

The effect of bad news on reputation and share price: An empirical study

Julian Kölbel has written a thesis for the Department of Management, Technology and Economics at ETH (the Swiss Federal Institute of Technology).

The thesis was supervised by Prof. Dr. Didier Sornette, who holds the Chair of Entrepreneurial Risks in the Department of Management, Technology and Economics at ETH Zurich and Dr. Ryan Woodard.

The leading question was: **Is there an effect of bad news concerning environmental and social conduct on a company's share price ?**

The investment universe for this study were constituents of the MSCI World and the analysis was based on weekly closing prices. As a proxy for environmental, social and ethical performance, the Reputational Risk Index (RRI) from ECOFACT's RepRisk® tool (www.reprisk.com) was used. The RRI is a measure of how often and how strongly a company has been criticized at a given time and is currently available for approximately 5000 companies worldwide. For the study, the matrix of RRI timeseries used comprised of 364 companies.

The strategy was to buy companies with a high RRI (indicating that they had consistently received strong criticism) and to see if there was a difference in returns between a benchmark portfolio and a portfolio that consists only of companies that scored the maximum RRI in their sector.

Three portfolios were compared to each other: The MSCI World Portfolio, the Max RRI portfolio and a simulated benchmark portfolio. The period of observation was from 1 January 2006 until 1 April 2008 and the length of the screening interval was chosen as a variable between 11 and 52 weeks.

The results suggest that in the mid to long run, a RRI maximum is followed by losses. Significant differences and pre-sign tests both indicate that for periods longer than 20 weeks, a Max RRI portfolio underperforms the market. Julian's thesis shows that the RRI may have predictive power for the share price (benchmark: MSCI World, e.g. developed markets). Bad RRI-companies over perform short-term but under perform long-term. Julian argues that this is probably because their clients and employees act on the bad reputation.

Julian's paper is quite groundbreaking in that it shows an anomaly, i.e. a deviation from the common rule regarding investment strategies and returns.

If you wish to receive more information about the thesis, please contact Julian Kölbel, koelbelj@ethz.ch or for questions regarding the RepRisk® data please contact Charlotte Mansson at ECOFACT (+41 44 350 60 22) mansson@ecofact.com or visit our websites www.ecofact.com or www.reprisk.com.