

How Does Diversity Play in the Market? A Study of the Stock Market Performance of HRC Classified Firms

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Abstract: This study examines the relationship between the social performance profile of the organisation and its associated market effect using market measures of relative risk and excess profit. Specifically, we consider the market effect of Corporate Social Responsibility (CSR) as offered by the Human Rights Campaign (HRC) regarding organisational acceptance of Gay, Lesbian, Bisexual and Transgender individuals (GLBT). We find, consistent with economic theory, that organisations that have promulgated policies that support GLBT issues have a higher risk profile than firms judged by the HRC to be un-accepting of such agendas. However, we find no difference in the market return profile between the two HRC groups: Supportive and Un-Accepting. The conclusion is that organisations may adopt policies and projects supportive of the GLBT communities without fear of sacrificing their market profitably profile.

Key words: Human rights, GLBT sensitivity, financial performance

INTRODUCTION

The launch and continuing success of numerous Social Responsible Investing (SRI) financial indexes can be seen as an indication of how the issue of social responsibility has gained importance over the years. The Domini 400 Social Index (DS 400), the first SRI index, was launched in 1990. Other indexes such as the Pax World Balanced (PAXWX), Dow-Jones Sustainability Index (DJSI), the FTSE4Good Indices, Pan European Sustainability Benchmark (DJSI STOXX), WilderHill Clean Energy Index-ECO, the Domini Social Equity (DSEFX) and the KLD NASDAQ® Social Index (KLD NS) followed. Currently many corporations publish, along with their financial reports, information on ethical issues such as environmental and social performance. Clikeman^[1] notes that in 2002 more than 600 companies released sustainability reports worldwide. This publicly available SRI information has been used in many studies to examine whether there exists a relationship between the social behaviour of firms and their financial performance. The results, which of course vary over the studies, suggest, in general, that there is a positive relationship between financial performance as measured according to Generally Accepted Accounting Principles (GAAP) and Corporate Social Responsibility (CSR). These studies

have essentially concentrated on GAAP measures of profitability such as Net Profit and Earnings Per Share. Lusk, *et al.*^[2].

We want to expand the measurement focus to financial performance as measured by the stock market return of the organisation. In so doing, we will also consider the corresponding risk measured as the variability of the returns. Risk, measured in this way, can be broken into two independent components: non-diversifiable risk, also called systematic risk, which is the risk-relative relationship that the organisation has with the market and diversifiable risk, also called idiosyncratic risk, which is unique to the firm. In addition, we want to focus the CSR dimension of our study on the organisational support of Gay, Lesbian, Bisexual and Transgender (GLBT) issues as reported by the Human Rights Campaign Foundation (HRC).

It is true that there are other groups that report their assessment of the CSR profile of organisations. For example, in 1988 Kinder, Lydenberg, Domini and Co. (KLD) established a measurement system that consists of 16 dimensions called issue-screens in order to provide an independent assessment possibility of organisational performance. They include: Community, Corporate Governance, Diversity, Employee Relations, Environment, Human Rights, Product, Abortion, Adult Entertainment,

Alcohol, Contraceptives, Firearms, Gambling, Military Weapons, Nuclear Power and Tobacco. The CSR scoring of KLD, excellent though it may be, perhaps is too extensive covering too many issues. We want to focus on the diversity dimension specifically considering organisational support of the GLBT communities. This has not been previously reported in the scientific literature. We will use the publicly available information provided by the HRC which yearly publishes the Corporate Equality Index (CEI), by which firms are rated according to the level of support these organisations have respecting GLBT issues. Consider now the Corporate Equality Index.

THE HRC FOUNDATION AND THE CORPORATE EQUALITY INDEX

The Human Rights Campaign was founded in 1980 as a small lobby group addressing issues of equal rights for the GLBT communities. Since then, the number of members has increased continuously; currently, the HRC has almost 800,000 members. Due to this growing support, HRC is now acknowledged as America's most influential organisation respecting promoting acceptance/non-discrimination of GLBT individuals. Singh^[3]. Looking at their mission statement, <http://www.hrc.org>, we find the clearly defined goals by which they have become America's most powerful political action group:

HRC is a bipartisan organisation that works to advance equality based on sexual orientation and gender expression and identity, to ensure that gay, lesbian, bisexual and transgender Americans can be open, honest and safe at home, at work and in the community. In order to achieve the above stated goals HRC engages in actions such as lobbying Congress and strategic investment for the election of a fair-minded Congress. Further, the organisation tries to increase public awareness and understanding with the help of education and innovative communication tools.

