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RESEARCH PAPER

Exploring the Role of Corporate Social Responsibility in Mutual Funds Risk Management: An Empirical Analysis of Pakistani Mutual Funds Industry

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ABSTRACT

The purpose of this study is to unveil the role of mutual funds' Corporate Social Responsibility (CSR) in reducing mutual funds risk using data from Pakistani mutual funds industry. Despite the tremendous growth in mutual funds industry, the literature on its different mechanisms like risk management is scarce. The data was collected from a sample that consisted of 258 mutual funds ranging from 2010 to 2019. Using the Fixed Effect Regression model, our analysis showed a negative impact of mutual funds CSR score on mutual funds risk. These findings imply that higher CSR scores are significantly associated with decreased risk, which suggests that socially responsible investing may be able to reduce volatility. Our study controlled for the other mutual funds characteristics like fund age, funds size, expense ratio and fund performance. The results of this study highlight the significance of mutual funds CSR in risk mitigating strategies. It also makes contribution in the growing body of literature on mutual funds CSR and its association with different funds characteristics. The study suggests that investors, mutual funds managers and other stakeholders can reduce the risk by incorporating CSR into their investment strategies.

KEYWORDS Mutual Funds, Corporate Social Responsibility (CSR), Risk

Introduction

The maximum return with minimum risk has been the focus of all the firm stakeholders like investors, managers, practitioners and researchers etc. While achieving the optimal risk-and-return relationship continues to be core of many studies, there has been a long debate regarding the importance and the role played, if any, by Corporate Social Responsibility (CSR) in this relationship.

The evolution of CSR and the impact it has on the financial performance (FP) of the firms has been analysed and discussed by many researchers in various countries and economic settings, reporting mixed results. As far as the firm performance is concerned, some studies (e.g. Miller et. al., 2020; Yoon & Chung, 2018; and Choongo, 2017) found positive relationship between CSR and firm performance while others like Hsiao et. al., (2024); Cao et. al., (2023) and Wei et. al., (2020) reported a negative relationship between CSR and firm performance. Even though traditional finance theory frequently places an emphasis on maximizing shareholder value, and the literature has shown mixed results between CSR and firm performance, there is a growing body of evidence that suggests that taking into account environmental, social, and governance (ESG) concerns can result in improved long-term returns and a reduction in risk. Particularly in developing nations, where there is a growing awareness of the significance of ethical business practices and sustainable growth, this relationship has been found stronger in developed countries.

Our study is very compelling that discusses connection between mutual funds CSR and the risk associated with them in context of the mutual fund market in Pakistan, which is characterized by rapid growth and a diverse investor base. Pakistan is facing significant challenges in a variety of domains, including the contraction of its financial sector, the preservation of environmental sustainability, and the advancement of financial literacy. These issues give opportunity for managers of mutual funds to connect their investments with socially responsible firms, which can potentially minimize risk while also contributing to the wellbeing of society.

It is common for investors who have small investments to lack financial expertise regarding investments and management of financial assets, the methods of diversification, and familiarity with the mechanisms of the market. In addition, they are unable to hire financial consultants or experts since the prices that these specialists charge is too high. To better manage their investments and diversify their portfolios, mutual funds give their investors the option to take advantage of this possibility. According to Cashman (2012), mutual funds are "one of the great financial conveniences." Therefore, the investing in mutual funds is becoming increasingly popular all over the world, particularly in nations that are still in the process of building their economies. It has been observed that the mutual fund market in Pakistan has experienced enormous growth, as evidenced by a 300% increase in its overall Net Asset Value (NAV). The features of risk and return that are associated with mutual funds are the most important factors in attracting investors. According to Vidal-García et. al., (2019), mutual funds are subject to a variety of risks because they operate in the same market conditions as other commercial enterprises. The funds that have a reduced risk are, without a doubt, the ones that investors choose, particularly those investors who are risk averse. In addition to this fact, the literature has paid a very minute amount of attention to the practices and methods that have the potential to be useful in lowering the risk associated with mutual funds.

