBIT 2

The Drivers of Value



3. *The investment efficiency lever:* Growth in revenues requires investment in the resources needed to produce these goods and services. Rather than relying on the narrow accounting definitions of capital expenditures, we define reinvestment broadly to include not only investments in plant and equipment or working capital, but also in expenditures on research and development and on acquisitions. Investment efficiency is measured by how much reinvestment is needed to deliver the forecasted increase in revenues (from the growth lever), with more efficient companies delivering greater added revenue for every dollar of capital invested.
4. *The risk lever:* Rather than get mired in endless debates about risk and return models in finance and the difficulties of measuring risk, we argue that risk in a valuation shows up in two places. The operating risk of a business as a going concern, measuring uncertainty about revenues and operating income in the future, is captured in a *cost of capital*; higher costs of capital, for any given set of expected cash flows, will lead to lower value. There is also the risk that the company will not survive as a going concern, and this risk is highest early in the corporate life cycle (because two-thirds of start-ups fail) and late in the corporate life cycle (as aging companies find themselves caught between declining operations and large debt loads).

We capture this risk as a *risk of failure*, with a higher risk of failure leading to lower value.

The role of the four value drivers is illustrated in Exhibit 2.

If being a good company increases value, it will have to show up in these inputs. It is this framework that we use to analyze what we call the *virtuous cycle*, where doing good and doing well go hand in hand, followed by the punitive scenario where being bad causes backlash and failure and, finally, a dystopian world, where bad companies end up being rewarded at the expense of good companies.

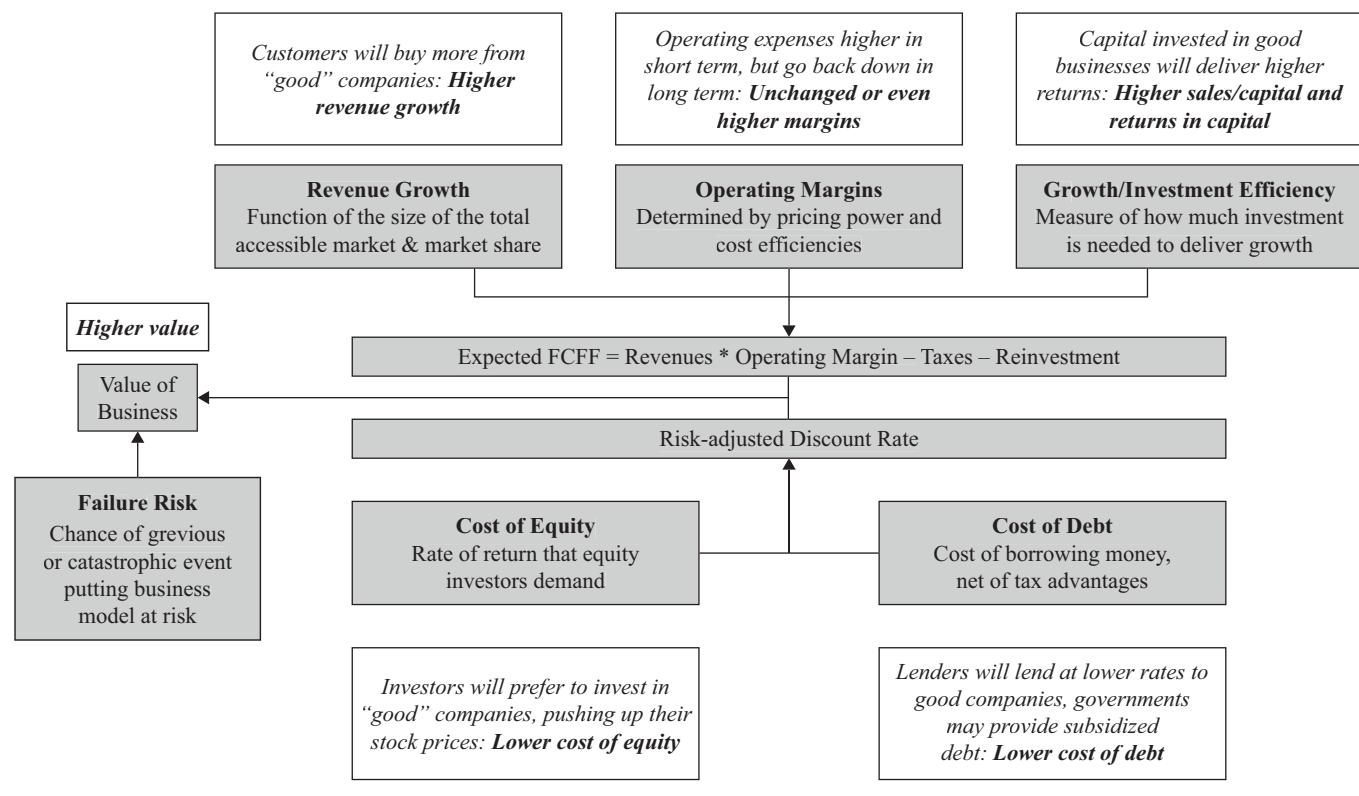
The Virtuous Cycle

The most direct way to induce companies to behave in a socially responsible manner is to make it in their financial best interests to do so. There is a plausible scenario, where being good creates a cycle of positive outcomes, which makes the company more valuable. Exhibit 3 describes this virtuous cycle:

In terms of Exhibit 3, being good benefits the company on every dimension. Customers, attracted by its social mission, favor its products over its competitors, allowing it to gain market share and to grow revenues. Although being good creates more operating expenses in the short term, the company's cost structure adjusts quickly to new norms, allowing for unchanged or even

EXHIBIT 3

The Payoff to Being Good: The Virtuous Cycle



higher margins in the long term. This allows good companies to invest more efficiently than bad companies. That may seem like a stretch, but consider a few of the most positive scenarios. A firm that spends more on employee wages and welfare might bear higher costs, at least initially, but this firm may not only have less employee turnover, but those employees may be motivated to work more efficiently to deliver better results. Similarly, seeking out suppliers who meet a social code may lead to higher input costs, in the near term, but these suppliers may also provide higher quality inputs and be less likely to switch to competitors. With regard to the discount rate, equity investors, attuned to social responsibility, direct their money toward good companies, potentially driving down the cost of equity, and lenders are willing to provide more attractive terms, and governments may offer subsidized loans to a company because of its social or environmental missions.¹ Finally, by operating as a good corporate citizen, the company minimizes the chance of a scandal or a catastrophic event

that could put its business model at risk. In the language of ESG, it makes them a more *sustainable business*.

