

The expected returns of ESG excluded stocks. Shocks to firms costs of capital? Evidence from the World's largest fund.

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Abstract

We investigate the consequences of widespread ESG-based portfolio exclusions on the expected returns of firms subject to exclusion. We use the exclusions of Norway's "Oil Fund" as a sample of low quality ESG stocks. The fund is the world's largest SWF, whose ESG decisions are viewed as a model for many institutional investors. We construct portfolios representing their exclusions and find that these portfolios have significantly superior performance (alpha). The sheer magnitude of these excess returns (more than 5% in annual terms) leads us to conclude that low-quality ESG stock has a return premium, as predicted by e.g. Pastor et.al-(2021). We also show evidence of the mechanism. Excluded firms face a higher cost of capital. If the exclusion is revoked, their capital costs fall. Companies with low ESG at the time of exclusion (more scope for improvement), and higher revenue growth (investment needs) are more likely to get their exclusion revoked, which we interpret as evidence of dynamics: Firms improve their ESG to revoke exclusions and achieve lower required returns. In fact, firms that get off the exclusion list do not have superior performance going forward.

Research issue

- ESG - Environmental, Social and Governance aspects of corporate decisions.
- Institutional investors unwilling to invest in "bad" ESG firms.
- Of interest: Consequences of ESG-based portfolio exclusions on the expected returns of firms subject to exclusions?
- Theory: Tradeoff ESG/Cost of Capital
- Use: exclusions by the worlds largest fund.
 - What are the returns of the portfolio of excluded firms?
 - What are the implications for cost of capital?
 - Are firms reacting to their exclusions? With consequences for cost of capital?

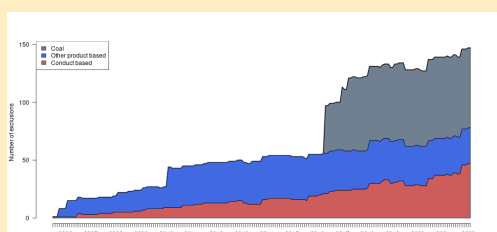
Norway's GPF (The Oil Fund)–exclusions

- World's largest Sovereign Wealth Fund. Market value of equity 1 trillion USD at the end of 2021.
- "Near index fund."
- Exclusions handled by external "Council of Ethics", established 2004.
 - Period 2004–2021: 189 firms in total excluded, shorter or longer time periods.
 - At yearend 2021, fund invested in \approx 10 thousand companies
 - \rightarrow 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

The number of exclusions



Our Analysis

Construct portfolio of excluded firms.

- Does the portfolio have "too high" returns (alpha)? \rightarrow **Yes**
- Is this due to short-term overreactions, or changes to long term cost of capital \rightarrow **It is the long term cost of capital**

After firms get on the exclusion list

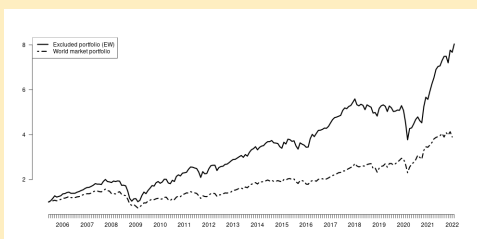
- Are firms happy with their high cost of capital? \rightarrow **No, they try get their exclusions revoked to get back to a lower cost of capital.**
- If a firm's exclusion is revoked, what happens to cost of capital? \rightarrow **It Falls**

Returns of firms subject to exclusion

Method - Construct *Exclusion Portfolio*

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

Exclusion Portfolio vs World Market



- Exclusion portfolio perform better
- Exclusion portfolio more exposed to crises ('08 and '20 covid)
- Has the exclusion portfolio higher/lower returns than it "should have?"
- \rightarrow Estimate "alpha" – risk-adjusted excess return.
- Find: Alpha: $>$ 5% in annual terms – highly significant
- Finding robust to alternative asset pricing models, weighting scheme, reasons, etc.

Deconstructing alpha:

High alpha due to

- Short term price pressure from exclusion?
- Changes to long term cost of capital?

\rightarrow Alpha too high for short-term explanation.

Mechanism: Only the bad stay excluded

- Seen: Low quality ESG firms provide exceptionally high returns
- \rightarrow The cost of capital for new investments for low quality ESG firms also exceptionally high.
- \rightarrow If firms can not sustain such high returns, low quality ESG firms have to move towards better quality ESG ("greener investments") to lower their cost of capital. \rightarrow Implication of theoretical models of Pástor, Stambaugh, and Taylor (2021) and Pedersen, Fitzgibbons, and Pomorski (2021).

Which firms try to get exclusion revoke?

Those with

- Low ESG measure at time of exclusion
- High revenue growth later

Exclusions revoked

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

Firms whose exclusion is revoked

- If firms get off exclusion list to reduce cost of capital, returns of firms after exclusion revoked is lower.
- To test, construct "Post-exclusion" portfolio of firms who has had their exclusion revoked.
- The Post-exclusion Portfolio does not have exceptional reeturns

Key takeaways

- 1 Sheer *magnitude* of the return difference linked to ESG.
- 2 *Speed* by which the increased cost of capital affects returns.
- 3 *dynamics* of corporate reactions to exclusion.

Reflections

- Society view: Exclusions forcing firms to improve ESG a desired outcome.
- To ponder:
 - Would the high returns have happened without the exclusions? I.e. Have the owners of the GPF really lost out?

- 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.
- Lasse Heje Pedersen, Shaun Fitzgibbons, and Lukasz Pomorski. Responsible investing: The ESG-efficient frontier. *Journal of Financial Economics*, 142(2):572–597, 2021. doi: 10.1016/j.jfineco.2020.11.001.