The Experimental Approach To Trust In Socially Responsible Investment Funds

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1 Introduction

In this chapter, we introduce the experimental method as an element in the toolbox available for students of socially responsible investment (SRI). Paying heed to the attention that is devoted to the financial performance of SRI funds, we briefly survey behavioral data that investigated the importance of this performance for socially responsible investors. Then, we turn to a more recent trend in behavioral experiments, which focuses on the perceived trustworthiness of SRI funds. Building on the idea that SRI funds carry moral values, this trend of research assumes that these values can impact on the perceived trustworthiness of the funds. We draw on the methods developed in our research group to illustrate how this hypothesis can be experimentally investigated, and we finally consider future perspectives for the experimental approach to SRI funds and their trustworthiness.

2 Socially responsible investors and the performance of SRI funds

Financial scholars have paid great attention to the performance of SRI funds relative to conventional investments (Derwall, 2007; Bauer, Derwall, & Otten, 2007; Goldreyer & Diltz, 1999; Hamilton, Jo, & Statman, 1993; Hoepner & Zeume, 2009; Rennebog, Ter Horst, & Zhang, 2008b; Schroeder, 2007; Statman

& Fisher, 2002; Gregory & Whittaker, 2007; R. Luther, Matatko, & Corner, 1992; R. G. Luther & Matatko, 1994; Mallin, Saadouni, & Briston, 1995; Cortez, Silva, & Areal, 2009a, 2009b). In parallel, empirical and experimental studies have been conducted that investigate the importance of financial performance to SRI investors, as compared to conventional investors.

Rennebog, Ter Horst, and Zhang (2008a) speculated that socially responsible investors were willing to accept lower performance based on some aversion to corporate behavior, when corporate behavior was deemed unethical. In a later paper (Rennebog, Ter Horst, & Zhang, 2011), the same authors did found SRI investors to be less concerned about negative returns. Analyzing the monthly volatility of cash flows, Bollen (2007) reported data that supported the 'loyalty' hypothesis about socially responsible investors, and an analysis of institutional shareholders ownership revealed that long term investment was positively related to corporate social performance (Cox, Brammer, & Millington, 2004). Interview studies were also conducted, which mostly focused on institutional investors. Interviews with institutional investors revealed that they considered social, ethical and environmental information as useful for their investment decisions (Solomon & Solomon, 2006), but also that they were not ready to sacrifice essential financial requirements to address ethical concerns (MacKenzie & Lewis, 1999). Finally, questionnaire surveys have been commonly used to inquire about investors preferences about SRI funds. (e.g. Harte, Lewis, & Owen, 1991). Unsurprisingly, socially responsible investor showed a preference for investing in morally commendable companies, although no clear rules emerged as to how they could trade-off principles and performance (Lewis & MacKenzie, 2000; Lewis & McKenzie, 2000; McLachlan & Gardner, 2004).

In parallel, experimental researchers also studied the importance of financial return to socially responsible investors. For example Pasewark and Riley (2010) asked undergraduate students to choose between bonds issued by a tobacco company and a another, non-tobacco company (a steels and alloys producer). The experiment manipulated the yield of the tobacco company to be either identical, .5 percentage point, or 1 percentage point greater than the yield of the other company. Participants personal values concerning tobacco interacted with yield to predict their investment decision. When tobacco bonds had a 1% greater yield, the decision to invest in the other company was highly dependent on the participants concern about the societal implications of a tobacco investment.

In another study (Glac, 2009), business school students were presented with one of three mutual funds, with different levels of return (6%, 11% and 16%). In each case, they had to decide the level of return they would accept from a SRI fund, in order for them to invest in the SRI fund rather than in the conventional fund. Participants required lower performance from SRI funds, and the absolute amount of performance they were willing to sacrifice was the highest for the most performant conventional fund. Finally, another study (Webley, Lewis, & Mackenzie, 2001) compared the decisions of conventional and ethical investors, who had to reallocate imaginary portfolios. These portfolios included conventional and SRI funds, whose performance was good or bad depending on the experimental condition. As opposed to conventional investors, ethical

investors were generally committed to ethical funds and kept them even if they performed badly.