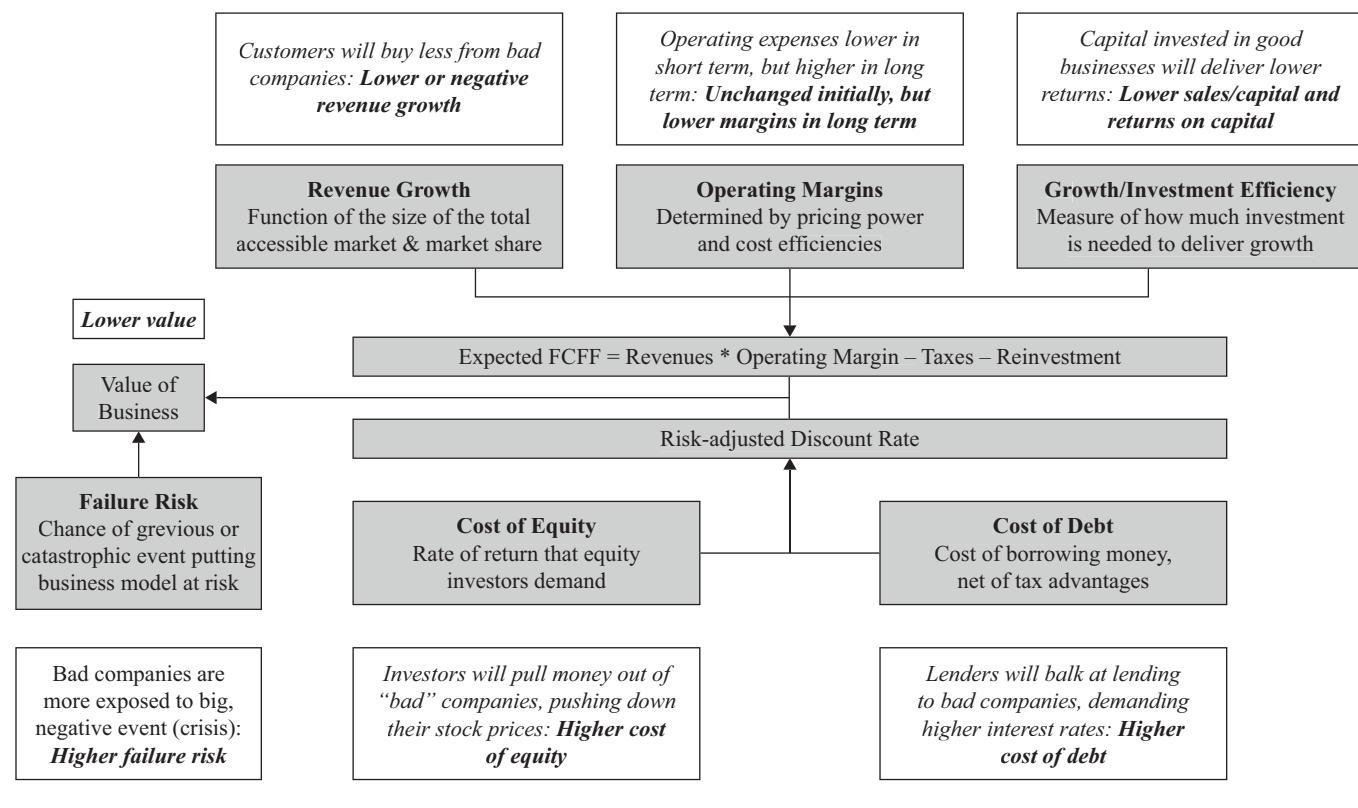
For proponents of corporate social responsibility, this is the best-case setting for their cause, because being good and doing well converge. This scenario holds, though, only because customers, employees, investors, and lenders all put their money where their convictions lie and are willing to make sacrifices along the way. For this scenario to unfold at a company, it must meet specific criteria:

1. *Smaller, rather than larger*: Although it is not impossible for a large company to hit all the high notes in the virtuous cycle, it is far easier for a small company than a large one, because even a small subset of all investors can provide the capital at the favorable terms needed for this scenario to unfold.
2. *Niche business, with a more socially conscious customer base*: Adding to the smallness theme, it is easier for a company that serves a small customer base to attract customers with its *good company* mantle than a company that seeks to reach a mass market.

¹See, for example, Goldman Sachs (2019).

EXHIBIT 4

The Punishment for Being Bad: The Punitive Vision



A company like Patagonia, with revenues of \$750 million, can more easily make the compromises to stay socially responsible than a company like Nike, with revenues of \$34.35 billion, which is forced to make compromises that will undercut its goodness.

3. *A privately held company or a public company with an investor base that values corporate goodness and prices it in:* Being a private company can help, especially if the payoff to corporate goodness is long term, another point working in Patagonia's favor. A public company that is closely held or controlled by its founders can also make choices that may not be feasible for a widely held company with a vocal stockholder base.

It is worth noting that the companies that tend to be most vociferous about their social conscience tend to meet these criteria, at least early in their corporate lives. However, they will face a challenge, if they are successful and want to grow, because growth will bring in customers and investors not so committed to ESG.

The acid test of social consciousness occurs when a company scales up and must decide whether to continue to grow or accept a lower scaling and (perhaps) lower value to preserve its good company status.