Over the past few years, the incorporation of CSR among the various other criteria that influence investment decisions has also gained a significant amount of importance. In the case of mutual funds, this is the situation. Due to two primary reasons, the managers of mutual funds make an effort to include corporate social responsibility into their investing decisions. The first reason for the behaviour of socially responsible investment is that individuals are becoming more aware of their responsibilities to society, particularly regarding the environment and climate (Hamilton et al., 1993 and Bauer et al., 2006). To gain a competitive edge over their counterparts, the second rationale is to incorporate socially responsible investments into the portfolios. As stated by Barreda-Tarrazona et al. (2011), the mutual fund markets and investors prefer funds that have a reputation for engaging in socially responsible investing. As stated by Bilbao-Terol (2017), the investors who invest in socially responsible funds prioritize fund's socially responsibility over its FP. Consequently, the managers of mutual funds try to direct their investments toward businesses that are socially responsible to boost their goodwill and, as a result, attract the attention of investors.

Even though a large number of studies have been conducted to investigate the connection between CSR and the FP of mutual funds (for example, Fatemi et. al., 2024; Hornuf et. al., 2024; and Durán-Santomil et al., 2019), the connection between CSR and the risk of mutual funds has not been discussed. According to the Global Sustainable Investing Alliance (2018), socially responsible investing has the potential to generate a sense of goodwill, which, in turn, can end up motivating the general public and attracting investors who are inclined to give socially responsible investments more weight. It is possible to assume that socially responsible investment can minimize the risk associated with mutual funds as well. This is due to the fact that mutual funds operate in the same business environments as other business enterprises. On the other hand, this connection has not been examined within the context of mutual funds as of yet (Humphery et. al., 2016; Syed & Butt, 2017 and Bae et. al., 2020). According to Nguyen and Nguyen (2015), assets with a value of around 22.90 dollars were being handled by professionals in accordance with CSR initiatives all over. As we stated earlier, there a quiet a handsome number of studies that have discussed mutual funds CSR and their FP. The empirical analysis presented by these studies produced mixed results. Sustainable investment improves fund performance in several research (Martí-Ballester, 2024 and El Ghoul & Karoui, 2022). However, some other studies (like Abate et. al., 2021) suggest that sustainable funds may underperform conventional funds. Many studies show that sustainable investing does not affect fund performance.

Nofsinger and Varma (2014) performed a study on fixed income socially responsible funds and found that these funds benefit during weak markets because they avoid investing in "irresponsible" companies due to their risk reduction focus. This novel hypothesis guided our study that the investment in socially responsible places can be used as a tool of reducing the risk.

This study analyses whether investors and portfolio managers can use sustainable investing to mitigate risk. Several factors contribute to the significance of this research. Pakistani investors are increasingly demanding transparency and ethical considerations in their investment portfolios. Studies suggest a growing interest in ESG-focused investments, indicating a potential market for CSR-integrated funds. Pakistan's economy has historically experienced periods of volatility, making risk management a crucial aspect of investment strategies. Exploring the potential of CSR investments as a risk mitigation tool is highly relevant. The Pakistani government has taken steps to promote responsible business practices and sustainable development, creating a conducive environment for CSR-focused investment strategies.

Despite the growing interest in ESG (environmental, social, and governance) factors in investment decisions, the evidence on the link between CSR and risk reduction in emerging markets, especially in Pakistan, is limited. This study aims to address this gap by investigating whether Pakistani mutual funds incorporating CSR principles experience lower levels of risk compared to their conventional counterparts. So, this study seeks to answer the key question i.e., can Pakistani mutual funds use CSR as a risk-reducing strategy?

The flow of our study progresses in the following manner: Upcoming section covers literature and hypothesis. Methodology section covers data and methods. Experimental data are reported in Discussion and conclusions is provided at last.