Experimental data thus concur with the hypothesis that socially responsible investors give less weight to performance in their investment decisions than conventional investors do (but see McLachlan & Gardner, 2004, for a questionnaire study that failed to replicate this finding). The question arises, then, of which aspect of the fund they give more importance too. In recent years, a useful set of constructs emerged to address this question, suggesting that socially responsible investors may be concerned about the perceived trustworthiness of the funds. We now turn to this emerging trend of research.

3 Trust and its measurement

Trust is an essential component to economic development (Fukuyama, 1996). It is an economically relevant component of a culture (Francois & Zabojnik, 2005), and the general level of trustworthiness in a society is related to the economical outcomes of this society (Glaeser, Laibson, Scheinkman, & Soutter, 2000; La Porta, Lopez-de Silanes, Shleifer, & Vishny, 1997; Knack & Keefer, 1997).

Arguably, the financial crisis of 2008-2009 resulted in a loss of trust from the general public towards the financial sector. Edelman (2010a) asked Americans and Europeans between 35 and 64 how much they trusted the business sector to do what is right. Positive answers dropped about 20 percentage points between 2008 and 2009. Market data also support a connection between trust and stock prices. The U.S. consumer confidence index set a record low in February 2009 (Board, 2010). Other trust indexes, like the German ifo-Business Climate Index, behaved the same at this same point in time. Trust in the banking sector was severely affected in particular. In the USA, trust in banks dropped 30 percentage points since 2007. This figure was 16, 17, and 20 percentage points in France, Germany, and the United Kingdom, respectively (Edelman, 2010b). Restoring the trust of the general public and investors in the financial sector seems to be critical for future economic development. In the rest of this chapter, we will explore experimental tools to measure trust and lay bare its psychological precursors, in the domain of socially responsible investment.

We begin with a few preliminary remarks. We first remark that trust, as the willingness to be vulnerable to the actions of another party without ability to monitor or control that other party (Mayer, Davis, & Schoormann, 1995), is different from actually being vulnerable to the other party. Risk taking behavior in a relationship is not trust per se. Measuring trust therefore requires to tap into the *willingness* to be vulnerable to the trustee. Second, we will restrict ourselves in the following to specific trust (trust in a given physical or moral person), as opposed to generalized trust (the general propensity to trust other people; see Glaeser et al., 2000, for a review).

Measures of specific trust come into two main flavors. Experimental economics and behavioral game theory make extensive use of implicit trust mea-

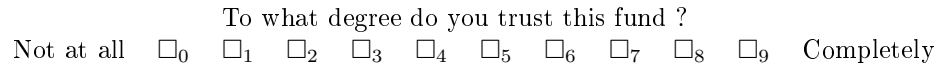

Figure 1: A 10-point Likert type scale for measuring trust in a fund.

sures such as the decision in a trust game (Berg, Dickhaut, & McCabe, 1995). In other fields, simple Likert type scales (Fig. 1) are the most popular measures of trust. These basic scales are used to measure trust in a variety of domains, such as trust in one's manager (Bews & Rossouw, 2002), trust in supplier firms (Doney & Cannon, 1997), and, of course, trust in mutual funds. A good precaution for using these scales is to let participants practice with the format before they start responding to the survey. another good precaution is to help them calibrate through the use of 'end anchors'. This method consists of presenting participants with extreme stimuli first, which are likely to fall at both ends of the scale, providing participants with a frame of reference before they judge the target items of the survey (N. Anderson, 2008; N. H. Anderson, 1982, 2001).

4 Integrity as a precursor of trust

We now turn to precursors of trust, or, more precisely, determinants of perceived trustworthiness (Mayer et al., 1995; Ring & Van de Ven, 1992; Hovland, Janis, & Kelley, 1953). Trustworthiness is based on expectations of how another person would behave (Good, 2000), an draws on the perception of their competence and integrity, especially in fiduciary relationships (Lieberman, 1983). Integrity is a prominent concept in academic models of trustworthiness (Mayer et al., 1995; Siegrist, Earle, & Gutscher, 2003; Bews & Rossouw, 2002; Morgan & Hunt, 1994; Mishra, 1996), and its importance has been regularly grounded in data (e.g. Moorman, Deshpande, & Zaltman, 1993; Morgan & Hunt, 1994).