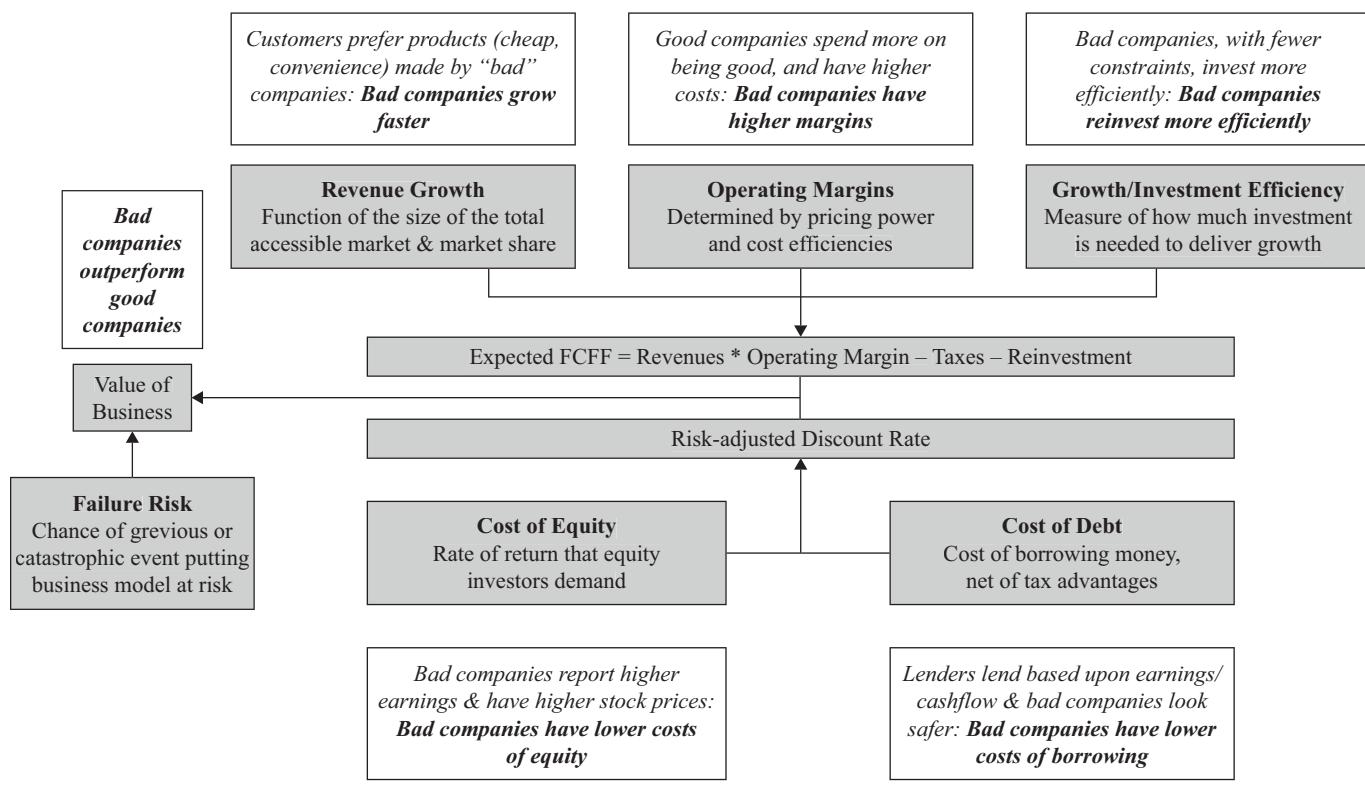
The Punitive Scenario

Even if good companies are not rewarded by customers and investors, the case for ESG can still be made, if bad companies get punished by the same groups. This less upbeat scenario is captured in Exhibit 4.

Here, the punishment for bad companies is meted out from every direction, with customers refusing to buy their products, even if they are lower priced, and higher operating expenses (and lower margins) in the long term, as the company has trouble holding on to employees and finding suppliers. As investors are less willing to buy their shares, the cost of equity goes up, and lenders are leery about lending money to the company, leading to higher costs of debt. Finally, these companies risk exposure to grievous, or even catastrophic, events arising

EXHIBIT 5

The Bad Companies Win: The Dystopian Vision



from operating with too little consideration of societal costs. It is often these events, such as the Union Carbide gas leak in Bhopal, Vale's dam bursting in Bhopal, and BP's oil spill in the Gulf of Mexico, that highlight shortcomings and create long term problems for the company.

With regard to promoting social responsibility, this scenario is not as good as the virtuous cycle, because it will tend to scare companies away from being bad, rather than induce them to be good. That said, this is a more realistic pathway to corporate social responsibility, because there are examples of bad companies that one can point to as cautionary tales. Consider the rise and fall of Valeant, a Canadian pharmaceutical company that rose from a small market capitalization to being one of the largest companies in the sector, in terms of market cap. Along the way, its business model was to acquire drugs still under patent protection that were being underpriced and to reprice them to generate substantial profits. Although the model was legal, it pushed ethical and moral bounds, and when a series of missteps led to a backlash, the market capitalization not only

melted down quickly, but the company's bad reputation became an almost insurmountable obstacle to its rehabilitation. Regulators cracked down on the company, scientists refused to work in its research department, and politicians used it as a punching bag. Eventually, the company had to replace its top management, abandon its business model, and change its corporate name; even with all that, it is still struggling.

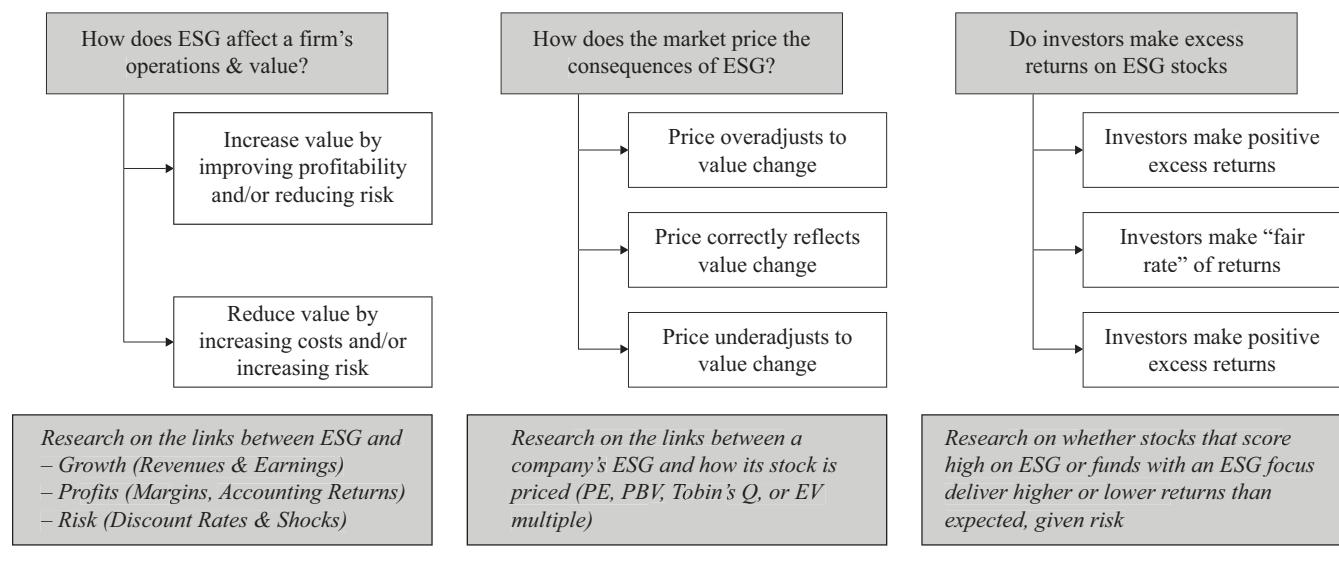
Dystopian World

There is a final and darker scenario that is also plausible, where being good does not yield an upside and bad companies are not punished but are rewarded, creating a perverse outcome where bad companies outperform good ones, not only on operating metrics, but also with respect to stock returns. Exhibit 5 portrays this scenario.

In this scenario, bad companies mouth platitudes about social responsibility and environmental consciousness without taking any real action, but customers buy

EXHIBIT 6

The Big Questions on ESG



their products and services, either because they are cheaper or because it is convenient, employees continue to work for them because they can earn more, and investors buy their shares because the expected returns are higher for reasons discussed later. As a result, bad companies may score low on corporate responsibility scales, but they will score high on profitability and stock price performance.

THE EVIDENCE ON ESG AND CORPORATE SOCIAL RESPONSIBILITY

Testing whether social responsibility pays off is difficult for two reasons. One is that, as we noted earlier, there is no consensus on what comprises a good company, with different raters using different metrics and measures. The second is that even within the research, there is confusion regarding what is being tested, and what the findings say about the payoff to being socially responsible. As we see it, there are three fundamental questions:

- *Do good companies create more value than bad companies?* If good companies grow faster and are more profitable than bad companies, it would clearly be supportive of the virtuous cycle and lead to good companies being more valuable than bad ones. An alternative possibility is that if bad companies are

viewed as riskier than good companies, that would lead them to have higher costs of equity and capital, and lower values, also supportive of the thesis that it is better to strive for corporate responsibility.

- *Do markets price good companies higher than bad companies?* If good companies are priced higher by markets, either because they are perceived to be better performers or because investors prefer to hold them as investments, it, too, would be a powerful incentive for companies to be socially responsible.
- *Does investing in good companies earn higher average returns than investing in bad companies?* If investments in good companies offer higher expected returns, it would make the push toward socially responsible investing much easier.

