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The expected returns of ESG excluded stocks. Shocks to firms costs of capital?

Evidence from the World's largest fund

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We investigate the consequences of **ESG-based portfolio exclusions on the expected returns of excluded firms**. The exclusions conducted by Norway's "Oil Fund" provide a sample of stocks that face widespread exclusions by institutional investors. **The excluded firms' portfolio has significantly superior performance (alpha) of about 5%.** Excluded stocks have a return premium. Investigating the corporate reactions to exclusion, we find that companies with **low ESG at the time of exclusion (scope for improvement) and higher revenue growth (investment needs) are more likely to get their exclusion revoked.** We interpret this as evidence of dynamics: Firms improve their ESG to revoke exclusions and achieve lower cost of capital. In fact, **firms that get off the exclusion list do not have superior performance going forward.**

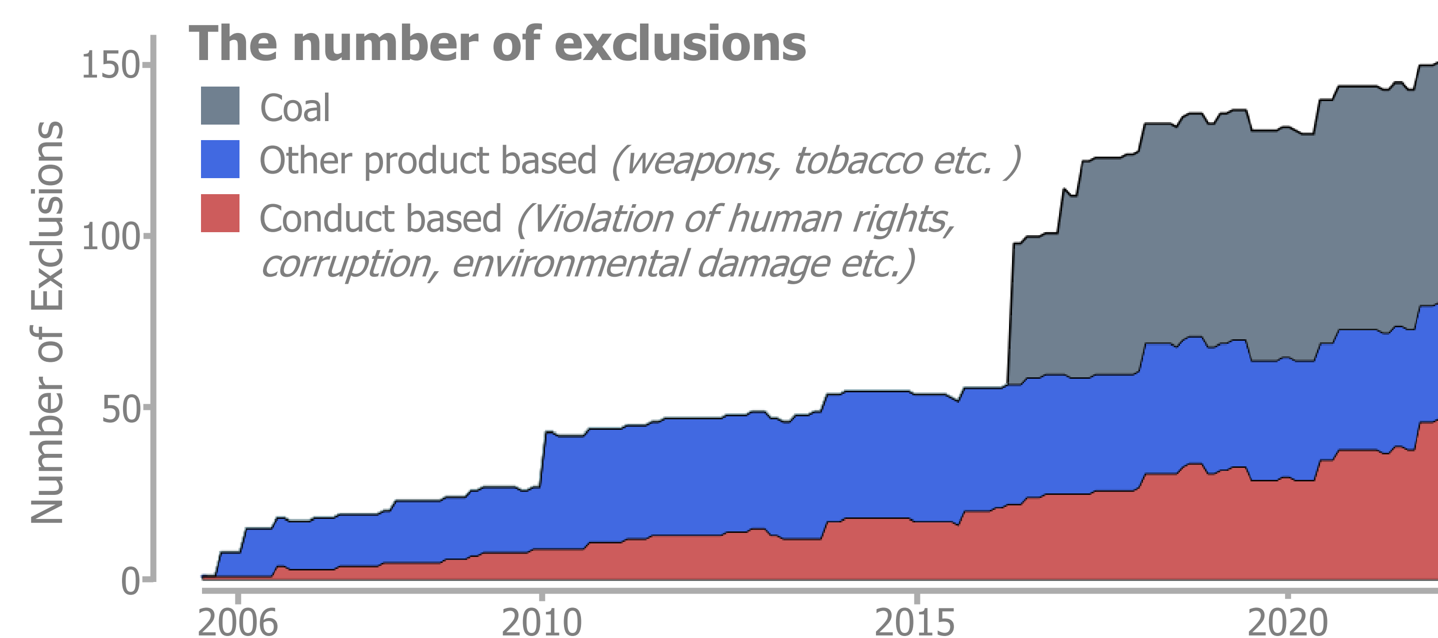
Research Issue

Of interest: Consequences of ESG-based portfolio exclusions on firms' expected returns subject to exclusions?

Approach: Construct a portfolio of excluded firms. Firms enter when excluded, and if the decision is revoked, the firms leave. Compare to the world market portfolio provided by Ken French.

Key questions: What are the implications for the cost of capital? Are firms reacting to their exclusions? With consequences for the cost of capital?

