

# The stock market and corporate consequences of the ethical exclusions by the world's largest fund

Erika Berle, Wanwei (Angela) He and Bernt Arne Ødegaard  
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## Abstract

We investigate the stock market and corporate consequences of ethically motivated portfolio exclusions. The divestments by Norway's "Oil Fund," the world's largest SWF, provide a sample of stocks facing widespread exclusions by institutional investors. We estimate a return premium (alpha) of about 5% for this "unethical portfolio." We also consider firms where the oil funds' exclusion has been reversed. For this portfolio of "newly ethical firms" we do not find a return premium going forward. We investigate to what extent these results can be directly linked to the Oil Fund's actions. We do not find evidence of a causal link. We investigate the corporate reactions to exclusions. Only 14% of the excluded firms make sufficient changes to their operations for the exclusions to be revoked.

### Research issue

Ethical exclusions – Institutional investors unwilling to invest in "bad" firms.

General research question

- What are the consequences (if any) of such exclusions?

Specific research questions

- Are *returns* of excluded firms "different"?
- How does the *stock market* react to divestments and exclusion announcements?
- Do *companies* react to being excluded? Which companies?
- Do companies *gain* (in cost of capital terms) by reversing exclusions?

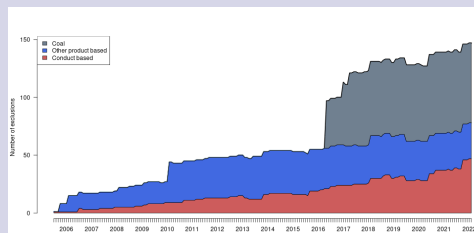
### Norway's GPF (The Oil Fund) - exclusions

- World's largest Sovereign Wealth Fund. 2021 Market value of equity: 1 trillion \$.
- Exclusions handled by external "Council of Ethics", established 2004.
  - Period 2004–2021: 189 firms in total excluded, shorter or longer time periods.
  - Fund invested in  $\approx$  ten thousand companies
  - $\rightarrow$  exclusions are truly exceptional

### Exclusion reasons

Conduct	Environment	28
	Individuals' rights in war	11
	Violation of human rights	12
	Environment/human rights	4
	Ethical norms	5
	Greenhouse gas	4
Product	Gross corruption	2
	Coal	75
	Weapons	27
	Tobacco	21

### The number of exclusions



### Some exclusions reversed

14% of exclusions revoked, due to:

Change of product mix	11
Cease of activity	7
Sale of subsidiary	4
Other reasons	6

### Why should ethical exclusions matter?

Special case of more general issue: Does the ESG profile of a firm matter for its performance?

- No?
    - Will not other investors "take up the slack"?
  - Yes?
    - Good ESG (green) firms have higher returns? Reward for being ethical "Doing well by doing good"
    - Bad ESG (brown) firms have higher returns? To attract sufficient funding (offset excluded funds) necessary to offer higher returns. Alternatively: High competition to fund "Good ESG"
- Both:  $\rightarrow$  Lower cost of capital (i.e. return) (Pedersen, Fitzgibbons, and Pomorski, 2021) (Pástor, Stambaugh, and Taylor, 2021)

Empirical evidence:

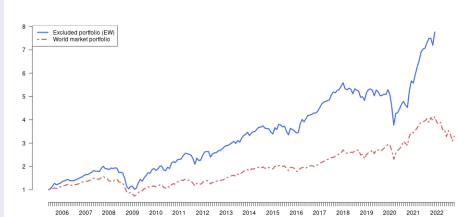
- Mainly find green firms do worse (Negative green return premium)
- Well known example: Higher returns for "sin" stocks (tobacco, guns). (Hong and Kacperczyk, 2009)

### Analysis I: "Unethical" portfolio

Method - Construct *Exclusion Portfolio*

- Firms enter portfolio when excluded.
- If exclusion revoked, firms leave.

Portfolio returns



Exclusion Portfolio vs World Market

- Exclusion portfolio does better. Needs testing, though. There could be other reasons (risk) for extra return.
  - To test, ask: Has the exclusion portfolio higher/lower returns than it "should have?" (alpha). Asset pricing estimation. Example: CAPM
 
$$r_{pt} = \alpha_p + (r_{ft} + E[r_{mt} - r_{ft}]) + \varepsilon_{pt}$$
  - Alpha:  $> 5\%$  in annual terms – highly significant
- $\rightarrow$  Unethical stocks have higher returns.
- Finding robust to alternative asset pricing models, weighting scheme, subsets, etc.
  - Consistent with literature's typical finding of a negative green return premium

### Analysis II – Firms whose exclusion is revoked

If firms remove "unethical" piece of their operations, exclusion is revoked.

How many do?

14% act to get exclusion revoked  
 $\rightarrow$  Most firms do not react to exclusion.

### Return (cost of capital) consequences

- Construct "Newly ethical" portfolio of firms that had their exclusion revoked.
- Firms get off exclusion list, alpha  $\rightarrow$  zero.  
 $\rightarrow$  No return premium going forward  
 $\rightarrow$  lower cost of equity capital

### Analysis III: Do stock prices react specifically to GPF (actions)?

Actions by GPF

- Selling off 1.5% of company shares, before
- announcing that the company is excluded.

If GPF actions lead to return premium, should see permanent fall in stock price. To Test: Event study of stock price reaction

- One-day negative reactions (CAR), reverses immediately.

$\rightarrow$  The GPF actions do not have a permanent negative effect on stock prices.

### Analysis IV - Firm's reactions to exclusion

Characteristics of "revoked" firms

- Low ESG measure at time of exclusion (low cost of "fixing" ESG?).
- High revenue growth later (need capital?). (albeit marginally significant)

### Takeaways

- Higher return (alpha) for "bad" ESG (unethical) portfolio.  $\rightarrow$  Negative green return premium
- Price reaction when exclusion announced muted
  - Little sign the price drop necessary to drive an increase in returns.  
 $\rightarrow$  actions by GPF no causal effect.
  - ESG consequences already baked in?
- Firms acting to get exclusion revoked
  - Rewarded with lower cost of capital.
- Few firms bother reacting to announced exclusion.
  - The few that do
    - low cost to rectify the cause of exclusion?
    - strong need for capital?

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- Lúboš Pástor, Robert F Stambaugh, and Lucian A Taylor. Sustainable investing in equilibrium. *Journal of Financial Economics*, 142(2):550–571, 2021. doi: 10.1016/j.jfineco.2020.12.011.
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