Exhibit 6 considers the possible answers to each of the three questions, and how their interactions make testing the effects of ESG difficult.

The bulk of research to date has focused on answering the last question. As our review documents, the answers are highly ambiguous. A major reason for the ambiguity is the failure to consider sufficiently the impact of market pricing on the observed returns. The situation is further complicated, if market prices are not always rational and can overreact or underreact to ESG information. In this context, Exhibit 7 considers six possible combinations of answers to the first two questions,

EXHIBIT 7

Value Effects, Market Pricing, and Excess Returns

Value Effect	Market Pricing	Investor Returns to ESG
ESG increases value	Markets overreact, pushing up prices too much.	Negative excess returns for investors in good ESG firms.
ESG decreases value	Markets overreact, pushing down prices too much.	Positive excess returns for investors in good ESG firms.
ESG increases value	Markets underreact, with prices going up too little.	Positive excess returns for investors in good ESG firms.
ESG decreases value	Markets underreact, with prices going down too little.	Negative excess returns for investors in good ESG firms.
ESG increases value	Markets react correctly, with prices increasing to reflect value.	Zero excess returns for investors in good ESG firms.
ESG decreases value	Markets underreact, with prices going down too little.	Zero excess returns for investors in good ESG firms.

on operating value and market pricing, and how they relate to excess expected returns for investors.

Given the multitude of possibilities, a finding that investments in highly rated ESG stocks provide positive excess returns tells us little about the payoff to companies of being socially responsible, because it is entirely driven by what markets incorporate into stock prices. Adding to the empirical messiness is the difficulty of measuring ESG that we noted at the start of this article, with different interest groups prioritizing different elements of social goodness in coming up with their scores. Despite such potential short-run complexity, in the long run we would expect rational pricing to obtain. As we explain in greater detail in the next section, if investors have a preference for highly rated ESG stocks, then those stocks will offer lower average excess returns. Note that this conclusion is contrary to the views of many ESG advocates in the investment profession. For instance, Blackrock CEO Larry Fink (2020) states that, “Our investment conviction is that sustainability and climate integrated portfolios can provide better risk-adjusted returns to investors.”

ESG and Value

To summarize, being socially responsible (or improving your ESG standing) can make a firm more valuable, either by increasing profitability and cash flows or by reducing the discount rate. In this section, we summarize the research findings are on both fronts.

ESG and profitability. The argument that socially responsible companies should generate higher profits, either because they have greater revenues or face lower regulatory and legal costs, and that these lead to more sustainable healthy performance seems to rest largely on faith. As an example, Larry Fink’s (2020) assertion in his letter on social responsibility that “a company’s prospects for growth are inextricable from its ability to operate sustainably and serve its full set of stakeholders” comes with little or no supporting evidence. Even when the linkage is tested and a positive relationship is found between ESG scores and profitability, a question regarding causality remains. Causality can run from performance to a higher ESG rating because companies that are doing well are in a better position to spend money being socially responsible. In this context, ESG spending can be thought of as a luxury good that successful companies buy to embellish the reputation of management.

If there is a consensus view that emerges from the research evidence, it is that the relationship is positive, but the findings are fragile and sensitive to both how ESG and profitability are measured. An early study by Waddock and Graves (1997) found that companies that ranked high on social performance (what they termed CSP, a precursor to ESG) also ranked high on financial performance. However, Zhao and Murrell (2016) extend the Waddock–Graves study over a longer time period (1991–2013) using a larger sample and conclude that the original findings do not hold up.

In a review of the literature, Margolis et al. (2009) examined 251 studies of the linkage between ESG and operating profitability in 214 papers and found only a small positive link between the two, leading them to conclude that “citizens looking for solutions from any quarter to cure society’s pressing ills ought not appeal to financial returns alone to mobilize corporate involvement.” Friede et al. (2015) present results of a meta study of more than 2,000 studies that looked at the link between ESG and corporate financial performance (CFP), and conclude that “roughly 90% of the studies find a non-negative ESG-CFP relation.” Breaking down ESG into its component parts, they find that environment (E) offered the strongest positive link to performance and social (S) the weakest, with governance (G) falling in the middle.

Pedersen et al. (2019) also find that firms with good governance realize higher accounting rates of return, but this result is not robust to different measures of ESG or to different profitability metrics. Nollet et al. (2016) use Bloomberg’s ESG scores for S&P 500 firms and find a negative relationship between ESG and return on capital, though they find that imposing a nonlinear relationship creates a U-shaped relationship, which they construe, rather hopefully, as evidence that the long-term effects are positive. Schreck (2011) tries to control for the endogeneity problem, that is, whether good performing companies are socially responsible or socially responsible companies are good performers and concludes that there is no link between profitability and social responsibility.

ESG and risk. If the link between profitability and ESG is weak, there is still the possibility that value is higher for companies that are socially responsible, if they are less risky, with two variants on the risk story. In the first, companies that are socially responsible are rewarded with lower discount rates, which leads to higher value, because investors prefer to hold good companies and build these preferences into expected returns. In the second, bad companies or companies that score low on ESG expose themselves to reputational and disaster risks that are infrequent but can have a large impact when they occur.

Good companies and expected returns. Fama and French (2007) develop a simple framework that can be applied to show how investors preferences for good companies affect expected returns. They show that when utility functions for at least some investors include variables other than future consumption, prices deviate from

the standard predictions of conventional risk and return models. In particular, if investors prefer to invest in good companies, the expected return on companies that are socially responsible will be lower, with the magnitude of the effect depending on how much money they have to invest. With upwards of \$30 trillion of investment being affected by ESG considerations, the price impact is likely to be material. A more recent and detailed model developed by Pastor et al. (2020) reaches the same conclusion that if investors have a preference for good companies the risk-adjusted expected returns on those companies well be less.

As an illustration of this effect, both Hong and Kacperczyk (2009) and Dimson, Marsh et al. (2015, 2020) study what they call “sin” stocks, that is, companies involved in businesses such as producing alcohol, tobacco, and gaming. They hypothesize that these are stocks for which investors have negative tastes. Consistent with Fama and French’s theory, both groups of authors find that sin stocks are less commonly held by institutions and that they have higher average returns than otherwise comparable stocks. They conclude that investors must be compensated in terms of greater expected return for the reputational cost associated with holding sin stocks. Fabozzi et al. (2007) also report similar results in their comparison of sin stocks against market indices around the world, with the highest excess returns in gaming and weapons companies. Blitz and Fabozzi (2017) do push back against the sin stock premium and argue that almost all of the premium can be explained away by two quality factors—profitability and investment.

In recent years, there have been attempts to explicitly build ESG into an asset pricing/return framework, with the intent of explicitly adjusting discount rates for differences in ESG. Zerbib (2019) develops an asset pricing model that incorporate investor tastes for socially responsible companies (Sustainable-CAPM) and applies the model to US stocks from 2000–2018 to find that investor taste for sustainability creates an average exclusion effect of 3% for sin stocks. Pedersen et al. (2020) incorporate the information in ESG score about fundamentals and investor preferences into deriving an ESG-efficient frontier and use it to conclude that the sin stock premium is smaller than estimated by Hong and Kacperczyk for sin stocks, but that there remains a premium. Finally, Ang et al. (2020) explicitly bring ESG into a factor model and note that it is correlated with established factors, with higher momentum and quality stocks scoring better on

ESG, and that the portion of ESG that is not factor-related has little or no relationship to returns.

