THE SUBCONSCIOUS IMPACT OF CSR RATINGS & STORY-TELLING ON INVESTORS

While individual investors prefer to buy stocks of companies that have strong social responsibility and sustainability performance, they don’t realize that when they’re aware of how good or bad that performance is, it subconsciously has a significant impact on their financial valuation calculations.

Meanwhile, most Fortune 100 companies are garbling their message when it comes to the details of presenting that performance in CSR reports. Sophisticated but less-numerate investors are affected by a mismatch they subconsciously detect between words and pictures in the reports, and that makes them less likely to want to invest.

Inside this Brief
This brief is based on two peer-reviewed studies conducted by teams that included faculty at the University of Illinois College of Business.

Additional interpretation and analysis included in this brief was provided by one of the researchers, W. Brooke Elliott, who is a professor of accounting at the College and an expert on the psychology of investors and how presentation of information affects perceptions of firms’ value.

On the following pages is detail on each of the two studies, which each look at different aspects of how CSR ratings and reports affect investor judgments and actions.

▶ Section One: Investors’ awareness of CSR performance effects their valuation of companies without them realizing it (page 2) and implications (page y).

▶ Section Two: The subconsciously perceived mismatches between words and pictures in CSR reports influence less-numerate investors without their knowing it (page z) and implications (page zz).

The Upshot
There are significant implications for:

▶ Investors: How to act on their CSR inclinations but not overpay.

▶ CSR and IR professionals: How their work affects cost of capital and how to tell their stories effectively.

▶ Regulators: How their push for simplicity in reporting may in some cases be having unintended effects.

Individual Investors’ Impact
Research on individual investors’ behavior is critical:

▶ Individual investors hold about 37% of US corporate equities, amounting to $8.4 trillion. They can play a significant role in shaping the price-formation process and, in turn, many public companies’ cost of capital.

▶ Regulators and standards-setting bodies work to protect individual investors and rely on research to help them do their jobs.

▶ Sustainable and responsible investing (SRI) is a fast-growing field. SRI strategies guided about $3.74 trillion in investments as of the end of 2011 and mutual funds incorporating SRI factors reached $640.5 billion, up from only $12 billion in 1995.
THE SUBCONSCIOUS IMPACT OF CSR RATINGS ON INVESTOR’S FINANCIAL VALUATION

Investors are subconsciously influenced by social responsibility and sustainability performance when they’re estimating a company’s fundamental value—and how much they are willing to pay for its stock.

When investors are aware that a company’s CSR performance is good, they bump up their valuation of that company substantially without realizing it. The reverse is true for negative performers.

Specifically, investors’ fundamental value estimates are about 35% higher when CSR performance is positive instead of negative. Further, when asked, these same investors report that CSR had little to no influence on their estimates of value. That’s because when they have an emotional reaction to CSR they’re less likely to scrutinize the performance beyond a superficial level, believing that CSR is in no way entering into their valuations.

When investors are aware that a company’s CSR performance is good, they bump up their valuation of that company substantially without realizing it.

The findings come from an experiment conducted using as subjects graduate business students, who had taken at least one MBA-level financial analysis class and therefore were reasonably sophisticated in their ability to do company valuations.

Why Does This Happen?

Here’s how the experiment was done: The investors were given a dummy company’s financial report and its CSR report, which highlighted numerical ratings of social responsibility and sustainability performance. They were asked to estimate the fundamental value of the firm.

The investors were then nudged to think more carefully about the CSR report, which prompted them to delve into specifics of the company’s programs and performance. That triggered unprompted adjustments to their valuations. They adjusted downward the valuation of companies with good CSR performance, revealing that they had become aware that they’d been adding a premium without realizing it. They adjusted upward the valuations of neutral and poor performers, also reflecting a realization that CSR had crept into their numbers.

The experiment was a test of whether what is known in psychology as “affect as information” carries over to the world of CSR reporting.

An affective or emotional reaction is a subconscious response that shapes our judgments. The weather, for example, has been shown to affect people’s general life satisfaction on a given day. On sunny days, people report being happier than on cloudy days. However, once people are reminded that it is either sunny or cloudy, the differences in life satisfaction go away. This happens because the individuals are made aware of the source of an emotional response, in this case the weather, that is affecting other judgments that they are making that day. Once they can attribute the emotional response to its source, it no longer affects other judgments that they may make.

