The expected returns of ESG excluded stocks. The case of exclusions from Norway's Oil Fund

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

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Abstract

What are the consequences of widespread ESG-based portfolio exclusions on the expected returns of firms subject to exclusion? We consider two possible theoretical explanations. 1) Short-term price pressure around the exclusions leading to correction of mispricing going forward. 2) Long term changes in required returns. We use the exclusions of Norwegian Government Pension Fund Global (GPFG –"The Oil Fund") to investigate. GPFG is the world's largest SWF, and its ESG decisions are used as a model for many institutional investors. We construct various portfolios representing the GPFG exclusions. We find that these portfolios have significant superior performance (alpha) relative to a Fama-French five factor model. The sheer magnitude of these excess returns (5% in annual terms) leads us to conclude that short-term price pressure can not be the only explanation for our results, the excluded firms expected returns must be higher in the longer term.

Research issue

- Consequences of widespread ESG-based portfolio exclusions on the expected returns of firms subject to exclusions?
- Two possible theoretical explanations:
  - Short-term mispricing around the exclusions
  - Long-term changes in required returns.

ESG in asset allocation

- ESG – Environmental, social, and governance considerations of firm conduct
- Institutional investors way of dealing with low ESG ranking firms
  - Dialogue – the most common. Arguably a better way of achiving change
  - Exclusion: a reaction of last resort

Norway's GPFG (The Oil Fund)

- World's largest SWF. Market value of equity 1 trillion USD at the end of 2021.
- "Near index fund".
- Exclusions handled by external "Council of Ethics", established 2004.

Number of exclusions

- Period 2004–2021: 189 firms in total excluded, shorter or longer time periods.
- At yearend 2021, fund invested in ≈ 10 thousand companies
- → exclusions are truly exceptional

Exclusion reasons

Conduct	66
Environmental damage	28
Individuals' rights in war or conflict	11
Violation of human rights	12
Environmental damage / Violation of human rights	4
Violation of ethical norms	5
Greenhouse gas emissions	4
Gross corruption	2
Product	123
Coal or coal-based energy	75
Weapons	27
Tobacco	21

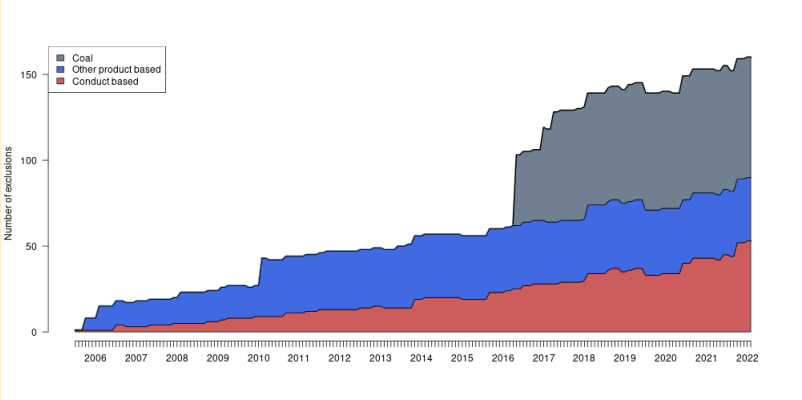
Method - Portfolio of excluded firms

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

Two methods for constructing

- Equally weighted
- Value weighted — larger firms receive higher weights.

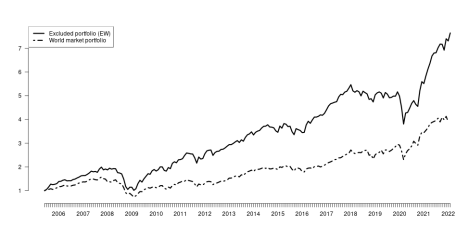
Evolution of exclusions



Why care about exclusion portfolio?

The exclusion portfolios represent the expected returns of stocks with low ESG rankings.

Intuition: Comparing value evolution of exclusion portfolio with world market



Cumulative returns of equally weighted exclusion and global market portfolios

- Exclusion portfolio perform better
- However, exclusion portfolio seem more exposed to crises ('08 and '20 covid)

Testing for performance

- Investigate whether the exclusion portfolio has higher/lower returns than it "should have".
- → Estimate the "alpha", the risk-adjusted excesss return. (Return that can not be explained by an asset pricing model).
- Asset pricing model: Fama-French international five factor model (but do check alternatives)

Asset pricing estimates of alpha for ew exclusion portfolio

alpha	0.0043**
	(0.0017)
$R_m - R_f$	0.8990***
	(0.0388)
SMB	0.1507
	(0.1045)
HML	0.4689***
	(0.1272)
RMW	0.1509
	(0.1378)
CMA	−0.3331
	(0.2453)
Observations	199
Adjusted R^2	0.8078

- Alpha: 5% in annual terms — economically and statistically significant
- The exclusion portfolio substantial higher returns than it "should have"
- Finding robust to other asset pricing models, weighting scheme, timing of exclusion.

Interpretation

- Low quality ESG firms provide exceptionally high returns
- → The cost of capital for new investments for low quality ESG firms also exceptionally high.
- → To survive most low quality ESG firms have to move towards better quality ESG ("greener investments") to lower their cost of capital
- From society's point of view: This is the desired outcome.
- To ponder:
  - Would this have happened without the exclusions?
  - Have the owners of the GPFG lost out?