Environmental, Social and Governance

ESG and Institutional Investors

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Overview

- CSR shareholder proposal

- ES coordinated engagements: PRI Collaboration Platform

- Empirical evidence: institutional investors as a driving force behind ES performance

- The real impacts of environmental activism
Shareholder activism

“Activism” represents a range of activities by one or more of a publicly traded corporation’s shareholders that are intended to result in some change in the corporation.

Exit and selection: Institutional investors can use the threat of exit, or the threat of selecting only firms with specific ESG policies to influence firms’ choices (Negative and positive screening).

Voice: Investors can engage with management using the voice that comes with their shareholding to influence firms’ ESG policies.
  – Public engagement: Shareholder proposal and vote
  – Private engagement
Why do firms engage in CSR activities?

- **Shareholder theory**: Firms pursue CSR because such activities enhance shareholder value.
  - The shareholder theory is similar to the enlightened value maximization theory of Jensen (2001), which posits that firm value is maximized in the long run when the interests of shareholders and other stakeholders are aligned.

- **Agency theory**: Engaging in CSR is symptomatic of an agency problem or a conflict between the interests of managers and shareholders. Managers use CSR as a means to further their own social, political, or career agendas, at the expenses of shareholders (Friedman, 1970).

- **Delegated philanthropy theory**: Firms are as a channel for the expression of citizen values.
  - Investors, customers, and employees are often willing to sacrifice money (yield, purchasing power, and wage, respectively) so as to further social goals. Put differently, stakeholders have some demand for corporations to engage in philanthropy on their behalf.
Shareholder proposal


<table>
<thead>
<tr>
<th>Year</th>
<th>Shareholder proposals</th>
<th>Approved proposals</th>
<th>Approved proposals (%)</th>
<th>Average vote outcome (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>111</td>
<td>0</td>
<td>0.00</td>
<td>7.05</td>
</tr>
<tr>
<td>1998</td>
<td>119</td>
<td>0</td>
<td>0.00</td>
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<tr>
<td>1999</td>
<td>126</td>
<td>1</td>
<td>0.79</td>
<td>7.82</td>
</tr>
<tr>
<td>2000</td>
<td>144</td>
<td>0</td>
<td>0.00</td>
<td>7.42</td>
</tr>
<tr>
<td>2001</td>
<td>159</td>
<td>1</td>
<td>0.63</td>
<td>9.23</td>
</tr>
<tr>
<td>2002</td>
<td>162</td>
<td>2</td>
<td>1.23</td>
<td>10.01</td>
</tr>
<tr>
<td>2003</td>
<td>142</td>
<td>1</td>
<td>0.70</td>
<td>11.84</td>
</tr>
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<td>2004</td>
<td>187</td>
<td>4</td>
<td>2.14</td>
<td>11.36</td>
</tr>
<tr>
<td>2005</td>
<td>195</td>
<td>2</td>
<td>1.03</td>
<td>9.97</td>
</tr>
<tr>
<td>2006</td>
<td>206</td>
<td>5</td>
<td>2.43</td>
<td>14.08</td>
</tr>
<tr>
<td>2007</td>
<td>215</td>
<td>7</td>
<td>3.26</td>
<td>17.23</td>
</tr>
<tr>
<td>2008</td>
<td>212</td>
<td>6</td>
<td>2.83</td>
<td>15.32</td>
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<tr>
<td>2009</td>
<td>196</td>
<td>8</td>
<td>4.08</td>
<td>18.01</td>
</tr>
<tr>
<td>2010</td>
<td>197</td>
<td>4</td>
<td>2.03</td>
<td>18.66</td>
</tr>
<tr>
<td>2011</td>
<td>179</td>
<td>7</td>
<td>3.91</td>
<td>20.15</td>
</tr>
<tr>
<td>2012</td>
<td>179</td>
<td>3</td>
<td>1.68</td>
<td>19.69</td>
</tr>
<tr>
<td>Total</td>
<td>2,729</td>
<td>51</td>
<td>1.87</td>
<td>13.48</td>
</tr>
</tbody>
</table>

- The vast majority of CSR proposals receive little support at shareholder meetings, suggesting that shareholders may not find them desirable.
- Both the number of shareholder proposals submitted and the increasing shareholder support and approval rates have seen an exploding increase.
Shareholder proposal


<table>
<thead>
<tr>
<th>Proposal sponsor</th>
<th>Shareholder proposals</th>
<th>Approved proposals</th>
<th>Approved proposals (%)</th>
<th>Average vote outcome (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>449</td>
<td>6</td>
<td>1.34</td>
<td>8.88</td>
</tr>
<tr>
<td>Public pension fund</td>
<td>437</td>
<td>17</td>
<td>3.89</td>
<td>21.28</td>
</tr>
<tr>
<td>Religious</td>
<td>834</td>
<td>5</td>
<td>0.60</td>
<td>10.55</td>
</tr>
<tr>
<td>SRI fund</td>
<td>506</td>
<td>17</td>
<td>3.36</td>
<td>16.94</td>
</tr>
<tr>
<td>Union</td>
<td>201</td>
<td>4</td>
<td>1.99</td>
<td>15.48</td>
</tr>
<tr>
<td>Other</td>
<td>302</td>
<td>2</td>
<td>0.66</td>
<td>10.06</td>
</tr>
</tbody>
</table>

- The most successful activists are public pension funds and SRI funds of their proposals being approved.