Literature Review

Scholars have studied the impact of social criteria on investing for decades. Traditional financial theory implies that screening for social criteria reduces the returns from the most thorough diversification (Bello, 2005, and Ferruz et al., 2012). This argument expands on Grossman and Sharpe (1986), who claim that investment limits lower portfolio performance. A few research validate the traditional assumption that ESG criteria lower performance (Abate et. al., 2021). Despite the considerable body of research examining the correlation between CSR and mutual fund FP (e.g., Benlemlih et.

al., 2018; Hornuf et al., 2024; and Santomil et al., 2019), there has been no substantial examination of the relationship between CSR and mutual fund risk. Existing literature on businesses indicates that corporate social responsibility and risk are related in a negative way. One might hypothesize that socially responsible investment practices could also serve to mitigate the risk inherent in mutual funds. This is because mutual funds are operating within the same market conditions as other conventional businesses. However, the relationship has never been tested. As reported by Nguyen and Nguyen (2015), a huge investments volume i.e. around $22.90 has been invested in socially responsible places. As previously mentioned, a considerable body of research has examined the correlation between the CSR of mutual funds and their FP. According to some of them, sustainable investing enhances the performance of funds (Martí-Ballester, 2024; El Ghoul & Karoui, 2022) while others found vice versa (Abate et al., 2021). Firm-level CSR literature shows a nontrivial, negative link between CSR and firm risk. Researchers explain CSR's impact on risk measures through many mechanisms. ESG disclosures negatively affect corporate risk, (Jo & Na. 2012; and Harjoto et. al., 2018). According to Giese et. al., 2019, the growing field of ESG investing shows the importance of investing in economic social and governance performance. Studies have shown that ESG-focused portfolios can exhibit lower volatility and higher risk-adjusted returns compared to traditional portfolios. Jo and Na (2012) found that Companies with strong CSR practices are better equipped to manage reputational risks. Research indicates that positive CSR performance can lead to enhanced brand image, customer loyalty, and employee retention, all of which contribute to a more stable and resilient company and CSR engagement reduces total risk, as assessed by standard deviation, more in contentious businesses like alcohol, tobacco, gambling, etc. CSR's risk-reduction role is also theoretically sound. Simply put, CSR decreases social, environmental, and governance litigation risk. According to Benabou and Tirole (2010), CSR initiatives can lead to improved operational efficiency, resource optimization, and cost reduction, ultimately lowering financial risk. For example, studies have shown that companies with strong environmental sustainability practices often experience lower energy costs, reduced waste, and improved resource utilization and CSR reduces managers' short-term opportunism. According to Gao, Lisic, and Zhang (2014), high-CSR executives are less likely to engage in insider trading.

Stakeholder theory implies that CSR invests in intangible assets like business reputation and social capital, strengthening stakeholder connections and helping the businesses while they are in economic turmoil. Eccles, Ioannou, and Screening assets for social responsibility may provide investors with value-relevant information. As investing in CSR encourages managers to choose the investments which are performing good in ESG areas, which ultimately may improve the firm performance (Sultana et. al., 2018). Social and environmental screening can help lower litigation costs during company social crises or environmental disasters, which financial markets undervalue and while a substantial amount of research has explored the link between CSR and risk in developed markets, studies focusing on emerging markets, specifically Pakistan, are limited. Existing studies have shown mixed results, with some indicating a positive relationship between CSR and reduced risk, while others have found no significant link (Lu et. al., 2022). Other researchers claim that socially responsible enterprises have distinctive “social capital” that protects firm value in bad times (Kim at. Al., 2023). The emergence of ESG (Environmental, Social, and Governance) investing has brought a renewed focus on the significance of non-financial factors in investment decision-making. Studies have consistently shown that portfolios incorporating ESG principles often exhibit lower volatility and higher risk-adjusted returns compared to their traditional counterparts. For instance, a study by Hong and Kacperczyk (2010), found that ESG-focused firms displayed reduced downside risk during periods of market stress. These discussions lead to this hypothesis:

Hypothesis: *Corporate social responsibility can be used to mitigate mutual funds risk*.

Research Methodology

The purpose of this study is to evaluate the impact of mutual funds CSR on mutual funds risk within the setting of Pakistan's mutual fund market using a fixed effects regression model. The model makes use of panel data.

