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

Erika Berle, Wanwei (Angela) He and Bernt Arne Ødegaard

Journal of International Financial Markets, Institutions, and Money (2025)

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?

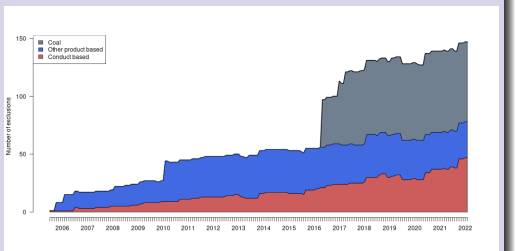
Norway's GPFG (The Oil Fund) - exclusions

- 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	Environment	28
	Individuals' rights in war	11
	Violation of human rights	12
	Environment/human rights	4
	Ethical norms	5
	Greenhouse gas	4
	Gross corruption	2
Product	Coal	75
	Weapons	27
	Tobacco	21

The number of exclusions



Some exclusions reversed

14% of exclusions revoked, due to:

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

Why should ethical exclusions matter?

Special case of more general issue: Does the ESG profile of a firm matter for its performance?

- No?
  - Will not other investors "take up the slack"?
- Yes?
  - Good ESG (green) firms have higher returns?
    Reward for being ethical
    "Doing well by doing good"
  - Bad ESG (brown) firms have higher returns?
    To attract sufficient funding
    (offset excluded funds)
    necessary to offer higher returns.
    Alternatively: High competition to fund "Good ESG"
    Both: → Lower cost of capital (i.e. return)
    (Pedersen, Fitzgibbons, and Pomorski, 2021)
    (Pástor, Stambaugh, and Taylor, 2021)

Empirical evidence:

- Mainly find green firms do worse (Negative green return premium)
- Well known example: Higher returns for "sin" stocks (tobacco, guns).
  (Hong and Kacperczyk, 2009)

Analysis I: "Unethical" portfolio

Method - Construct *Exclusion Portfolio*

- Firms enter portfolio when excluded.
- If exclusion revoked, firms leave.

Portfolio returns

Exclusion Portfolio vs World Market

- Exclusion portfolio does better. Needs testing, though. There could be other reasons (risk) for extra return.
- To test, ask: Has the exclusion portfolio higher/lower returns than it "should have?" (alpha). Asset pricing estimation. Example: CAPM

$$r_{pt} = \alpha_p + (r_{ft} + E[r_{mt} - r_{ft}]) + \varepsilon_{pt}$$

- Alpha: $> 5\%$ in annual terms – highly significant

→ Unethical stocks have higher returns.

- Finding robust to alternative asset pricing models, weighting scheme, subsets, etc.
- Consistent with literature's typical finding of a negative green return premium

Analysis II – Firms whose exclusion is revoked

If firms remove "unethical" piece of their operations, exclusion is revoked.

How many do?

14% act to get exclusion revoked
→ *Most* firms do *not* react to exclusion.

Return (cost of capital) consequences

- Construct "Newly ethical" portfolio of firms that had their exclusion revoked.
- Firms get off exclusion list, alpha → zero.

→ No return premium going forward
→ lower cost of equity capital

Analysis III: Do stock prices react specifically to GPFG actions?

Actions by GPFG

- Selling off 1.5% of company shares, before
- announcing that the company is excluded.

If GPFG actions lead to return premium, should see permanent fall in stock price.
To Test: Event study of stock price reaction

- One-day negative reactions (CAR), reverses immediately.

→ The GPFG actions do not have a permanent negative effect on stock prices.

Analysis IV - Firm's reactions to 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 (alpha) for "bad" ESG (unethical) portfolio.
  → Negative green return premium
- Price reaction when exclusion announced muted
  - Little sign the price drop necessary to drive an increase in returns.
  - → actions by GPFG no causal effect.
  - ESG consequences already baked in?
- Firms acting to get exclusion revoked
  - Rewarded with lower cost of capital.
- Few firms bother reacting to announced exclusion.
  - The few that do
    - low cost to rectify the cause of exclusion?
    - strong need for capital?

Harrison Hong and Marcin Kacperczyk. The price of sin: The effects of social norms on markets. *Journal of Financial Economics*, 93(1):15–36, 2009. doi: 10.1016/j.jfineco.2008.09.001.

Lúboš Pástor, Robert F Stambaugh, and Lucian A Taylor. Sustainable investing in equilibrium. *Journal of Financial Economics*, 142(2):550–571, 2021. doi: 10.1016/j.jfineco.2020.12.011.

Lasse Heje Pedersen, Shaun Fitzgibbons, and Lukasz Pomorski. Responsible investing: The ESG-efficient frontier. *Journal of Financial Economics*, 142(2):572–597, 2021. doi: 10.1016/j.jfineco.2020.11.001.