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Chaire Finance Durable et Investissement Responsable

Societal Impact and Financial Performance of Responsible Investments

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Context

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- **Responsible investments** represent a **significant fraction** of assets under management
  - In Europe in 2015, €11.045 trillion (Eurosif) out of €21.6 trillion (EFAMA est.)
  - More than 50%! This is including exclusion strategies that are widespread
- The **business case** for responsible investments is **not always clear**
  - Is it a passive or an active strategy?
  - What type of financial performance to expect?
  - What impact on corporate behavior and societal performance?

Objective of the talk

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- Discuss the **business model**, financial performance and societal impact of **responsible investments**

- **Methodological setting** is an extension of the **Capital Asset Pricing Model**
  - Based on the paper *"The washing machine: investment strategies and corporate behavior with socially responsible investors"* investment strategy (Gollier and Pouget, 2019)
  - *Differences of opinion* regarding the materiality of Environmental, Social and Governance (ESG) factors among investors
  - Endogenous *strategic decisions* by companies' shareholders

Passive Responsible Investments

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- **Passive responsible investments** screen assets on the basis of
  - Activity types: negative screening (ethical or norm-based)
  - ESG performance: best-in-class or positive screening approach
- **Insufficient diversification** – Loss of financial performance due to:
  - Foregone profits (you may miss the next Google)
  - Excessive losses (you may end up with too many bad apples)
- **Better valuation for responsible firms**
  - More investors focus on similar assets

Passive Responsible Investments

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- **Business case**
  - Performance controlling for the investment universe is similar to traditional funds
  - Overall expected *financial performance* is *lower…*
  - … But *clients are protected* from moral or reputational issues

- **Societal impact** is achieved indirectly **through the cost of capital** that increases for irresponsible companies and decreases for responsible ones

Relation to empirical evidence

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- Hong and Kacperczyk (2009) on sin stocks
  - Sin stocks have 19% of institutional investors compared to 22% for comparable firms in other industries (data 1980-2003)
  - 2.1 analysts vs 2.5 (data 1976-2003)
  - 4% per year more return controlling for risk after 1965 (data 1926-2003)
  - Market-to-book ratio 15% lower (data 1965-2003)

- Bauer, Derwall, and Hann (2009) on employee relations and stock returns (KLD ratings, data 1995-2006)
  - Lower cost of debt and higher credit ratings for stronger employee relations

Relation to empirical evidence

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- Chava (2011) on green companies (data 1992-2007)
  - Enjoy lower cost of debt
  - Have larger syndicates
  - Enjoy lower cost of equity
  - Have more institutional shareholders

- Empirical results suggest that:
  - There is a *responsibility premium* in firm valuation
  - Passive responsible strategies *underperform on average*

Abnormal returns of responsible investments?

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- Proposing a business model in which responsible investors outperform traditional ones is **challenging**
- Outperformance may only derive from **active investment**

Abnormal returns of responsible investments?

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- Consider that CSR pays at the company level

Abnormal returns of responsible investments?

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- Consider that CSR pays at the company level
- If financial markets are **informationally efficient**
  - Both responsible investors and traditional funds overweight virtuous firms
  - These funds display *identical performances*
- If one considers that financial markets are **inefficient**
  - Both responsible investors and traditional funds collect information and find mispricings
  - Again, these funds may display *identical performances*

Three drivers of performance for RI

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- Superior securities' selection
- Better market anticipations
- Engagement

Superior securities' selection

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- A fund may implement active responsible investments to bet on the **ESG factors that are expected to impact** future returns and risks
  - Focus on relatively low number of firms (as traditional speculators)
  - Bet that some ESG-related information will become incorporated into market prices
- **Short-term trading** that enhances market efficiency
- Key performance driver: **superior extra-financial analysis skills**
- **No societal impact** is expected from this strategy, apart from improved market efficiency

Better market anticipations

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- A fund may implement active responsible investments to bet on the fact that a given **ESG issue is going to become more salient**
- **Medium-term trading** that may enhance market efficiency
  - Increases efficiency if the issue was overlooked by traditional investors
  - Decreases efficiency if the issue was already well accounted for
- Key financial performance driver: **better market-wide ESG trends' perception**
- **No societal impact** is expected from this strategy, apart from improved market efficiency