Disaster and reputational risk. An alternate reason why companies would want to be good is that bad companies are exposed to disaster risks, where a combination of missteps by the company, luck, and a failure to build in enough protective controls (because they cost too much) can cause a disaster, either in human or financial terms. That disaster can not only cause substantial losses for the company, but the collateral reputational damage created can have long-term consequences. Glossner (2017) created a value-weighted portfolio of controversial firms that had a history of violating ESG rules and reported negative excess returns of 3.5% on this portfolio, even after controlling for risk, industry, and company characteristics. He argues that these lower excess returns are evidence that being socially irresponsible is costly for firms, that markets do not fully incorporate the consequences of bad corporate behavior. It is important to stress that results such as these require that markets fail to incorporate the impact of bad behavior. Once the market has incorporated the bad behavior, the return discount should disappear or even become a premium. Karpoff et al. (2005) examine fines, damage awards, and market capitalization losses at firms that violate environmental standards. They find that these firms suffer significant market value losses but that these losses are roughly equivalent to the legal penalties imposed. They find no evidence of additional losses from reputational damage.

It is worth noting that this argument for ESG is less an argument for companies to be good, because they will be rewarded, than for companies not to be bad, because they will be punished. It is in keeping with the punitive vision that we outlined earlier, but as we noted there, it is a much less ambitious argument, with less in terms of social payoff from corporate actions, than the utopian vision, where being good will deliver higher growth, more sustainable profit margins, and higher returns on capital.

ESG and Pricing

If being socially good creates a payoff for firms, either as higher cash flows or lower discount rates, their values should increase. But will markets have the foresight to look past what may be near-term lower earnings and reward them with higher pricing? That question

is important not only from the lofty perspectives of efficient markets, but it can also have more immediate consequences. To the extent that markets are myopic and ignore the value effects of being good, the managers of these firms, whose compensation and tenure are tied to stock price performance and/or current financial performance, may be loath to follow the path of social responsibility.

The research on this question is sparse, due to two challenges. The first is that it requires a measure of ESG that can be correlated with current pricing, with that pricing measured using multiples such as PE, price to book, or EV to EBITDA. The second is that even if a correlation exists, it is difficult to establish causation. In other words, do companies with high ESG scores get rewarded with higher market pricing or are companies with higher market pricing just more favorably viewed by society? One simple proxy that can be used to address the question of the link between ESG and pricing is to look at the pricing multiples of stocks held by ESG funds versus the rest of the market. A snapshot from early 2020, for instance, yields the results shown in Exhibit 8.

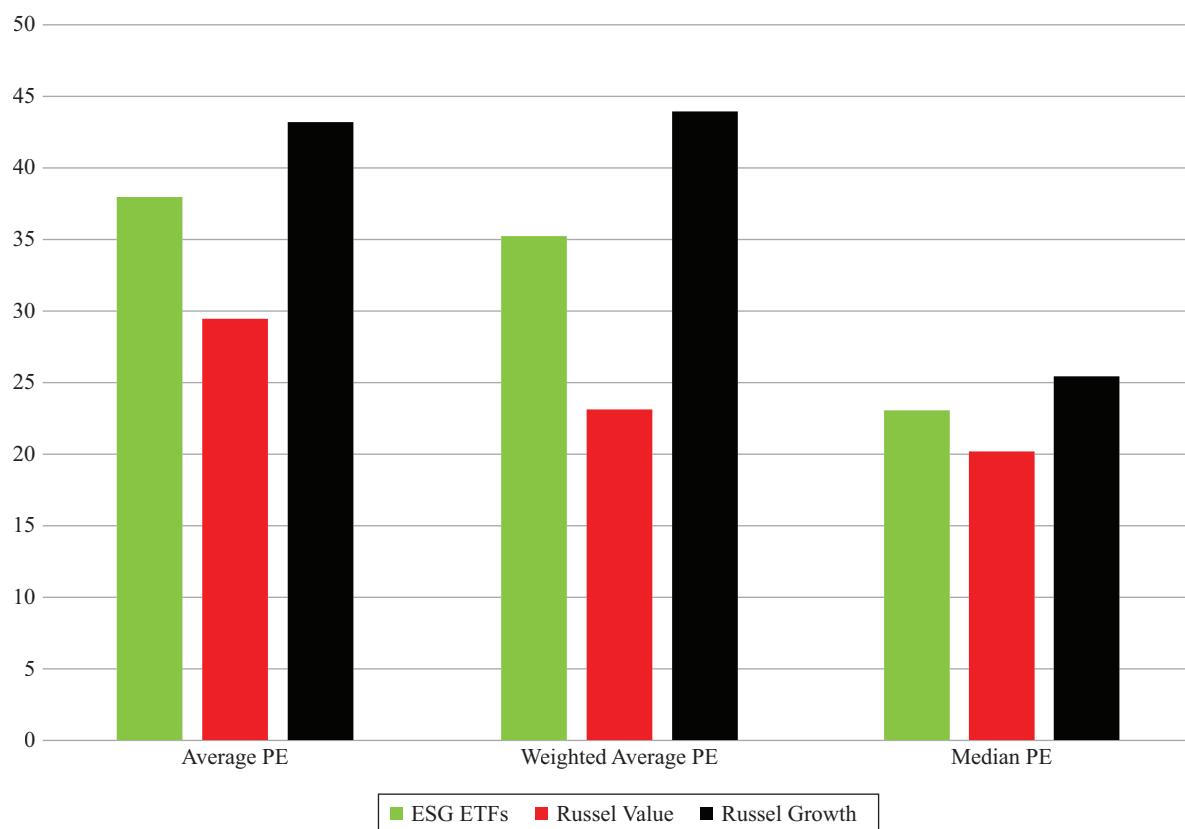
Exhibit 8 suggests that ESG stocks are priced closer to growth than value stocks but, without controlling for the differences in growth, it is difficult to draw a strong conclusion about whether this is indicative of a forward-looking market incorporating ESG considerations.

One way to avoid the interlinkages that make it difficult to isolate the effects of ESG on pricing is to focus on ESG events, that is, events that would lead to market to reassess a firm's ESG standing. Capelle-Blancard and Petit (2019) look at 33,000 ESG news stories on 100 listed companies between 2002 and 2010 and conclude that negative events cause a market drop of 0.1% but that firms gain nothing from positive events. This finding is echoed by Mitsuyama and Shimzutani (2015), who study the market reaction to announcements of the ESG Branding of Japanese firms, where firms are recognized for their "goodness." The authors find little evidence of a positive market reaction to the announcements.

In summary, the evidence that markets reward companies for being good is weak, which can either be taken to mean that markets are rationally assessing ESG actions and finding that they have little effect on value or that markets are short-sighted and are not incorporating the long-term value increases associated with being more socially conscious. Either conclusion is not

EXHIBIT 8

ESG and PE Ratios



Source: FactorResearch.

promising for ESG advocates; the first undercuts their central thesis that being good translates into doing well, and the second makes it less likely that managers will invest more in ESG, because they will realize few tangible benefits in the market today.