One of the ways that the HRC executes this mission is through The Corporate Equality Index (CEI) that they began publishing in 2002. The CEI gives detailed information on how corporations that are listed on major exchanges and have more than 500 employees treat their GLBT employees. The required data is provided by HRC:WorkNet as they own an extensive database on policies affecting the GLBT community as well as former indexes such as the *glvIndex* found at: glvReports.com which have conducted similar surveys since 1993. These two indexes were acquired by HRC:WorkNet in 2001.

The Corporate Equality Index is based on the following seven basic criteria that provide a broad measurement of how firms approach their GLBT employees, consumer and investors:

- Are the words sexual orientation included in the company's non-discrimination policy and expressed in a written form?
- Are the words gender identity and/or expression included in the company's non-discrimination policy and expressed in a written form?
- Are benefits such as health insurance coverage or cash compensation offered for same-sex partners firm-wide?
- Does an employee resource group exist who engages in GLBT support activities or would the formation of such a council be allowed?
- Is diversity awareness created and employee training offered, respectively?
- Does the company engage in marketing and advertising to the GLBT community?
- Is any corporate action undertaken with the aim to abolish equal rights for gay, lesbian, bisexual and transgender people?

Each criterion is weighted equally when computing the score. For example, at the time of our study, if a firm included the words sexual orientation in its written non-discrimination policy, it received 14 percentage points. In total, companies can achieve an indexed score between 0 and 100% of the total possible points. They automatically receive full points for the last factor unless the HRC Foundation has evidence to the contrary. Considering question four, only half the points are awarded if such a council does not exist but was supported in general. If corporations wish to participate, they are asked to complete a questionnaire and to provide evidential support. Firms are not included in the CEI unless HRC has validated the information submitted by the corporations. This independent assurance is one the cornerstones to the credibility given to the CEI in judging the rated organisations.

RESEARCH DESIGN

Statement of expectations: We expect that organisations with a positive GLBT profile as scored by the HRC on the CEI will on average at least not have lower returns than those organisations scored as not accommodating their GLBT employees. This expectation is consistent with the following studies that have examined CSR, in general, as it affects the financial and market performance of the organisation: Gordon and Buchholz^[4-14,2]. Therefore, we are assuming, in forming the above expectation, that the results of these studies which have investigated the many diverse dimensions of CSR reasonably extending to our more focused study of GLBT employees for which there are no precedent studies.

Regarding risk, we expect that organisations that have focused on policies and projects in support of the rights of GLBT employees will have a higher risk profile. According to economic theory, this is essentially unavoidable due to the fact that risk is being measured by the variation of returns. Sharpe^[15]. In this context, the more committed an organisation is to follow a particular agenda to the exclusion of other possible paths of action, the higher will be the variation of returns and so lead to higher systematic risk. See Bodie and Merton^[16]. As for unique risk, we do not offer an expectation but will provide this information in an exploratory spirit as the nature of unique risk is conditioned on many performance issues and so it is difficult to rationalize a particular expectation^[17].

The CEI data: All together, 250 companies from the Fortune 500 and the Forbes 200 were ranked on the CEI published in 2003. We grouped these CEI-scored organisations into the following two groups for purposes of analysis: Organisations with $CEI \leq 28$ are classified as Un-Accepting, $n = 26$; and organisations with a CEI score ≥ 86 are classified as Supportive, $n = 93$. That means that companies, which fulfilled only at most two of the above noted criteria, were assigned the classification Un-Accepting. In contrast, companies that achieved a score of at least 86 are considered as Supportive. Put differently, these supportive organisations incorporated at least six of the seven above stated criteria. In this way we have developed polar profiles of these CEI scored organisations.