Relation to empirical evidence

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- Edmans (2011) on employee satisfaction and stock valuation (data 1984-2005)
  - Employee satisfaction is measured according to the list of "100 Best Companies to Work For in America"
  - Best Companies have more positive earnings surprises
  - Enjoy larger returns (4% positive alpha)…
  - … Until the market recognizes the value of employee satisfaction (on average, 4 years of abnormal performance)

Relation to empirical evidence

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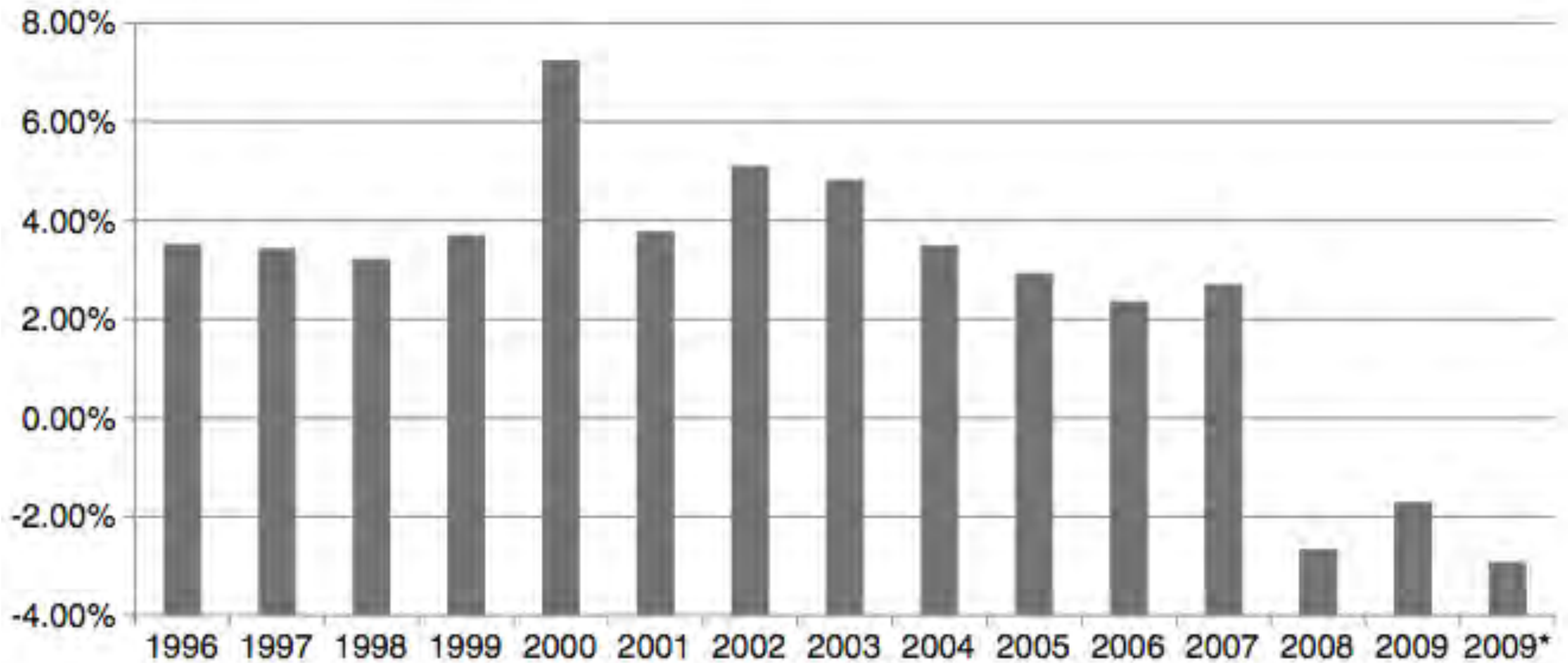
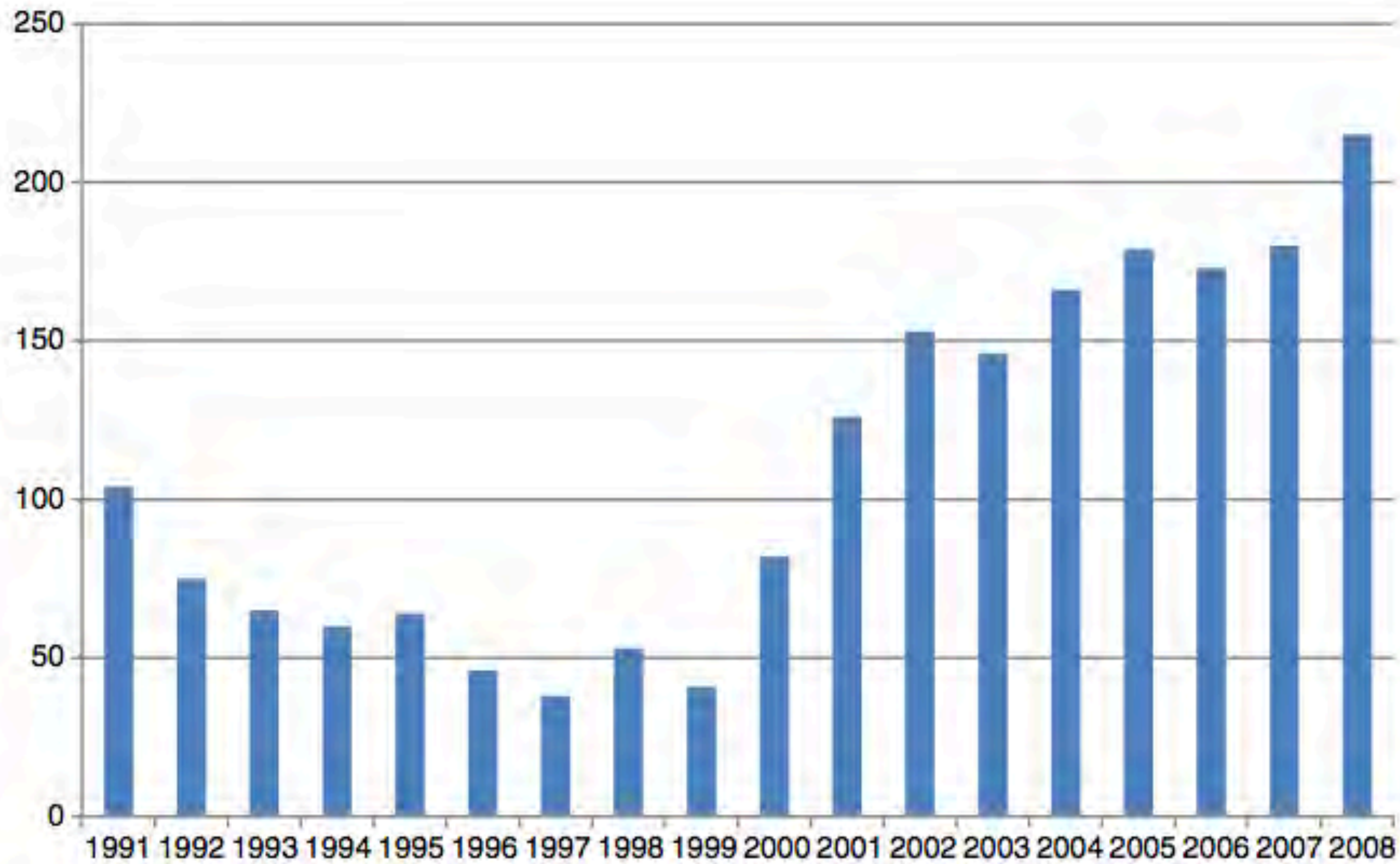
- Borgers, Derwall, Koedijk, and Horst (2013) on errors in analysts' forecasts related to ESG issues (data 1992-2009)
  - ESG information predicts errors in analysts' forecasts and greater returns…
  - … until attention to this information has increased (in the late 00's)



