Divest: for what impact?

E4S Executive Summary

2021 – 4

EXECUTIVE SUMMARY

Sustainable finance is experiencing a period of spectacular growth and the role of finance is being questioned in an unprecedented manner. Among the environmental, social and governance (ESG) strategies used by responsible investors, the simplest, and undoubtedly the most popular, is that of excluding bad ESG performers.

Exclusion represents a substantial portion of sustainably invested assets worldwide, with USD 19,771 bn of assets applying it in 2018. This underlines its importance and justifies the need to study its real impact on the activities of target companies and on investors' portfolios.

Excluding bad performers would have two main objectives: the first is to alter business practices by depriving the firm of funding and reinforcing the stigmatisation of its current practices; the second is to reduce risk and improve portfolio performance.

Exclusion is likely to affect the target's operating conditions and possibly its ESG strategy through three different channels: managerial incentives, the strengthening of stigmatisation and a capital rationing effect.

The effectiveness of exclusion, particularly through managerial incentives and stigmatisation, seems limited, variable, and dependent on various factors. Two conditions must be met in order for the first two channels to have an effect: first, the investors must publicly declare their intention to divest and, second, the amount divested must be sufficiently large or even very large. Both conditions are necessary to create sufficient pressure on prices, which could incentivise management to improve business practices, as well as to raise stakeholder awareness. An internal exclusion policy is unlikely to have much impact on financial markets and the public debate. Exclusion is more likely to change the company's operations through managerial incentives, depending on the costs of reform, the type of screening applied, and the compensation scheme and time horizon of the management. As for stigmatisation, even though it de-normalises target industries for stakeholders and may diminish their political influence, its effectiveness remains uncertain given the historical responses of the players involved. These responses include stigma dilution or greenwashing.

It is through capital rationing on the primary market that exclusion could undoubtedly have the most significant effect. It can ultimately deprive the company of funding and prompt it to change its practices, depending on its size and operating environment. Companies that are young, small, local or operate in difficult political, economic, or technical environments will be more affected by capital rationing and are therefore more likely to comply with investor demands. In contrast, for large cap and older multinationals, which are internally funded or have a larger pool of potential investors, the financial pressure will be much lower, if not totally ineffective, and the impact of exclusion reduced or eliminated.

Good and bad ESG performers differ intrinsically, and notably in terms of cost of capital, and therefore in terms of financial returns. Investors seem to expect higher returns for stocks with poor environmental ratings. These differences between good and bad ESG performers need to be integrated into the investor's strategic asset allocation.

ESG portfolios applying negative screening have performed at least as well as traditional portfolios in recent years, disproving the tenet that bad ESG performers are characterised by higher returns**.** This performance can be explained by portfolio concentration or sectoral, regional, and risk factor exposures, but it is not always the case. The popularity of ESG investing and the unsustainable price movements that it implies are probably the cause instead.

This momentum effect in favour of good ESG performers cannot last indefinitely. When a new equilibrium is reached, i.e. when the momentum effect fades, green companies are likely to have lower returns.

There would therefore be a financial cost to being a responsible investor in the steady state. This cost is partially offset for first movers, in the ESG strategy popularity phase. It is therefore not always possible to "do well while doing good".

Exclusion would fail to achieve its target in terms of impact on the company's activities and on investor performance. This is before even considering the undesirable consequences that the financial constraints imposed by exclusion might also have. Financial constraints could discourage investments in process improvements or in low carbon technologies, create divestment wave risk and thus disrupt financial stability or worsen poverty in some regions without having a real impact on the environment.

This discussion on exclusion reveals the following key points:

1. Finance is not all powerful. Having an impact on the real economy, including through divestment, requires good judgement.
2. It is essential to distinguish between primary and secondary markets. Exclusion should therefore be particularly focused on primary and bond markets.
3. A more thorough and dynamic ESG analysis is required as a prerequisite for a possible exclusion decision that seeks to balance environmental and social impact and reward good attitudes and improvement strategies.
4. The prospects for achieving an impact are much better with shareholder engagement strategies. Instead of judging a portfolio's sustainability by its current ESG score or carbon footprint, it would be wiser to consider its potential to change the economy of tomorrow.

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Enterprise for Society (E4S) is a joint venture of the University of Lausanne through its Faculty of Business and Economics (UNIL-HEC), the Institute for Management Development (IMD) and the Ecole polytechnique fédérale de Lausanne (EPFL), under the stewardship of its College of Management of Technology, with the mission of spearheading the transition towards a more resilient, sustainable and inclusive economy. E4S is committed to training the next generation of leaders, inspiring economic and social transformation, and promoting change by strengthening start-ups and boosting innovation.

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