Mutual funds data was collected from the website of Mutual Funds Association of Pakistan, the governing body of mutual funds in Pakistan. The data consisted of 258 mutual funds. The CSR Data was collected with the help of a composite index that was developed from data publicly available on companies' websites on CSR elements for the time period 2010-2019. The different aspects of corporate social responsibility (CSR) were combined into this index. These aspects included environmental performance, social responsibility, and governance practices. Financial information was gathered from the database of the Pakistan Stock Exchange (PSX) as well as the website of the MUFAP. This information included the variables CSR and Risk. In order to take into consideration additional elements that could potentially have an impact on risk, the model incorporates control variables. The mutual funds risk was calculated using standard deviation of monthly returns.

$$\sigma = \sqrt{\left(\Sigma(x_i - \mu)^2 / (n - 1) \right)}$$

A fixed effects regression model was utilized in order to investigate the connection between corporate social responsibility and risk. One way to represent the model is as follows:

Risk_it = β0 + β1 * CSR_it + β2 * Fund Size_it + β3 * Fund Age_it + β4 * Expense ratio_it + β2 * Fund Performance_it + εit

Where:

Risk_it shows the risk of mutual fund i in year t.

CSR_it is CSR score of mutual fund i in year t.

Fund size_it represents the size of mutual fund i in year t.

Fund Age_it is the Age of mutual fund i in year t.

Expense Ratio_it shows the expense ratio of mutual fund i in year t.

Performance_it represents the Performance of mutual fund i in year t.

εit represents the error term.

The fixed effects model was used to control unobserved fund-specific factors that might influence both CSR performance and risk. This approach eliminates the potential bias arising from omitted variables, providing a more accurate estimate of the relationship between CSR and risk.

Results and Discussion

This part of our study reports results and their interpretations. As states in the previous chapter, we used mutual funds risk as dependent variable while CSR is used as main explanatory variable. Other funds characteristics are used as control variables.

Table 1
Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Risk	0.18	0.05	0.08	0.32
CSR Score	6.5	1.2	4	9
Fund Size (Assets held)	250	150	50	600
Fund Age (Years)	10	5	2	25
Expense Ratio (%)	1.2	0.3	0.7	2
Fund Performance (Annual Return)	12.5	3	8	18

Descriptive Statistics

Table 1 given above presents the descriptive statistics for the study variables including dependent, independent and control variables. The average risk level (Risk) of mutual funds is 0.18 with a standard deviation of 0.05, indicating moderate variability in risk across the sample. The CSR Score averages 6.5 with a standard deviation of 1.2, suggesting a relatively high engagement in CSR activities among the sampled funds. Fund Size, measured by the assets held, has a mean of 250 million dollars and a standard deviation of 150 million dollars, reflecting significant diversity in the size of funds. Fund Age averages 10 years with a standard deviation of 5 years, indicating a mix of both new and established funds. The Expense Ratio averages 1.2% with a standard deviation of 0.3%, and Fund Performance, measured by annual return, has a mean of 12.5% and a standard deviation of 3%.

Table 2
PW Correlations

Variable	Risk	CSR Score	Fund Size	Fund Age	Expense Ratio	Fund Performance
Risk	1					
CSR Score	-0.35	1				
Fund Size	-0.12	0.21	1			
Fund Age	0.05	-0.15	0.65	1		
Expense Ratio	0.28	-0.42	-0.18	-0.22	1	
Fund Performance	-0.18	0.38	0.08	-0.02	-0.55	1

Pairwise Correlations

Table 2 presents the pairwise correlations among the variables. The value shown in this table at the intersection of mutual funds CSR and risk is (-0.35), indicating that mutual funds CSR and risk associated with them are correlated negatively i.e. move in opposite direction. Fund Size has a slight negative correlation with Risk (-0.12), suggesting that larger funds may have marginally lower risk. Fund Age shows a very weak positive correlation with Risk (0.05), implying minimal impact on risk. Expense Ratio is positively correlated with Risk (0.28), indicating that funds with higher expense ratios tend to be riskier. Fund Performance is negatively correlated with Risk (-0.18), suggesting that better-performing funds are less risky. Additionally, CSR Score is positively correlated with Fund Performance (0.38), highlighting a potential link between CSR engagement and better performance.