Investor Returns and Social Responsibility

As we noted earlier in the section, the weakest test of the payoff to positive ESG behavior is looking at returns earned by investors on stocks that score well on the ESG scale, because it can be compatible with a wide range of possibilities, some of which are not favorable to the ESG case. That said, the bulk of the research on ESG has been done in this area and the findings have been read broadly, and in our view, often casually as evidence that being socially good delivers positive results.

In the long term: ESG as a constraint. To begin with, the notion that adding an ESG constraint to investing increases expected returns is counterintuitive. After all, a constrained optimum can, at best, match an unconstrained one and, most of the time, the constraint will create a cost. To illustrate, the TIAA-CREF Social Choice Equity Fund explicitly acknowledges this cost and uses it to explain its underperformance, stating that “The CREF Social Choice Account returned 13.88 percent for the year [2017] compared with the 14.34 percent return of its composite benchmark. ... Because of its ESG criteria, the Account did not invest in a number of stocks and bonds ... the net effect was that the Account underperformed its benchmark.”²

The research in this area, though, is directed at answering the question of whether you can have your cake (be socially conscious as an investor) and eat it too

²TIAA-CREF Annual Report (2017, 34).

(by earning higher returns).³ At a practical level, the empirical findings are mixed.

- There are the studies that we referenced earlier as backing for good firms having lower discount rates, including the ones that showed that sin stocks deliver higher returns than socially conscious companies. Dimson et al. (2015) provide a comparison of two Vanguard Index funds, the Vice fund (invested in tobacco, gambling, and defense companies), and the FTSE Social Index fund (invested in companies screened for good corporate behavior on multiple dimensions) and note that a dollar invested in the former in August 2002 would have been worth almost 20% more by 2015 than a dollar invested in the latter.
- At the other end of the spectrum, there are studies that seem to indicate that there are positive excess returns to investing in good companies. Di Bartolomeo and Kurtz (1999) showed that stocks in the Anno Domini Index outperformed the market, but that the outperformance was more due to factor and industry tilts than to social responsiveness. Derwall et al. (2005) look at the payoff to socially responsible investing by comparing the returns on two portfolios, created based upon eco-efficiency scores, and conclude that companies that are more eco-efficient generate higher returns, which cannot be explained by investment style or industry factors. Some of the strongest links between returns and ESG come from the governance portion, which, as we noted earlier, is ironic, because the essence of governance, at least as measured in most of these studies, is fealty to shareholder rights, which is at odds with the current ESG framework that pushes for a stakeholder perspective.
- Splitting the difference, there are other studies that find little or no differences in returns between good and bad companies. A Morningstar Quantitative study (2020) of ESG stocks found that companies that scored high on ESG generated mildly lower

returns than companies that scored poorly, though the difference was statistically insignificant.

In steady state, it is internally inconsistent to argue that good companies will benefit from lower discount rates and that investors can also earn higher returns at the same time. Thus, we are not surprised that the evidence pushes in many directions and that the pitch that investing in good companies will generate higher returns does not have stronger empirical support.

In the near term: a transition period payoff?

If, as the research seems to suggest, there is little or no payoff to investors from companies being socially responsible, why do investors push companies to be good? There is one possible scenario where being good benefits both the company (by increasing its value) and investors in the company (by delivering higher returns), but it requires an adjustment period, where being good increases value, but investors are slow to price in this reality. After all, concern over ESG is a relatively new phenomenon coming to the fore during the past 10 years or so; it is possible that market prices have been adjusting to a new equilibrium that reflects ESG considerations. As the market adjusts to incorporate ESG information, and assuming that the information is material to investors, the discount rate for highly rated ESG companies will fall and the discount rate for low-rated ESG companies will rise. Due to the changes in the discount rates, the relative prices of highly rated ESG stocks will increase and the relative prices of low-ESG stocks will fall. Consequently, during the adjustment period the highly rated ESG stocks will outperform the low-ESG stocks, but that is a one-time adjustment effect. Once prices reach equilibrium, the value of high-ESG stocks will be greater and the expected returns they offer will be less. In equilibrium, highly rated ESG stocks will have greater values, but investors will have to be satisfied with lower expected returns. As one example of this adjustment process, Bebchuk et al. (2013) document the disappearance of a return premium associated with highly rated corporate governance during an earlier period. This adjustment process means that the measured performance of stocks as a function of their ESG rating will depend on the sample period. If the sample is drawn from a time period during which the adjustment is underway, highly rated ESG stocks will be found to outperform and the reverse for low-ESG stocks. On the other hand, if the sample is drawn from a period after

³Some of the research, especially the portions that are sponsored either by ESG funds or institutes that are promoters of social responsibility, has to be discounted because of the bias that they have toward finding that investing in ESG stocks generates positive excess returns.

which the adjustment is complete, highly rated ESG stocks should be observed to have lower average returns.

The presence of a transition period, in which markets learn about ESG and price them, can also explain why there may be a payoff to more disclosure and transparency on social and environmental issues. Eccles et al. (2014) use a matched sample of 180 US companies to show that companies that adopted sustainability policies in 1993 and disclosed nonfinancial information on these policies significantly outperformed their less socially responsible counterparts both on profitability and stock performance measures. It is perhaps this hope of transition period excess returns that has driven some institutional investors to become more activist on ESG issues and can explain why some have been able to show excess returns from increasing (reducing) their holdings in good (bad) companies. It is not just the large players like Blackrock and Vanguard that have jumped on this bandwagon, with Blackrock announcing that it would divest itself of coal companies, but also pure return-focused investors like Elliott Management and Third Point, which recently targeted utility companies about their excessive carbon footprints. Their activism goes well beyond jawboning management and includes efforts that range from stopping mergers to proxy fights to altering boards of directors. Dimson et al. (2015) examine 613 public firms that were targeted by an activist institutional investor focused on improving ESG practices and find positive excess returns in the 18% of engagements where the activism succeeded. In a follow-up study in 2019, the same authors conclude that these engagements also resulted in improvements in corporate profitability and performance.

If there is an investing lesson embedded here, it is the unsurprising one that investors who hope to benefit from ESG cannot do so by investing mechanically in companies that are already identified as good (or bad), but have to adopt a more dynamic strategy built around either aspects of corporate social responsibility that are not easily measured and captured in scores, or from getting ahead of the market in recognizing aspects of corporate behavior that will hurt the company in the long term.

Green bonds. To this point, we have focused on equity. However, there has been a good deal of attention to green bonds that have become popular in recent years. Corporate green bonds are bonds whose proceeds are committed to finance environmental and

climate-friendly projects. A question that arises immediately is why a company would even want to issue such bonds. By forcing itself to use the proceeds in a specific manner, a company loses the flexibility to employ the funds in a more general manner if circumstances change. Furthermore, if the green purpose is the best use of funds, then monies raised from generic bonds can always be devoted to green projects. As noted by Flammer (2020), there are three rationales that have been put forward to explain why companies issue green bonds. First, green bonds may serve as a credible signal of the company's commitment toward the environment. Second, issuing green bonds could be a form of public relations greenwashing. Third, if investors are willing to pay more for green bonds, then the company should be able to issue them at a lower yield. This is the bond market version of our prior discussion regarding the cost of equity.