Market variables and data: To examine the performance of these two CEI groups on their market performance, we collected daily return information from the Centre for Research in Security Prices (CRSP®) for the selected 119 from 1 January 2002 until 31 December 2003. The specific market measures that we will use are organised into the following four groups:

The CAPM measures: The first measure is Jensen's α . Jensen's α is the difference between the average rate of return of a security or portfolio and its security market line-i.e., the CAPM risk-return line. Computationally, it is the intercept of the excess returns regression and thus a measure of excess return performance. A positive (negative) Jensen's α indicates that the company outperformed (was outperformed by) a random market portfolio. The CAPM Beta (β) is a measure of relative variation; specifically, the co-variation of the company's return with the market's returns to the variation of the returns of the market. Therefore, β is a risk-return measure of the organisation relative to the market, assuming that

a variation-based measure of return surrogates for risk. If β is greater (less) than 1, the company has more (less) risk relative to the market-i.e., higher (lower) relative-return variation. Sharpe^[15]. These measures are un-indexed relative-to-the-market performance measures for the firm. As is common practice, we used the S and P 500 value-weighted index as the market surrogate. For the risk-free rate, we used the 30-day T-Bill composite.

The sharpe and treynor performance indices: These indices are risk-indexed excess return measures. The Sharpe Performance Index (SPI) is the excess return of the organisation relative to total risk as measured/surrogated by the standard deviation of the returns of the organisation. Computationally, the SPI is the average return of the organisation less the average risk-free rate divided by the standard deviation of the organisation's returns for the time period in question. The Treynor Performance Index (TPI) uses the same numerator as does the SPI, but divides it by the firm's period β . In this sense, the TPI measures excess return as the ratio of excess return to the non-diversifiable or systematic risk as indexed by β . Thus the SPI and the TPI present risk-indexed excess return information.

CRSP® Standard Deviation (σ) and Beta (β) peer groups: The excess return of an organisation may also be measured relative to the average return of a peer group. The CRSP® service reports such excess return information for the following two peer groups: a Standard Deviation (σ) or total-risk peer comparison group and a Beta (β) or systematic-risk peer comparison group. Computationally, these measures subtract from the organisation's daily return, the average return of the organisations that are in its daily peer comparison group. (CRSP®^[18], Definition Macro). For example, consider the β -peer group. The CRSP® service groups all of the organisations for which it collects data into a number of clusters based upon the range of β . Then, for each cluster, the mean return is computed and subtracted from the return of *each* organisation in that β -peer cluster. In this sense, organisations with a positive (negative) average for their β -peer group have *on average* outperformed (been outperformed by) their β -peers. We have included these measures because they provide a strong test of relative excess-return performance, in that they are measured against excess return of a peer group that over time must exceed the risk-free rate.

Ben-Horim and Levy Unique Risk: Ben-Horim and Levy^[19] argued that due to the nature of variation as it is used in the Sharpe measure of unique risk it is bias on the high side. Thus, they define the diversifiable and

non-diversifiable risk measures as two complementary components of the standard deviation of a security's rate of return. We will use their definition as our measure of unique risk that will be noted as B-HL Unique Risk.

RESULTS

To report inferences, we have conducted both parametric and non-parametric tests. For such inference, we will report the larger of the appropriate two-tailed p-values; this gives the most conservative rendering of the results. It is worth mentioning that we found no differences in the two groups (Supportive: Un-Accepting) relative to total sales or the number of employees so that the results do not seem to be conditioned on these variables. Consider now the results as to the market performance of the HRC CEI scored groupings: Supportive organisations, Noted as S and Un-Accepting organisations, noted as Un-A, as presented in the Table 1.

In Table 1, due to the fact that the scales of the variables are different, we have presented them as ratios of the Supportive (S) to the Un-Accepting (Un-A) organisations. This allows a simple comparison of the comparative results. For example considering Beta (β), the median β for the 93 organisations in the Supportive group was 0.92 and for the 26 organisations in the Un-Accepting category was 0.73. This gives a ratio of 1.26 and the p-value of this difference was 0.01 suggesting that the difference in medians between the two groups was sufficiently large to reject the null that there is no statistically significant difference in β between the two groups. Consider now the interpretation of the results presented in the table.