The CSR world, with its emotional imagery, would seem to have the potential to subconsciously trigger feelings about the company. The researchers set out to see whether that happens and whether those feelings subconsciously affect subsequent judgments about firm value.

It turns out they do. Investors are letting emotional responses to CSR performance creep into their financial calculations without realizing it. When CSR performance is good, the investors unknowingly boost their valuations and do the opposite when the performance is poor.

How do we know that’s what’s going on? Just like the weather example above, when investors were prompted to explicitly assess CSR performance, they were able to attribute their emotional responses to CSR information to their source and the differences in firm value for the company with good CSR as compared to bad CSR disappear. Put another way, once investors were able...
to attribute their emotional response to CSR performance to the CSR information itself, they estimated firm value for the good CSR performer and the bad CSR performer to be the same – the 35% premium that was initially awarded to the good CSR performer disappeared.

Interestingly, even though investors who assess CSR performance estimate fundamental value to be the same for the good and bad CSR performers, they are still willing to pay more for the stock of the good CSR performer. So, investors’ willingness to pay does not line up with how much they compute the firm to be worth using a typical valuation model.

Why Does CSR Value Disappear And Then Reappear On Closer Inspection?

Researchers believe there could be a few explanations for why the value of CSR seems to disappear when investors estimate firm value but then reappear when the same investors are asked how much they will pay for the stock of the same firm. The possible answers suggest the need for further research by academics, increased awareness by investors, and strategic thinking on the part of those who produce CSR reports. The findings suggest the following may be at work:

1. Investors do think CSR has long-term financial value but the link between what companies do in CSR and its actual financial return is not made clear in the reports.

2. There may be a disconnect between the CSR ratings and the quality and/or depth of the actions being undertaken by companies. If investors do believe there’s financial value to serious CSR performance, they’d naturally be looking at the effectiveness of the work a company is doing.

3. It is also possible that investors simply don’t have the tools to do the valuation themselves: There are no good methods for evaluating CSR performance in dollar terms and inputting it in a traditional valuation model, unlike financial aspects of firm performance.

4. Investors may, in fact, not believe that CSR has long-term financial value but may still be willing to pay more for the stock of firms with good CSR because these firms contribute to the “greater public good”.

The Upshot: Implications

- Companies’ efforts to raise their CSR profiles are producing immediate financial benefit, supporting their stock price and reducing their cost of capital. The imagery-provoking and value-laden nature of social responsibility reporting, rating, and advertising is having deep influence, even among those who don’t necessarily believe that CSR translates into financial value.

- It follows that every day investors make decisions about which stocks to buy and how much to pay without being aware that a company’s CSR image is influencing them. No matter whether they feel that CSR has financial value or not, they need to force themselves to look at details of social responsibility and sustainability.

- The good news for CSR proponents is that their preference for stocks of companies with responsible and sustainable practices remains. They’re just not willing to pay as much when they explicitly consider the details of those practices than when they are only exposed to CSR at a superficial level.
TELLING A COHERENT CSR STORY: THE SUBCONSCIOUS MISMATCH BETWEEN WORDS & PICTURES IN CSR REPORTS

Once they dig into a company’s CSR report, reasonably sophisticated but less-numerate individual investors become less willing to buy its stock if there’s a disconnect between the core framing and the way the CSR performance is portrayed. Most Fortune 100 companies have just such a disconnect in their reports.

The effectiveness in telling the CSR story, it turns out, has to do with the interplay of words and pictures. Companies often frame their CSR work as global or local. Their overarching message is about what they do for the world as a whole, or local communities in particular. It turns out that a global CSR narrative is processed most fluently and is relied on more by users when it puts an emphasis on words as opposed to pictures. The opposite is true when telling a local or community-centric CSR story.

Most Fortune 100 companies have just such a disconnect in their reports.

This happens because people feel it is easier to process things when they are communicated at the same level of detail. So if a company’s CSR strategy is at a concrete level such as “improving local communities” then CSR performance feels easier to process if it conveyed in a picture, which is also concrete. On the other hand, if a company’s CSR strategy is at a more abstract level such as “saving the world” then CSR performance feels easier to process if it is presented in words, which are more abstract in nature.