Of the three rationales, we view the public relations effort as being the most likely explanation. There are many ways that companies can, and do, signal their environmental commitment without altering their capital structure. In addition, empirical research such as Zerbib (2019a) finds that yields on green bonds are nearly identical to yields on otherwise comparable nongreen bonds. On the other hand, Goss and Roberts (2011) report that companies facing concerns regarding social responsibility pay higher interest rates on their loans, relative to companies without those concerns, leading to a higher discount rate for firms. However, once again causality could run the other way. Successful firms are both more responsible, because they can afford to be, and can borrow at more favorable rates.

CONCLUSION

In many circles, ESG is being marketed as not only good for society, but good for companies and investors. In our view, the hype regarding ESG has vastly outrun the reality of both what it is and what it can deliver. Claims of ESG payoffs are too often based on research that is ambiguous and inconclusive, if not outright inconsistent with some of the claims. The evidence as we see it is nuanced, and can be summarized as follows:

- The evidence that socially responsible firms have lower discount rates, and thereby investors have lower expected returns, is stronger than the

evidence that socially responsible firms deliver higher profits or growth. There are clearly firms that benefit from being socially responsible, but there are just as clearly firms where being socially responsible creates costs with no offsetting benefits. Telling firms that being socially responsible will deliver higher growth, profits, and value is false advertising. In addition, many of the firms that promote ESG are successful for other reasons.

- The evidence is stronger that bad firms get punished, either with higher discount rates or with a greater incidence of disasters and shocks. ESG advocates are on much stronger ground telling companies not to be bad than when they tell companies to be good. In short, expensive gestures by publicly traded companies to make themselves look good are futile, both in terms of improving performance and delivering returns.
- The evidence that markets incorporate social responsibility into pricing is weak, except for companies that are labeled as bad firms. Furthermore, there is a weak link between ESG and operating performance. In addition, the fact that markets do not reflect that link should serve as a note of caution when marketing ESG to corporate managers.
- The evidence that investors can generate positive excess returns with ESG-focused investing is weak, and there is no evidence that active ESG investing does any better than passive ESG investing, echoing a finding in much of active investing literature. Even the most favorable evidence on ESG investing fails to solve the causation problem. It appears just as likely that successful firms adopt the ESG mantle as adopting the ESG mantle makes firms successful.
- If there is a hopeful note for ESG investing, it is in the payoff to being early to the ESG game. Investors who are ahead of markets in assessing how corporate behavior, good or bad, will play out in performance and be priced, will be able to earn excess returns, and if they can affect the change, by being activist, potentially benefit even more.

Much of the ESG literature starts with an almost perfunctory dismissal of Milton Friedman's thesis that companies should focus on delivering profits and value to their shareholders, rather than play the role of social

policy makers (see Friedman 1970). The more that we have examined the arguments that advocates for ESG make for why companies should expand mission statements, and the evidence that they offer for the proposition, the more we are inclined to side with Friedman. In our view, what is needed is an open, frank, and detailed dialogue concerning ESG-related corporate policies, with an acceptance that being good can add value at some companies and may destroy value at others, and that in the long term, investing in good companies can pay off during transition periods but will typically translate into lower returns in the long term.

REFERENCES

- Amel-Zadeh, A., and G. Serafeim. 2020. "Why and How Investors Use ESG Information: Evidence from a Global Survey." *Financial Analysts Journal*, forthcoming.
- Ang, A., Y. Chan, K. Hogan, and K. Schwaiger. 2020. "ESG in Factors." Working Paper, <https://ssrn.com/abstract=3522354>.
- Bebchuk, L. A., A. Cohen, and C. C. Y. Wang. 2013. "Learning and the Disappearing Association Between Governance and Returns." *Journal of Financial Economics* 93 (1): 15–36.
- Bebchuk, L. A., A. Cohen, C. C. Y. Wang., and R. Tallarita. 2020. "The Illusory Promise of Stakeholder Governance." https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3544978.
- Berg, F., J. Koelbel, and R. Rigobon. 2019. "Aggregate Confusion: The Divergence of ESG Ratings." https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3438533.
- Blitz, D., and F. J. Fabozzi. 2017. "Sin Stocks Revisited: Resolving the Sin Stock Anomaly." *The Journal of Portfolio Management* 44: 105–111.
- Business Round Table. 2019. "Statement on the Purpose of a Corporation." <https://opportunity.businessroundtable.org/wp-content/uploads/2019/08/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures.pdf>.
- Capelle-Blancard, G., and A. Petit. 2019. "Every Little Helps? ESG News and Stock Market Reaction." *Journal of Business Ethics* 57: 543–565.

- Chatterji, A. K., R. Durand, D. I. Levine, and S. Touboul. 2016. "Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers." *Strategic Management Journal* 38 (8): 1597–1614.
- Damodaran, A. *Investment Valuation*. Hoboken, NJ: John Wiley & Sons. 2013.
- Di Bartolomeo, D., and L. Kurtz. *Managing Risk Exposures of Socially Screened Portfolios*. Boston, MA: Northfield Information Services. 1999.
- Derwall, J., R. Bauer, N. K. Guenster, and C. G. Koedijk. 2005. *Financial Analysts Journal* 61: 51–63.
- Dimson, E., O. Karakaş, and X. Li. 2015. "Active Ownership." *The Review of Financial Studies* 28: 3225–3268.
- . 2019. *Coordinated Engagements*. Working paper, <https://ssrn.com/abstract=3209072>.
- Dimson, E., P. Marsh, and M. Staunton. 2015. "Responsible Investing: Does It Pay to Be Bad?" *Credit Suisse Global Investments Yearbook 2015*: 17–27.
- . "ESG Investing." *Global Investment Returns Yearbook 2020*, 48–64. Zurich, Switzerland: Credit Suisse Research Institute. 2020.
- Dortfleitner, G., G. Halbritter, and M. Nguyen. 2015. "Measuring the Level and Risk of Corporate Responsibility – An Empirical Comparison of Different ESG Ratings Approaches." *The Journal of Asset Management* 17 (7): 450–466.
- Eccles, R. G., I. Ioannou, and G. Serfeim. 2014. "The Impact of Corporate Sustainability on Organizational Processes and Performance." *Management Science* 60: 2835–2857.
- Edmans, A. 2011. "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices." *Journal of Financial Economics* 101: 621–640.
- Fabozzi, F. J., K. C. Ma, and B. Oliphant. 2007. "Sin Stock Returns." *The Journal of Portfolio Management* 35: 82–94.
- Fama, E. F., and K. R. French. 2007. "Disagreement, Tastes and Asset Prices." *Journal of Financial Economics* 83 (3): 667–689.
- Fink, L. 2020. "A Fundamental Reshaping of Finance." *Blackrock Letter to CEOs*. <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>.
- Fish, A., D. H. Kim, and S. Venkatraman. 2019. "The ESG Sacrifice." https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3488475.
- Flammer, C. 2020. "Corporate Green Bonds." *Journal of Financial Economics*, forthcoming.
- Friede, G., T. Busch, and A. Basson. 2015. "ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies." *Journal of Sustainable Finance & Investment* 5 (4): 210–233.
- Friedman, M. *Capitalism and Freedom*. Chicago, IL: University of Chicago Press. 1962.
- . 1970. "The Social Responsibility of Business is to Increase its Profitability." *The New York Times Magazine*, September 13, 1970.
- Glossner, S. 2017. "The Price of Ignoring ESG Risks." Working paper. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3004689.
- Goldman Sachs. 2019. *Goldman Sachs Environmental Policy Framework*.
- Goss, A., and G. S. Roberts. 2011. "The Impact of Corporate Social Responsibility on the Cost of Bank Loans." *Journal of Banking and Finance* 35: 1794–1810.
- Hassler, J., P. Krusell, and C. Olovsson. 2018. "The Consequences of Uncertainty: Climate Sensitivity and Economic Sensitivity to Climate Change." *Annual Review of Economics* 10: 189–205.
- Hong, H., and M. Kacperczyk. 2009. "The Price of Sin: The Effects of Social Norms on Markets." *Journal of Financial Economics* 93 (1): 15–36.
- Karpoff, J. M., J. R. Lott, and E. W. Wehrly. 2005. "The Reputational Penalties for Environmental Violations: Empirical Evidence." *The Journal of Law and Economics* 48: 653–675.
- Khan, M., G. Serafeim, and A. Yoon. 2016. "Corporate Sustainability: First Evidence on Materiality." *The Accounting Review* 91: 1697–1724.
- Li, F., and A. Polychronopoulos. 2020. "What a Difference an ESG Ratings Provider Makes." Research Affiliates. <https://www.researchaffiliates.com/documents/770-what-a-difference-an-esg-ratings-provider-makes.pdf>.