The risk performance: The CAPM β . As noted above, the ratio of β s for the two groups is 1.26, which has a p-value of 0.01. This suggests, as expected, that there is a difference in the relative risk-return measure between the two categories of organisations. Organisations that have taken actions to be sensitive to GLBT issues have a higher risk relative to the market than organisations that have not concerned themselves with such issues. Offering as an explanation, this market systematic relative

risk result might be interpreted in terms of policy and project selection flexibility. Supportive firms have committed to policies and projects that accommodate GLBT agendas and so there are certain projects that they would not be able to select because said projects are inconsistent with their mission commitment to support GLBT agendas. Therefore they have a more limited set of possibilities than do the Un-Accepting firms that are free to select any policy or projects, within the constraints of the legal framework, including those that may be viewed as inconsistent with the GLBT agendas. This difference in flexibility or freedom to select projects in an unconstrained way translates into a risk differential. Inflexibility is usually associated with higher risk in the market and that is what we see in our results. In addition, it is interesting to note that the two β s are lower than 1.0 indicating that both groups have less risk relative to the market consistent with the fact that most of the organisations in the sample are large diversified organisations and so it is consistent with the usual distribution of β that such organisations will be less risky than the market; as such, this result is a good credibility check on the representativeness of the sample.

B-HL unique risk: Here we see the opposite result for the risk that is not part of the market relative risk. The Supportive firms have lower unique risk compared to the Un-Accepting firms. It is important to realise in understanding this result that unique and systematic risk are independent. Therefore, because the Supportive firms had more market relative risk does not indicate that they will have lower unique risk. Unique risk is the risk that the firm can reduce whereas the systematic risk cannot be eliminated by diversification. Essentially then, unique risk is the variation remaining after the market effect is accounted for by the CAPM-regression. High unique risk then means that the project and policy base have created high return variation that is not related to the structural relationships between the firm and the market; and, low unique risk means that the variation around the CAPM-regression is low. Thus for organisations with low unique risk, one has a better predication of their return than for firms for which the unique risk is high even though the systematic variation for both may be the same. In our case, this means that the Supportive organisations follow a more predictable path than do the Un-Accepting firms. This makes sense in that they are more predicable as they have announced a specific plan to follow agendas that are in line with GLBT agendas. Thus, possibly this intention to follow these agendas has reduced the variation around the CAPM line; one can conceive of this higher predictability leading to lower risk index return expectations.

Table 1: The CEI HSD screens for the market measures

Market measures	S/Un-A	p-value
Jensen's α	0.44	0.34
SPI	0.94	0.70
TPI	2.28	0.58
σ -Peer	0.89	0.49
β -Peer	0.92	0.66
Beta Systematic Risk	1.26	0.01
B-HL Unique Risk	0.95	0.08

Return performance: For the five market return measures: Jensen's α , the SPI, the TPI, α -Peers and β -Peers there is no statistically significant evidence of market performance differences between the Supportive and Un-Accepting HRC groupings. This follows our expectation in that organisations that took actions to provide a supportive GLBT environment did not pay for this decision in terms of market return.

CONCLUSION

In this study, we examined the relationship of CSR focusing on GLBT issues as they relate to risk and return in the market. From the above-presented results, the following simple market pattern emerges.

- On the one hand, corporations that have taken actions to support GLBT agendas seem to have higher systematic risk meaning that they are expected to return more than the firms with lower systematic risk; for our study these were the Un-Accepting firms. This risk relationship follows our understanding of the effect that decision flexibility has on risk.
- Unique risk is lower for the Supportive firms and this also follows logically from the fact that they have a more predictable profile relative to their allocation of resources.
- Finally, we find, consistent with our expectation regarding return performance, there is no difference between the two groups of HRC classified firms respecting their return performance as measured by: *Jensen's α , the SPI, the TPI, α -Peers and β -Peers.*

In conclusion, Supportive firms that are sensitive to GLBT issues seem to have a high-risk profile but importantly do not pay for support of the GLBT communities in terms of their market return profile.

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