# 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 link between ESG-based portfolio exclusions and the expected returns of excluded firms. The exclusions of Norway's "Oil Fund," the world's largest SWF, provide a sample of stocks that face widespread exclusions by institutional investors. The portfolio of excluded firms have significantly superior performance (alpha) of about 5%. Excluded stocks have a return premium. Looking at the time of exclusion, we note that while theory suggest that an increase in the cost of capital should drive the stock price down substantially, we find little evidence of that. In fact, stock prices are increasing while the fund is dumping its stake. That the implied cost of being excluded is small is also indicated by the few firms that take action to reverse their exclusion. The cost is not trivial, though, as we evaluate the incentives for getting the exclusion revoked, and find that companies with low ESG scores at the time of exclusion (scope for improvement), and higher revenue growth (investment needs) are more likely to get their exclusion revoked. 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.
- Research Question: Consequences of ESG-based portfolio exclusions on the expected returns of firms subject to exclusions?
- Theory: Tradeoff:
  Cost of ESG/Cost of Capital
- Exclusions by the worlds largest fund.
  - What are the returns of the portfolio of excluded firms?
  - What happens to stock prices when exclusion is announced?
  - Are firms reacting to their exclusions?

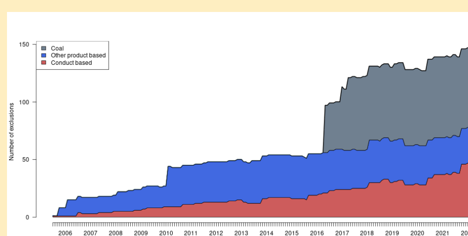
## Norway's GPFG (The Oil Fund) - exclusions

- 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 ≈ ten 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 |

**The number of exclusions**




## Analysis I: Green Return Premium (greenium)

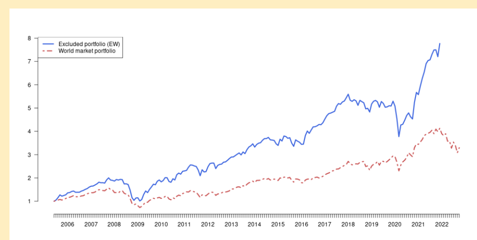
Construct portfolio of excluded firms.

- Does the portfolio have "too high" returns (alpha)?
  → **Yes**
  → Negative Green Return Premium

## I.1 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

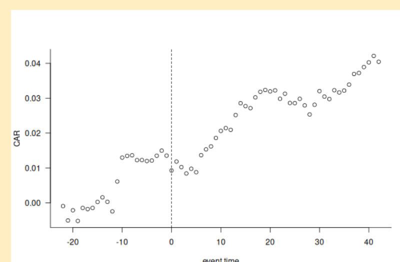
- Exclusion portfolio perform better
- Has the exclusion portfolio higher/lower returns than it "should have?" (alpha)
- Alpha: $>5\%$ in annual terms
  – highly significant
- Finding robust to alternative asset pricing models, weighting scheme, reasons, etc.
- Consistent with literature's typical finding of a negative green return premium

## Analysis II: Stock price reaction to exclusion

Cost of capital up → stock price down.

## II.1: Event study of stock price reaction

- Negative reaction (CAR) a few days around announcement.
- But small relative to CAR in month before announcement (when fund is selling).




## Analysis III - Firm's reactions to exclusion

## III.1 How many react?

If exclusion leads to higher cost of capital, firms have incentives to get exclusion revoked.
Can they? Yes, remove cause of exclusion.
How many do?
*14% act to get exclusion revoked*
→ *Most* firms do *not* react to exclusion.
Is exclusion *really* driving extra return?

## III.2 – What firms acts to revoke exclusions?

Look at the few firms actually doing something about the exclusion

## How are exclusions revoked?

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

## Determinants of revoking exclusion

Characteristics of "revoked" firms

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

## III.3: Firms whose exclusion is revoked

- Construct "Post-exclusion" portfolio of firms that had their exclusion revoked.
- The Post-exclusion Portfolio does not have exceptional returns (alpha)
- → If firms get off exclusion list, returns of firms after exclusion revoked is lower.

## Takeaways

1. Higher return for "bad" ESG.
   → Negative Green return premium
2. Price reaction when exclusion announced muted – little sign of price drop that should follow an increase in cost of capital.
3. Few firms bother to react to the announced exclusion.
4. The few that do driven by
   - low cost to rectify the cause of exclusion, or
   - strong need for capital.