Year-by-year difference in risk-adjusted return between top- and bottom-ranked portfolios in terms of ESG performance (Borgers et al., 2013)



Number of shareholder proposals on ESG-related issues for S&P 1500 firms (Borgers et al., 2013)

Relation to empirical evidence

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- Overall, the literature suggests that **ESG issues are now better taken into account** by financial analysts and priced by the market
- Active strategies based on ESG factors can thus be profitable for investors with superior **anticipation skills**
- But **no societal impact** is expected, apart from better informational efficiency

Engagement as a performance driver

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- **Engagement** of companies towards better ESG performance **can lead to superior investment performance**
- **Engagement** is also a way to **directly affect societal impact of firms** by improving corporate social responsibility
- This is the idea of the “Washing Machine” strategy (Gollier and Pouget, 2019)

The “Washing Machine” Strategy

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The “Washing Machine” Strategy

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The “Washing Machine” Strategy

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- Invest in **dirty** companies at **attractive prices**
- Turn them into **clean** companies
- Pocket in the **responsibility premium** when reselling shares

The “Washing Machine” Strategy

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- Invest in **dirty** companies at **attractive prices**
  - Control by non-responsible shareholders
  - Companies would trade at higher prices if clean
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The "Washing Machine" Strategy

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  - Acquire shares to be influent enough
  - Believe in CSR materiality
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The “Washing Machine” Strategy

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- Turn them into **clean** companies
  - Acquire shares to be influent enough
  - Believe in CSR materiality
- Pocket in the **responsibility premium** when reselling shares
  - New corporate strategies attract responsible investors
  - Keep a large enough stake to ensure that companies stay clean

Key Drivers for Successful Engagement

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- Financial success and corporate change are intimately related
- To benefit from ESG engagement strategies:
  - Invest in **non-responsible** firms and turn them **into responsible**
  - Have a **credible** orientation towards social responsibility
  - Have a **long-term** orientation
- Engagement strategies can be implemented
  - **Alone** by responsible private equity funds or hedge funds
  - **In group** by mutual funds or pension funds

Relation with empirical evidence (I)

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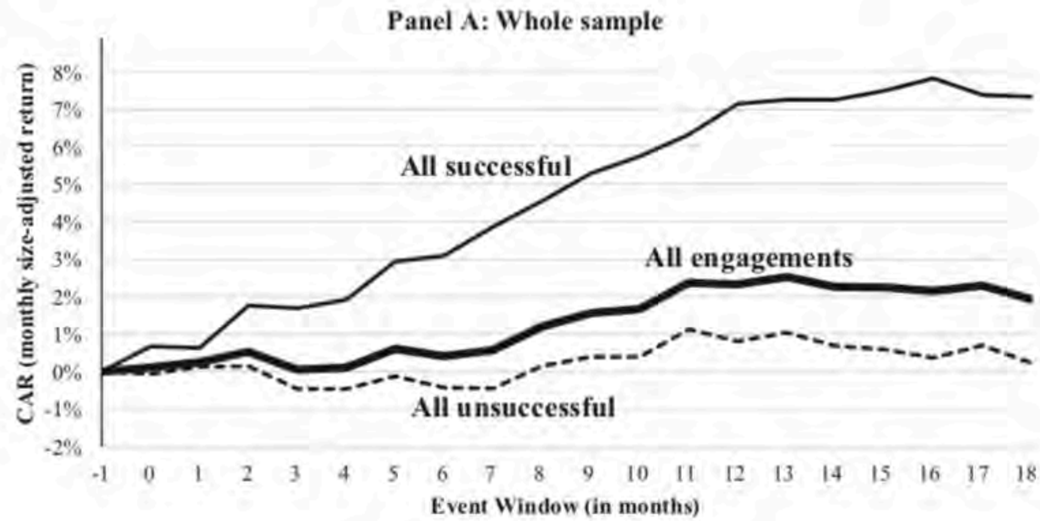
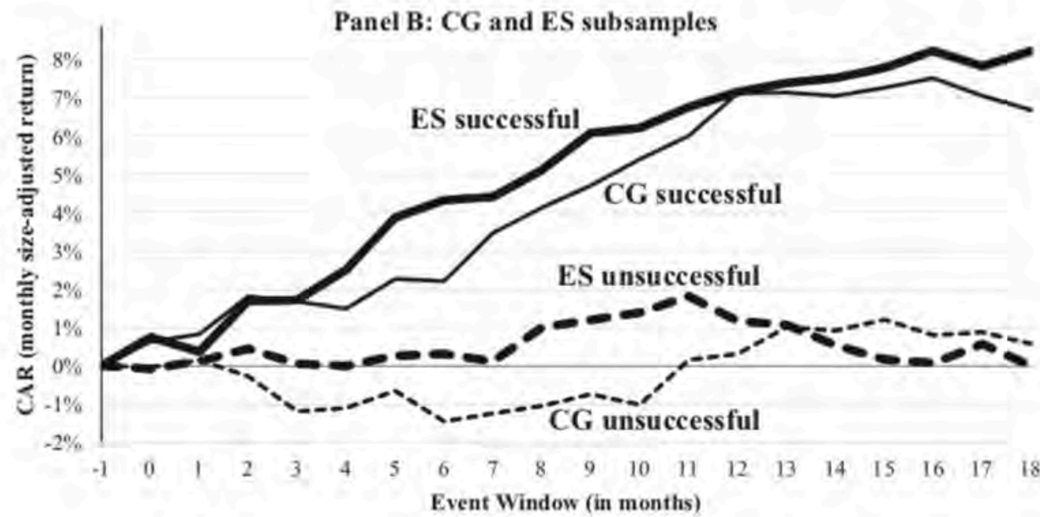
- Becht, Franks, Mayer, and Rossi (2009) estimate that Hermes UK Focus Fund generates a 4% abnormal return thanks to corporate governance engagement on the 1998-2004 period

