

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 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 find that the portfolio of excluded firms have significantly superior performance (alpha) of about 5%. 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, we find little evidence of that. In fact, stock prices are increasing while the fund is dumping its stake. The implied corporate cost of being excluded is small, as shown 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

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?

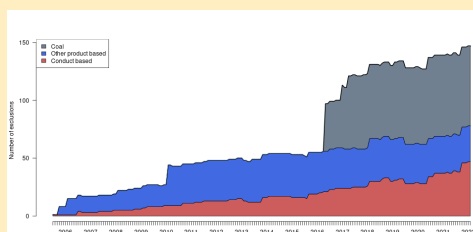
Norway's GPF (The Oil Fund) - exclusions

- 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	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)?
 - \rightarrow **Yes**
 - \rightarrow 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

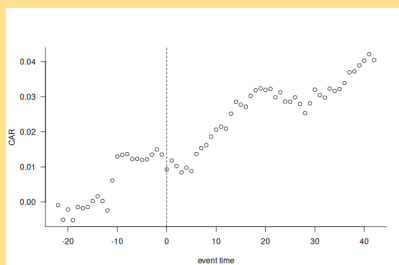
- Exclusion portfolio perform better
- Has the exclusion portfolio higher/lower returns than it "should have?" (alpha)
- Alpha: $> 5\%$ in annual terms – highly significant
- Finding robust to alternative asset pricing models, weighting scheme, reasons, etc.
- Consistent with literature's typical finding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

Analysis II: Stock price reaction to exclusion

Cost of capital up \rightarrow 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
 \rightarrow *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?).

Analysis IV: 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)
- \rightarrow If firms get off exclusion list, returns of firms after exclusion revoked is lower.

Takeaways

- Higher return for "bad" ESG.
 - \rightarrow Negative Green return premium
- Price reaction when exclusion announced muted
 - little sign of price drop that should follow an increase in cost of capital.
 - ESG consequences already baked in?
- Few firms bother to react to the announced exclusion.
 - The few that do
 - low cost to rectify the cause of exclusion, or
 - strong need for capital.
- Firms that manage to get exclusion revoked
 - Rewarded with lower cost of capital