Mayer et al. (1995) define integrity as the trustor's perception that the trustee adheres to a set of principles acceptable to the trustor. In the context of SRI, integrity can thus be conceived as the similarity between the ethical values of the investor and the values put forward by the fund. Individual investors would be more likely to judge a fund as trustworthy if the fund's values were similar to their own. Furthermore, we know that the perception of integrity plays a large role at the very first moments of a relation, an interaction or a transaction. Mayer et al. (1995); Schoorman, Mayer, and Davis (2007). At these early moments, perceived integrity dominates other precursors of trust. This suggests that socially responsible investors who have to pick a fund (as opposed to, say decide to drop a fund they have already invested in and know better) will pay special attention to the perceived integrity of that fund.

This definition of integrity raises practical questions for experimental researchers. In order to measure the similarity between investors' values and the values put forward by a fund, one has to decide which specific values might be relevant in the SRI context, how to measure them, and how to manipulate their degree of similarity.

In our research group, the choice was made to focus onto the values outlined in the OECD Guidelines for Multinational Enterprises (OECD, 2010). According to the report these guidelines were written for socially conscious investment funds and are thought as a tool from business ethics to help facilitate social change. The guidelines cover a large range of issues, such as labor and human rights, bribery and corruption, environmental impact and information disclosure.

Other choices are possible, of course. In that respect, some studies have outlined the values and preferences of various groups of investors. The famous home bias of investors favoring geological proximity (French & Poterba, 1991) might have some social aspects to it, however it is not relevant from a moral point of view and to our best knowledge no funds use it for social screening. In the USA, democrats are more likely to exclude industries like tobacco, guns and defense, or natural resources from their investments (Hong & Kostovetsky, 2011). In a working paper Hood, Nofsinger, and Varma (2011) report that women reject military stocks in favor of stocks with progressive labor policies for minorities, females and homosexuals. Younger investors avoid companies with poor environmental record but seek progressive labor policies whereas Catholics are more likely and Mormons less likely to own a sin stock that other investors. All these data, obviously, are highly specific to target demographic groups. Choosing the OECD guidelines thus appeared to best fit the objective to focus on all investors (and not some particular segment). The OECD guidelines also had the advantage of being specific to the business sector, as compared to other broad sets of values such as those included in the world value survey (Inglehart, university Consortium for Political, Research, & de Estudios Sociales, 2000).

5 Manipulating the perception of integrity

We now turn to the manipulation of perceived integrity, conceptualized as the similarity of the values of the fund and that of the investor. What needs be manipulated is the degree to which the funds values overlap with (are similar to) the values of each individual investor. We now illustrate possible methodological choices by presenting three different manipulations used in our research group to test the effect of similarity of values on trustworthiness.

5.1 Manipulation 1

Our first example consists in a 2-phase manipulation, aimed at first collecting data about participants' values, and then to construct funds based on these data, so that their values overlap to a predefined extent with the participants' values.

In Phase 1, participants are shown values randomly selected and adapted from the OECD Guidelines for Responsible Business Conduct. They rate the importance of these values for business ethics on a 10-point scale anchored at *Not at all* and *Completely.* Only six target values are meant to be used in

the second phase of the experiment—they are presented in random order and among a set of filler items. To further improve the accuracy of measurement, every question appears twice during this first phase, and the average of the two responses yields the subjective importance of each target value, for a given participant.

From these ratings, each value is assigned to a tier of importance for each participant. A given participant's Tier 1 values consists of the two values that she rated as the most important. Tier 2 values consists of the two values that come next in terms of importance, and Tier 3 consists of the two values that the participant rated as the least important.

In Phase 2, participants are asked to rate the trustworthiness of various investment funds on a 10-point scale anchored at *Not at all* and *Completely.*. Similarity with the participant's values is either *low, moderate,* or *high.* Here is one possible example of a fund description:

> The fund is an ethical fund and is run by a manager from London. She made the fund profitable for the last eight years and made it best in class. Recently the fund was evaluated by an ethical fund rating agency and received excellent grades in respect of workers rights and supply chain responsibility.