Table 3
Fixed Effect Regression Results

Variable	Coefficient	Standard Error	t-statistic	p-value
CSR Score	-0.025	0.008	-3.12	0.002 **
Fund Size	0.001	0.0003	3.33	0.001 **
Fund Age	-0.005	0.002	-2.5	0.013 **
Expense Ratio	0.018	0.006	3	0.003 **
Fund Performance	0.003	0.001	2.8	0.005 **
Constant	0.15	0.025	6	0.001 **
R-squared:	0.65			
Number of Observations:	568			

Fixed Effect Regression Results and Discussion

Table 3 presents the results of the fixed effect regression analysis examining the impact of CSR on mutual fund risk, controlling for other fund characteristics. The table shows that the coefficient for mutual funds CSR has a negative sign and value is 0.025 and a p-value of 0.002. This indicates a statistically significant negative impact of CSR on mutual fund risk at the 1% significance level. The mutual funds having a higher level of CSR show lower risk, supporting the hypothesis that CSR activities contribute to risk reduction.

As far as the control variables are concerned, the coefficient value in table for Fund Size is 0.001, and a p-value of 0.001. This positive relationship is statistically significant at the 1% level, suggesting that larger funds tend to have slightly higher risk, contrary to the negative correlation observed in the descriptive analysis. This could be due to the complexity and management challenges in larger funds. The coefficient for Fund Age is -0.005 and a p-value of 0.013. This indicates a statistically significant negative relationship at the 5% level, meaning older funds tend to have lower risk, possibly due to more established investment strategies and experienced management. Expense Ratio shown the value 0.018 in the above table with a p-value of 0.003. This positive relationship is statistically significant at the 1% level, confirming that higher expense ratios are associated with higher risk, likely due to the costs impacting overall fund performance and increasing operational risk. The coefficient for Fund Performance is 0.003, with a standard error of 0.001, a t-statistic of 2.8, and a p-value of 0.005. This statistically significant positive relationship at the 1% level indicates that better-performing funds tend to have higher risk, which could reflect a risk-return trade-off where higher returns are achieved through taking on more risk. The R-squared value of 0.65 indicates that 65% of the variance in mutual fund risk is explained by the model, demonstrating a strong explanatory power. The number of observations is 568, providing a robust sample size for the analysis.

The results from the fixed effect regression analysis showed negative and significant coefficient for mutual funds CSR. These results support the hypothesis our study made that higher CSR score of mutual funds tends to reduce mutual fund risk. This conclusion is supported by existing body of literature in the context of firms (e.g., Elbardan et. al., 2023; Eriandani & Wijaya, 2021; and Harjoto & Laksmana, 2018 etc.) that suggests firms that are involved in CSR activities have the potential to improve a company's reputation, cultivate trust among stakeholders, and result in more sustainable and stable FP, reducing the overall risk of the firm. Second, contrary to the findings of some earlier studies, the positive correlation between fund size and risk suggests that big funds may face a different situation of risk management challenges. The overall results of the study highlight the fact that there is a negative relationship between the mutual funds CSR and risk which suggests that CSR can be incorporated as a tool of reducing overall mutual funds risk.

Conclusion

Our study analysed the trivial relationship between mutual funds CSR and mutual funds risk. There have been many studies in firms' context showing mixed outcomes with many of them displayed significant inverse relationship between CSR and the risk and some others vice versa. However, this study is one of the maiden attempts in mutual funds industry addressing the role of CSR as a risk-reducing strategy. Our results confirm that the higher CSR scores are associated with lower risk levels. So, it may be concluded on the basis of empirical analysis of this study that mutual funds making investments in socially responsible places tend to reduce their risk.

As an additional point of significance, as far as the controlled variables are concerned, the findings shed light on the significance of fund characteristics such as size, age, expense ratio, and performance in context of risk that is associated with mutual funds. Our results suggest that older funds typically have a lower risk, whereas larger funds typically have a slightly higher risk. This is because larger funds tend to have more assets.

Recommendations

The purpose of this study is to give investors, fund managers, and policymakers an insight about role of CSR in reducing mutual funds risk and involves recommendations for mutual fund managers, asset management companies, investors and researchers. The managers can reduce the overall risk of the mutual funds by incorporation of CSR into their risk management strategies. Moreover, the investors are encouraged to invest in socially responsible funds as they can get sustainable investments with lower risk. Our study is very useful for all the mutual funds stakeholders because through the incorporation of CSR into investment strategies, fund managers have the potential to improve risk management and achieve more sustainable FP. The limitations of the study include smaller sample size, exclusion of the alternate analysis techniques and impact of individual CSR elements on funds risk.

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