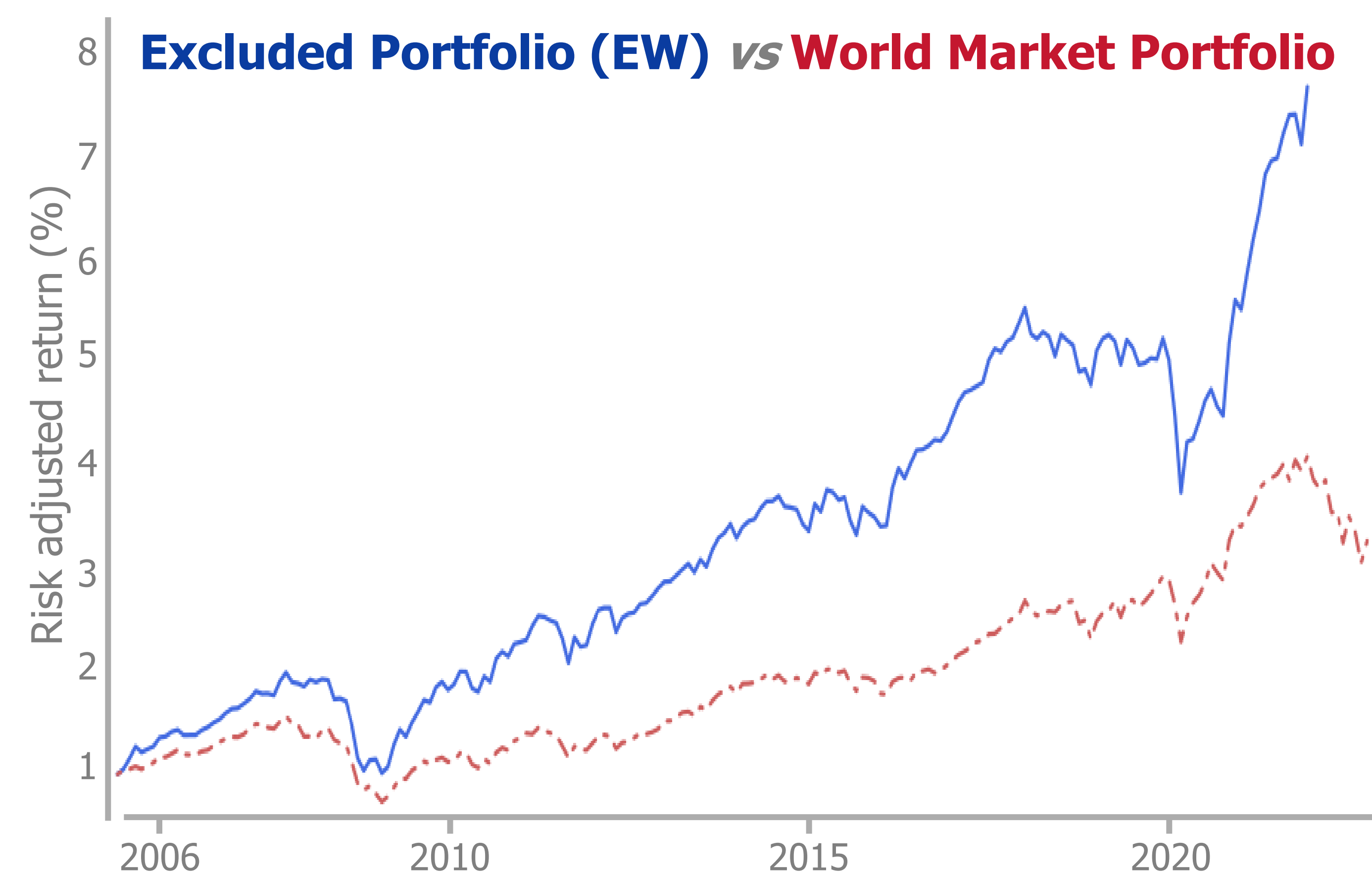
Norway's GPFG (The Oil Fund)



Over 1 trillion USD at the end of 2021. Exclusions conducted by an external "Council of Ethics", est. in 2004.