The value similarity between the fund and the participant is manipulated by changing the two social dimensions the fund excelled in. These are the participant's Tier 1 values in the high similarity condition, or her Tier 2 values in the moderate similarity condition, or her Tier 3 values in the low similarity condition. Each fund description appears twice for improving measurement. The target funds appear in random order among filler funds.

The main advantage of this method is to present participants with funds that precisely match (or not, or not quite) their own idiosyncratic set of values. What is important to one participant might be trivial to another, and these individual differences must be controlled by an appropriate experimental procedures, such as the one we just introduced, or the one we now offer.

5.2 Manipulation 2

Our second example is also a 2-phase manipulation, very similar to the first one but using an even closer translation of phase 1 data into Phase 2 funds. The main idea is till to collect participants' preferences in Phase 1, and use them to construct different conditions in Phase 2. This manipulation, however uses a calculation closer to that of Yaniv, Choshen-Hillel, and Milyavsky (2010), who manipulate the similarity of advice givers to advice receivers.

The materials used in Phase 1 are also randomly selected and adapted from the OECD Guidelines for Responsible Business Conduct. For each item, participants rate it's importance for business ethics on a 5-point scale anchored at *Not at all* and *Completely.* There are again six target values in Phase 1, introduced in random order among a set of filler items.

Performance : Profitable for 6 out of the last 10 years	
The fund received the following social responsibility ratings (5 is best):	
Transparency of the selected companies	4
Respect of environmental concerns of the selected companies	3
Struggle against corruption of the selected companies	5
Respect of public security of the selected companies	5
Conformity to national and international laws of the selected companies	1
Respect of workers rights by the selected companies	5

Table 1: An example of a fund description used in a 2-phase experiment on values.

In Phase 2, participants rate the trustworthiness of various investment funds on a 10-point scale anchored at *Not at all* and *Completely.*. The funds value similarity with each participant is either **low** or **high**, or there is no information about it. Table 1 offers one example of a typical fund description, whose format is adapted from the Securities and Exchange Commission prospectus requirements.

Value similarity is manipulated by changing the values of the six social responsibility ratings. In the high similarity condition, these ratings are identical to the ratings that the individual participant gave during Phase 1 when asked about their importance. In the low similarity condition, the ratings are at the opposite of the ratings that each participant gave in Phase 1 when asked about their importance (i.e., the rating in Phase 2 is 6 minus the rating in Phase 1). In this design, a supplementary control condition (where no ethical information about the fund is provided) merely states that 'The fund has not been evaluated by a social responsibility rating agency.' This control allows for comparing the effect of value similarity to a base rate of trustworthiness. Each fund description appears twice and the target funds appear in random order among filler funds.

This manipulation has the same advantages as our first variant. That is, it allows to precisely manipulate the similarity of a fund's values to that of each individual participant. The two methods, though, share the same drawback. Because participants are first asked about which values they deem important, they might enter a mindset where they believe that their task is to judge the funds on the basis of these values, instead of whatever they would spontaneously do. For this reason, these manipulations are adequately complemented with the third variant that we now introduce, and whose aim is to control that value similarity still has an effect when it is measured after the trustworthiness judgments.

5.3 Manipulation 3

Our third example is yet another 2-phase manipulation. In Phase 1, participants rate the trustworthiness of a series of investment funds on a 10-point scale anchored at *Not at all* and *Completely.*. In Phase 2, these same funds descriptions

are presented again, but this time what is measured is the similarity of their values to that of the participant. Similarity in values for each fund is measured by means of well-validated standardized scale (Earle & Cvetkovich, 1997, 1999; Siegrist, Cvetkovich, & Roth, 2000; Siegrist, Cvetkovich, & Gutscher, 2001; Siegrist et al., 2003; Poortinga & Pidgeon, 2003).

