[Stocks favoured by socially conscious investors fared better during the COVID crash]

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Key topics

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Firms favoured by socially conscious investors experienced reduced stock market losses during the March 2020 stock market crash

In March, as the consequences of the COVID-19 pandemic became clear, stock markets across the world experienced one of the most dramatic falls in history. The prospect of a global recession, international shutdowns and a multitude of new uncertainties sent many indexes, including the S&P 500, into a double-digit nosedive.

However, not all stocks were affected equally, with those favoured by socially conscious mutual fund investors faring better than the rest of the market. This was not due to these socially preferred businesses being inherently better or particularly well equipped to deal with a worsened economic environment. Instead, it had more to do with the nonpecuniary value socially minded investors placed on these stocks.

The feel-good factor

Asset prices, in the traditional sense, should reflect the financial “worth” of a firm. Profitable, well-run firms with good prospects should command higher prices, while firms that are doing less well should see lower share prices.

Socially conscious investors change this dynamic. Instead of solely focusing on the financial dimension of the firm, these investors also consider a moral mandate when making their investment decisions. Whether for religious, ethical or environmental concerns, these investors create an additional layer of demand for firms that suit their nonfinancial tastes.

> stocks preferred by socially conscious mutual fund investors experienced better stock returns, as well as lower returns volatility, during the crash

As a result, asset prices also reflect social preferences, which helps to push the price of socially preferred stocks slightly above the ones that are less preferred. It’s a well-documented phenomenon that investors driven by a moral code are willing to pay a little bit more than what a company is worth in purely financial terms.

The power these investors wield has been increasing for some time. According to the US Forum for Responsible & Sustainable Investment, in 2018 socially responsible investments added up to about a quarter of the total assets under professional management. The behaviour of a group of this size can have a significant effect on the market as a whole.

Socially conscious choices

Since it is still up for debate which firms deserve to be considered socially responsible, our research on the March crash takes a direct approach. Our analysis looks at firms in the S&P 500 with regards to the demand for their shares among actively managed US domestic equity mutual funds that are stated to invest with a social responsibility investment mandate. These funds seek to avoid certain types of businesses, like tobacco growers or weapons manufacturers, while prioritising companies they believe have a positive impact on the world.

We found that stocks preferred by socially conscious mutual fund investors experienced better stock returns, as well as lower returns volatility, during the crash. This is despite the fact that these socially preferred companies were affected just as much as the rest in terms of gross profitability, operating income, sales growth, and analyst expectations of the long-term growth rate of future earnings.

More precisely, a one standard deviation increase in socially conscious mutual ownership was linked to about a three per cent reduction in returns loss at the monthly level. Being valued by these socially conscious investors was not enough to escape the crash, but it did mitigate some of the losses. Indeed, while market valuations declined substantially as a whole, firms with greater socially conscious mutual ownership experienced a weaker drop.

Moral commitments

The empirical results above can be illustrated in a theoretical setting by categorising investors into one of two groups: the first comprises conventional investors who only care about money, with the second made up of socially conscious investors who factor morals into their financial decision-making.

These morals matter for socially conscious investors in two ways. Firstly, they feel good from holding shares of firms that they deem to be socially responsible. Secondly, socially conscious investors place lower importance on the financial aspects associated with these socially responsible firms. This factor, which has been suggested by others in recent years, is important to explaining why stocks with greater socially conscious mutual ownership dropped by less relative to the rest of the market.

> investors driven by a moral code are willing to pay a little bit more

Although there is something to be said about the distortions created by social tastes in capital markets, how people choose to invest is ultimately their own business. Thanks to their moderating effect seen here, it could be that investors may find some comfort in dedicating a portion of their portfolio towards these more socially preferred companies.

This is, of course, assuming such socially conscious investors don’t abandon their morals in a future economic downturn. With all the unknowns created by COVID-19, future human behaviour might become the most difficult factor to predict.

This article draws on findings from “Socially Conscious Investors: Mitigating Stock Market Losses During the COVID-19 Crash” by Ruoke Yang and Iva Koci (Imperial Business School), published in the Centre for Economic Policy Research's Covid Economics, Vetted and Real-Time Papers*.*

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