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

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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?

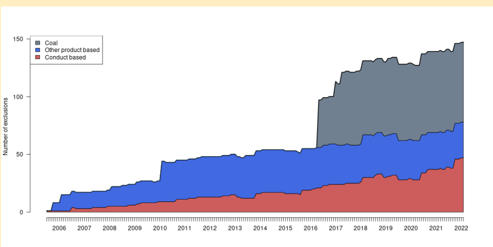
Norway's GPFG (The Oil Fund) - exclusions

- 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: "Unethical" portfolio

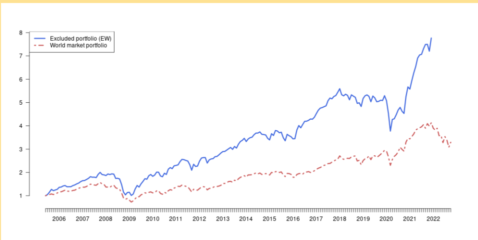
Construct portfolio of excluded firms.

- Does the portfolio have "too high" returns (alpha)?

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 – Firms whose exclusion is revoked

If firms remove "unethical" part of their operations, exclusion is revoked.
How many do?
14% act to get exclusion revoked
→ *Most* firms do *not* react to exclusion.

How are exclusions revoked?

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

- 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.

Analysis III: Do stock prices react specifically to GPFG trades?s

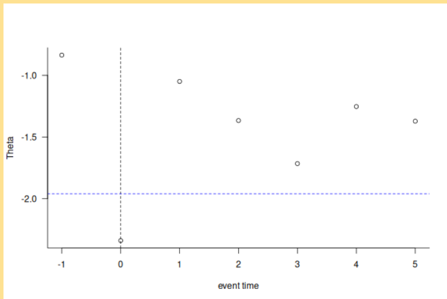
Actions by GPFG

- Sell off 1.5% of company shares in two month period.
- Announce that the company has been excluded

II.1: Event study of stock price reaction

- Short-horizon negative reactions (CAR).
- Not sufficient to conclude that the GPFG actions have a permanent effect on stock prices.

Test statistic θ_1 (MacKinlay, 1997)



Analysis IV - Firm's reactions to exclusion

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?). (albeit marginally significant)

Takeaways

- Higher return for "bad" ESG.
  → 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

A Craig MacKinlay. Event studies in economics and finance. *Journal of Economic Literature*, XXXV:13–39, March 1997.