This standardized scale consists of six items altogether measuring similarity in values. It involves a series of judgments on 7-point scales about the fund, respectively anchored at *shares my values* and *has different values*; *in line with me* and *in the wrong direction*; *same goals as me* and *different goals*; *supports my views* and *opposes my views*; *acts as I would* and *acts against me*; *thinks like me* and *thinks unlike me.* Computation of a composite score of similarity in values is then done for each fund, for each participant. This composite score is the average of the reverse-coded responses to the 6 items (so that a high score would correspond to a high similarity in value). The analysis can then proceed that attempts to show how this similarity score relates to the perceived trustworthiness of the fund.

6 Other precursors of trustworthiness

Establishing an effect of value similarity on trustworthiness is a valuable contribution on its own right, but the practical significance of this effect is increased if it can be compared to that of other predictors of trustworthiness. In our research group, the benchmarks that value similarity is compared to include ethical labeling and financial performance.

Previous research suggests that the effect of eco-labels should be compared to that of value similarity. For example, a marketing study (Loureiro & Lotade, 2005) showed that consumers were willing to pay a premium for fair trade coffee, and that this premium was greater than that they were willing to pay for organic coffee. In SRI proper, there exists a variety of social labels, often coupled with corporate social responsibility ratings (e.g., Novetic, Ethibel, Vigeo). Consequently, social labeling seems to offer a good benchmark to assess the magnitude of the similarity in values effect.

Our other common benchmark is simply financial performance. The choice of financial return as a comparison variable of perceived trustworthiness is motivated by two reasons. First, economic trust measures like the consumer confidence index are strongly correlated to stock index performances.[1] Second, the controversy about whether investors consider social responsibility as a financial disadvantage can be informed by psychological insights on the effects on trustworthiness.

On the one hand there is strong evidence that investors are ready to financial sacrifices to favor social responsibility Pasewark and Riley (2010); Glac (2009);

[1] An increase in equity value boosts sentiment (Otoo, 1999), and consumer confidence declines when stock prices decline (Fisher & Statman, 2003). Jansen and Nahuis (2003) found changes in consumer confidence to be positively correlated to changes in stock return for nine out of eleven European countries.

Webley et al. (2001). On the other hand, some investors appear to believe that social responsibility comes with a financial advantage. For example, Nillson (2008) showed that altruistic and profit oriented factors play on the investment decision and finds that some consumers perceive SRI funds as financial outperformers and invest significantly more for profit seeking reasons. Additionally, Winnet and Lewis (2000) found that popular models suggest that gains can be made using appropriate insights and that morality can be an investor's edge since short term sacrifice will bring long term gains. Whether the effect of similarity in values can compare to that of financial performance will be an important issue for future research.

7 Conclusion

This chapter laid out the basics of behavioral research on socially responsible investors. It paid special attention to the research trend that focuses on the perceived trustworthiness of investment funds. We described in particular various methods used to test the prediction that SRI fund carry values which impact on their perceived trustworthiness, depending on the similarity of these values to that of individuals investors.

The results obtained so far in our reserach group point to a consistent effect of value similarity on trustworthiness. The fact that value similarity might be the underlying mechanism for the effect of social responsibility on trust in investment funds, would have practical implications in addition to its theoretical contribution.

The most obvious practical implication is for fund managers to favor SRI screening procedures that are individually tailored to investor groups. However some aspects of our data hint towards more general pattern of investor values, that in turn would mean to favor groups of values. A promising approach would be to explore possibilities of segmentation. Measures used in marketing research might give methodological guidance. For example, List of Values (Kahle, 1983; Veroff, Douvan, & Kulka, 1981) or Values and Lifestyle (Mitchell, 1983) are methods used by practitioners for customer segmentation purposes.

The effect of value similarity could also be used for communication purposes. Because integrity (i.e., similarity in values) is most salient in the beginning of a relationship, new bank customers might be especially sensible to this aspect of investment products. In this regard it is necessary to be cautious about false claims of value similarity, which might result in higher short term trust, but will cause distrust in the long run if the bank is perceived as a free-rider in the SRI domain (Sethi, 2005). Independently from these applied perspectives, we hope that we have achieved our aim of introducing readers to the experimental approach to socially responsible investment. Although the approach is still new, and sometimes limited to convenience samples, it will quite certainly play an increasingly large role in future SRI research, alongside to more established analytical and empirical methods.

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