- Margolis, J. D., H. A. Elfenbein, and J. P. Walsh. 2009. “Does It Pay to Be Good? And Does It Matter? A Meta-Analysis of the Relationship between Corporate Social and Financial Performance.” Working paper, <http://ssrn.com/abstract=1866371>
- McKinsey & Company, T. Koller, M. Goedhart, and D. Wessels. 2018. *Measuring and Managing the Value of Companies, 6th Edition*. Hoboken, NJ: John Wiley & Sons. 2018.
- Merton, R. 1987. “A Simple Model of Capital Market Equilibrium with Incomplete Information.” *The Journal of Finance* 42 (3): 483–510.
- Mills, M. P. *The New Energy Economy: An Exercise in Magical Thinking*. Manhattan Institute. 2019.
- Mitsuyama, N., and S. Shimzutani. 2015. “Stock Market Reaction to ESG-oriented Management: An Event Study Analysis of Disclosing Policy in Japan.” *Economic Bulletin* 35: 1098–1108.
- Mittal, R. K., N. Sinha, and A. Singh. 2008. “An Analysis of Linkage between Economic Value Added and Corporate Social Responsibility.” *Management Decision* 46 (9): 1437–1443.
- Morningstar. 2019. *Morningstar Sustainable Indexes, February 12, 2019*.
- . 2020. “Better Minus Worse: Evaluating ESG Effects on Risk and Return.” *Morningstar Quantitative Research February 2020*.
- Nagy, Z., A. Kassam, and L.-E. Lee. 2015. “Can ESG Add Alpha?” White paper, MSCI.
- Nollet, J., G. Filis, and E. Mitrokostas. 2016. “Corporate Social Responsibility and Financial Performance: A Non-linear and Disaggregated Approach.” *Economic Modelling* 52: 400–407.
- Nordhaus, W. D. 2017. “Revisiting the Social Cost of Carbon.” *Proceedings of the National Academy of Sciences* 114 (7): 1518–1523.
- Pastor, L., R. F. Stambaugh, and L. A. Taylor. 2020. “Sustainable Investing in Equilibrium.” https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3559432.
- Pedersen, L. H., S. Fitzgibbons, and K. Pomorski. 2019. “Responsible Investing, The ESG-Efficient Frontier.” https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3466417.
- Schreck, P. “Reviewing the Business Case for Corporate Social Responsibility: New Evidence and Analysis.” *Journal of Business Ethics* 103: 167–188.
- Semenova, N., and L. G. Hassel. 2015. “On the Validity of Environmental Performance Metrics.” *Journal of Business Ethics* 132 (2): 249–258.
- Waddock, S. A., and S. B. Graves. 1997. “The Corporate Social Performance-Financial Performance Link.” *Strategic Management Journal* 18 (4): 303–319.
- Winegarden, W. “Environmental, Social and Governance Investing: An Evaluation of the Evidence.” Pacific Research Institute. 2019.
- Zerbib, O. D. 2019a. “Is There a Green Bond Premium? The Yield Differential Between Green Bonds and Conventional Bonds.” *Journal of Banking and Finance* 98: 39–60.
- . 2019b. “A Sustainable Capital Asset Pricing Model (S-CAPM): Evidence from Green Investing and Sin Stock Exclusion.” Working paper, SSRN, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3455090.
- Zhao, X., and A. J. Murrell. 2016. “Revisiting the Corporate Social Performance – Financial Performance Link: A Replication of Waddock and Graves.” *Strategic Management Journal* 37: 2378–2388.

To order reprints of this article, please contact David Rowe at d.rowe@pageantmedia.com or 646-891-2157.

ADDITIONAL READING

Sin Stocks Revisited: Resolving the Sin Stock Anomaly

DAVID BLITZ AND FRANK J. FABOZZI

The Journal of Portfolio Management

<https://jpm.pm-research.com/content/44/1/105>

ABSTRACT: Various studies report that investing in “sin stocks”—firms that make money from human vices such as alcohol, tobacco, gambling, and weapons—has historically delivered significantly

positive abnormal returns. This finding has inspired the hypothesis that sin stocks are shunned to such an extent that they become systematically underpriced, enabling investors who are willing to bear the reputation risk involved with investing in these stocks to earn a return premium. In this article, the authors further investigate this notion, finding that the performance of sin stocks can be fully explained by the two new quality factors in the recently introduced Fama–French five-factor model, profitability and investment. Their finding is robust over time and across different markets. In short, there is no evidence that sin stocks provide a premium for reputation risk after controlling for their exposure to factors in today's asset pricing models.

Sin Stock Returns

**FRANK J. FABOZZI, K. C. MA,
AND BECKY J. OLIPHANT**

The Journal of Portfolio Management

<https://jpm.pm-research.com/content/35/1/82>

ABSTRACT: *In this article, the authors examine the issue of how social values affect economic values. Based on a small subset of the stock universe that has been generally associated with sin-seeking activities, such as alcohol consumption, adult services, gaming, tobacco, weapons, and biotech alterations, the authors find that a sin portfolio produced an annual return of 19% over the study period, unambiguously outperforming common benchmarks in terms of both magnitude and frequency. Several likely reasons for the positive excess returns in sin stocks are identified. The authors argue that trustees or fiduciaries who develop institutional investment policy statements should fully understand the economic consequences of screening out stocks of companies that produce a product inconsistent with their value systems. In addition, institutional investors should question if the cost to uphold common social standards is worthwhile.*