When the framing and the way positive performance is depicted match up, it produces more extreme positive investment judgments. A mismatch, on the other hand, makes the investors less willing to invest in the company because they are less likely to rely on the positive CSR information in making their investment decisions.

Implications

► SEC financial reporting simplification initiatives can backfire: Graphics lead some investors to make unintended judgments, not only when it comes to CSR but on other types of information as well. As the SEC encourages the simplification of financial reports, there is some risk of actually confusing investors. This is the opposite of the SEC’s push is intended to do.

► Companies’ CSR reports can play a direct role in attracting investment. Aligning the core framing and the design of the reports determines how far-reaching the effect is, with the framing being particularly important in connecting with less-numerate investors. But, framing aside, CSR ratings and reports actually affect all investors because they elicit an affective reaction from investors.

► Individual investors need to force themselves to consider whether emotions may be creeping into their judgments, and financial advisors could develop a simple tool to help their clients become aware of such effects. Otherwise, it is a near-certainty that many investors are making decisions that are being subconsciously influenced. Investors may prefer to buy stocks of companies that are good on CSR and sustainability but it’s important that they make that decision with full awareness that that’s what they’re doing and how much it effects what they’re willing to pay for the stock.
Global vs. Local CSR Messaging:
How to Avoid Causing Subconscious Disconnects in Investors

- If your company wants to send an image that its CSR efforts are local then depicting performance with pictures would make it feel easier to process. If, instead, your company wants to send an image that its CSR efforts are global then using words to depict performance would be the way to go. The key is that there is a match in the level that the strategy and performance information is communicated.

- These implications also spillover to other disclosures such as traditional and interactive annual reports, the Chairman’s letter to shareholders, and the MD&A section of the 10-K. Consideration should be given to the way in which the company’s general efforts are introduced to investors and how this meshes with the way performance is subsequently depicted.

- Being strategic in the presentation choices in both CSR reports and more traditional financial disclosures could help promote the company’s CSR and other activities, and potentially attract new investors.
TELLING A COHERENT CSR STORY: RIGHT WAYS AND WRONG WAYS

TELLING A COMMUNITY OR LOWER-LEVEL CSR STORY

Target gets it right: This example from Target’s CSR report is a good example of how to build out a community or locally-oriented core message. They have a heavier weighting on pictures than words. To less-numerate investors, there’s a subconscious match between what they’re saying and how they’re saying it and that makes them more likely to want to invest in the company.

Wells Fargo gets it wrong: This company also frames its CSR work as being local/community in orientation but they trigger a subconscious disconnect among many investors by going heavy on words. An emphasis on words works for a global message but not a local one.
TELLING A GLOBAL OR HIGHER-LEVEL CSR STORY

Starbucks strikes the right balance between words and pictures: For companies that position their CSR work as global in orientation, putting more emphasis on words than pictures is more coherent and less likely to be a subconscious mismatch to readers.

Citi creates a disconnect: This report is clearly trying to position its CSR work as global and to paint a global picture—but emphasis on images over words is the wrong way to do that.
About Brooke Elliott

Brooke Elliott researches the psychology of investors, how presentation of information affects their perceptions of firms’ value. Her work includes analysis of factors that influence both individual and institutional investors, with implications for the quality of their decision-making and, in some cases, the effectiveness of government regulation. Much of Professor Elliott’s work is based on live experiments, an approach that maximizes control of the information environment and allows her to make causal statements about the effect of an array of disclosure features on investors’ judgments and decisions. She is professor of accountancy, the Roedgers Fellow in Accounting, and the Ken Perry Faculty Fellow at the University of Illinois College of Business.

Research this Brief is Based Upon

*The Unintended Effect of Corporate Social Responsibility Performance on Investors’ Estimates of Fundamental Value*  
By W. Brooke Elliott, Kevin E. Jackson, and Mark E. Pecher of the University of Illinois College of Business at Urbana-Champaign and Brian J. White of the University of Texas at Austin.

*How Features of Corporate Social Responsibility Reports Interact with Investor Numerach to Influence Investor Judgments*  
By W. Brooke Elliott and Stephanie M. Grant of the University of Illinois College of Business at Urbana-Champaign and Kristina M. Rennekamp of the Samuel Curtis Johnson Graduate School of Management at Cornell University.