- Dimson, Karakas and Li (2013) calculate a 2% abnormal return based on CSR engagement by a large UK institutional investor between 1999 and 2009





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Dimson, Karaças et Li (2015)

Relation with empirical evidence (II)

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- Cunat, Gine, and Guadalupe (2012) document a 2.4% increase in stock price in the week following close favorable votes on corporate governance shareholder proposals compared to proposals that did not pass (US data 1997-2007)

- Flammer (2015) documents a 1.9% increase in stock price in the two days following close favorable votes on ESG shareholders' resolutions (US data 1997-2010)

- **Engagement** strategies are used and **beneficial** (at least gross of engagement costs)

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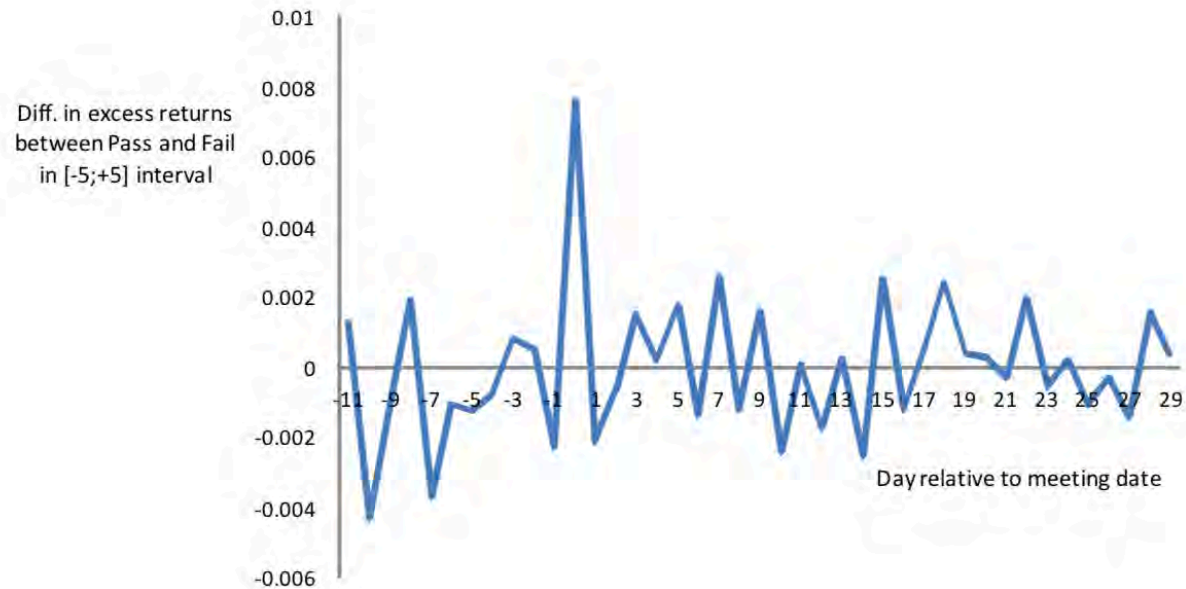
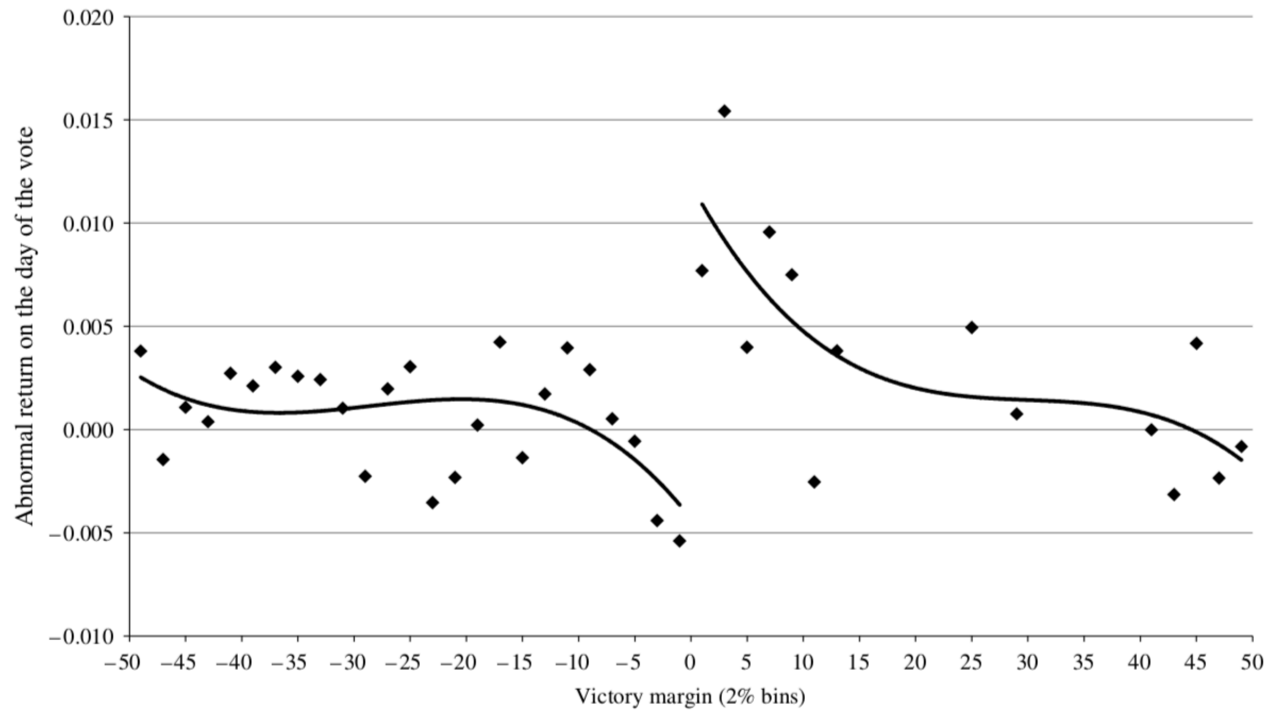


Figure 4. Day-by-day difference in excess returns, vote share in [-5;+5] interval. The y-axis measures the difference in daily excess returns between proposals that pass by a close margin [up to +5%] and proposals that are rejected by a close margin [up to -5%]. The x-axis shows the different days before and after the vote (date 0 is the day when the vote is passed).

Cunat, Gine et Guadalupe (2015)

Figure 3 **Abnormal Returns on the Day of the Vote**



Notes. The vertical axis indicates abnormal returns on the day of the vote. Abnormal returns are computed using the four-factor model of Carhart (1997). The horizontal axis indicates the victory margin (i.e., the vote share minus the majority threshold). Each dot in the figure represents the average abnormal return in 2% bins of victory margin. The solid line plots predicted values of abnormal returns from third-order polynomials in victory margin estimated separately to the left and right of the majority threshold.

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Flammer (2015)

Conclusion

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- Responsible investments' financial and societal performance depends on the type of strategy
- Passive strategies are expected to generate lower expected financial performance and to have only an indirect impact on societal performance of firms
- Active strategies may outperform financially, for skilled investors, but only engagement can have a positive direct impact on societal performance of firms

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THANKS FOR YOUR ATTENTION!!!