From 2004 to 2021, **189 firms are excluded** for shorter or longer periods. At year-end 2021, the fund invested in ≈ 10 000 companies -> exclusions **are exceptional.**

Findings



- Does the portfolio have "too high" returns (alpha)?
  → **Yes , >5% highly significant** and robust to alternative weighting schemes, reasons, and asset pricing methods
- Is this due to short-term overreactions, or changes to long-term cost of capital
  → **It is the long-term cost of capital**

After firms get on the exclusion list:

- Are firms happy with their high cost of capital?
  → **No, they try to get their exclusions revoked to get back to a lower cost of capital.**
- If a firm's exclusion is revoked, what happens to the cost of capital?
  → **It Falls**

Mechanism: Only The Bad Stay Excluded

Low-quality ESG firms provide high returns

- The cost of capital for new investments for low-quality ESG firms also exceptionally high.
- If firms can not sustain such high returns, low-quality ESG firms have to move towards better quality ESG ("greener investments") to lower their cost of capital.

Which firms try to get exclusion revoked?

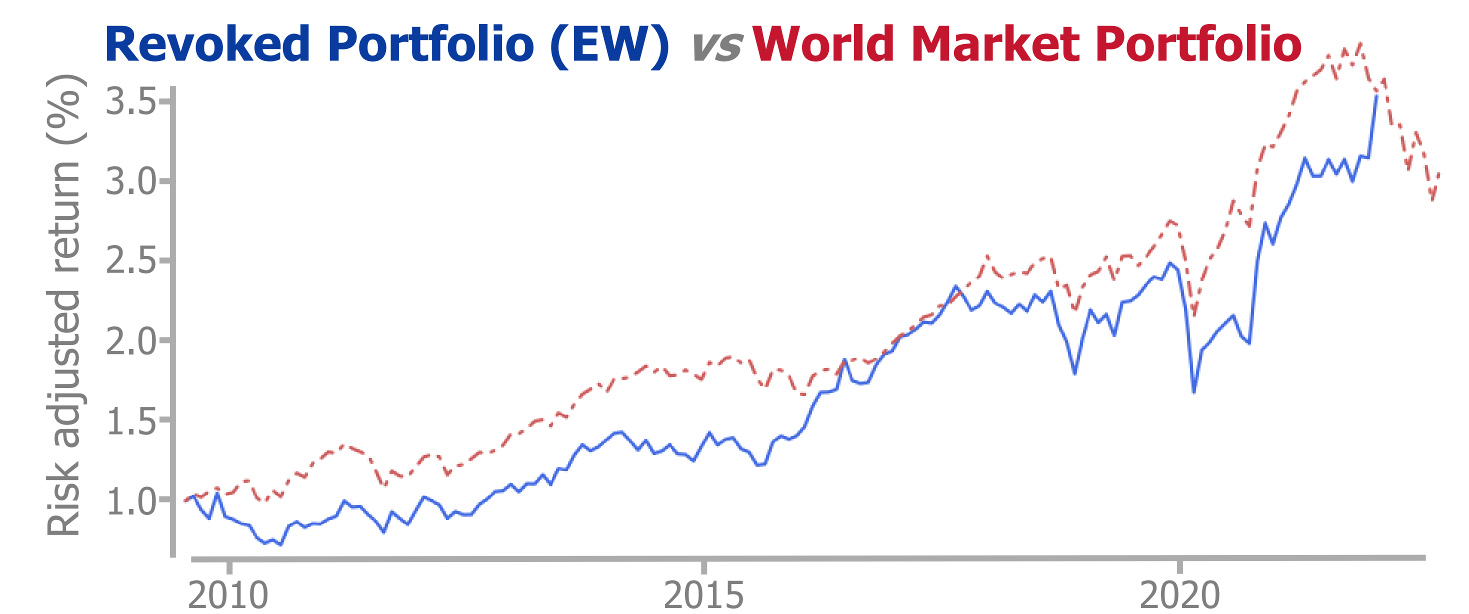
Those with:

- Low ESG measure at the time of exclusion
- High revenue growth later

Reasons for a revoked exclusion			
Δ in product mix	*Cease of activity*	*Sale of subsidiary*	*Other*
11	**7**	**4**	**6**

Firms whose exclusion is revoked:

- If firms get off the exclusion list to reduce the cost of capital, the firms' returns are lower after the exclusion is revoked.
- To test: construct a "Post-exclusion" portfolio of firms that have had their exclusion revoked.
  →The Post-exclusion Portfolio does not have exceptional returns



To Ponder:

Would the high returns have happened without the exclusions? Have the owners of the Oil Fund really lost out?

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