Shareholder proposal

- Failed ES proposals with high investor support significantly predict future firm risk, measured in extreme negative stock returns and real events such as negative ES incidents (2004-2016).
- One standard deviation increase in mutual fund support (on failed ES proposals) predicts:

  - **Abnormal returns**: 1.4%
  - **Negative ES incidents**: 24%

Engagement: PRI

- Principles for Responsible Investing (PRI): Investor initiative founded in 2006 with support from the United Nations
- PRI signatories: Signing the PRI requires organisations to demonstrate their commitments to investing responsibly.
  - asset owners (pension funds, foundation and endowment managers, sovereign wealth funds ...)
  - investment managers (asset managers, bank investment companies, etc.)
  - service providers (ESG data providers, investment consultants, etc.)

Source: PRI.
### PRI signatories: Joined in 2006, headquarter in UK

<table>
<thead>
<tr>
<th>Account Name</th>
<th>Signatory Category</th>
</tr>
</thead>
<tbody>
<tr>
<td>GO Investment Partners</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>BBC Pension Trust Limited</td>
<td>Asset Owner</td>
</tr>
<tr>
<td>Environment Agency Pension Fund</td>
<td>Asset Owner</td>
</tr>
<tr>
<td>HSBC Global Asset Management</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>FTSE Russell</td>
<td>Service Provider</td>
</tr>
<tr>
<td>BT Pension Scheme</td>
<td>Asset Owner</td>
</tr>
<tr>
<td>Universities Superannuation Scheme - USS</td>
<td>Asset Owner</td>
</tr>
<tr>
<td>Generation Investment Management LLP</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>Insight Investment</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>Janus Henderson Investors</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>Aviva Investors</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>The international business of Federated Hermes (formerly Hermes Investment Management)</td>
<td>Investment Manager</td>
</tr>
<tr>
<td>Threadneedle Asset Management Ltd</td>
<td>Investment Manager</td>
</tr>
</tbody>
</table>
Source: PRI.
The six principles and signatories commitment

- We will incorporate ESG issues into investment analysis and decision-making processes.
- We will be active owners and incorporate ESG issues into our ownership policies and practices.
- We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- We will promote acceptance and implementation of the Principles within the investment industry.
- We will work together to enhance our effectiveness in implementing the Principles.
- We will each report on our activities and progress towards implementing the Principles.
“LONDON, Sept 28 2020 (Reuters) - Five investors have been removed from the United Nations-backed Principles for Responsible Investment, in the first such move by the group for those failing to meet its minimum requirements.

The PRI has amassed more than 3,000 signatories managing in excess of $100 trillion in assets since it was launched in 2006 and membership is increasingly seen as crucial for asset managers pitching for mandates from pension schemes.

But the PRI, whose members were told in 2018 they had two years to reach a new set of minimum requirements, said on Monday four asset managers and one asset owner would be delisted.”
Coordinated engagements

- The PRI Collaboration Platform: ESG engagements on environmental and social issues
  - a total of 1,671 engagement sequences targeting 964 unique publicly listed firms located in 63 countries
  - a total of 224 unique investment organizations from 24 countries
  - aggregate assets under management (AUM) of $24 trillion

- It is the first to study the nature and benefits of coordinated, collaborative and international efforts to influence investee companies on environmental and social issues. (2007-2017)

**Coordinated engagements**

- Collaborative engagements are more successful whenever an institution leads the dialogue with the engaged firm.

- Coordinated engagements most successful when lead investors are domestic with supporting investors are international, and the investor coalition is influential (AUM, investment stake).

- Engagements concluding successfully are rewarded by the stock market.

- Successful engagements on ESG issues lead to improvements in accounting performance (i.e., firm sales and profitability).

Coordinated engagements

- With lead: An 4.6% increase in annual abnormal stock returns at target firms within the first year after the engagement initiation, relative to the pre-engagement level
- Without a lead investor: No change in target firms’ stock performance

Coordinated engagements

- **Successful engagement**: An 3.6% increase in annual abnormal returns for the subsample of successful engagements.
- **Unsuccessful engagement**: An 3.6% decrease in annual abnormal returns for the subsample of unsuccessful engagements.

Coordinated engagements

- **Successful** engagements with lead investors: 6.4% increase.
- **Unsuccessful** engagements without lead investors: 5.1% decrease

Coordinated engagements

- Successful engagements on ESG issues lead to improvements in firm sales and profitability.
- Successful engagements with lead investors decrease the stock return volatility.
- Hoepner et al (WP, 2019) show that successful ESG shareholder engagements can reduce firm’s downside risk.

Institutional investors: A driving force behind ES performance

Dyck et al. (2019) find that a one standard deviation change in institutional ownership is associated with:

- Stronger results when investors are signatories to PRI and commit them to ES activism.
- Private engagement is the most likely channel through which investors push firms for strong ES performance (Dimson et al, 2015, 2019).

BP Deepwater Horizon oil spill

Causality:

- Use BP Deepwater Horizon oil spill in 2010 as a quasi-natural experiment.
- This costly environmental disaster represents an unexpected shock that increased the perceived financial value of having in place robust environmental policies and procedures.
- Following the spill, firms from the extractive industry with higher institutional ownership improve their environmental policies more strongly than firms with low institutional ownership.

Institutional investors: A driving force behind E&S performance

- Chen et al (2020) conduct another study by using two distinct quasi-natural experiments to examine the effect of institutional shareholders on CSR.

- The study finds that an exogenous increase in institutional holding (caused by Russell Index reconstitutions) improves portfolio firms’ CSR performance.

- They conclude that institutional shareholders can generate real impact on CSR.

Russell index reconstitutions
(exogenous shock to institutional ownership)

- Each year, Russell Inc. constructs the Russell indices based on the end-of-May closing price implied market capitalization ranks.

- The 1000 firms with the highest market value (i.e., firms ranked between 1 and 1000) that day become members of the Russell 1000 Index and the next 2000 largest firms (i.e., firms ranked between 1001 and 3000) constitute the Russell 2000 Index.
Russell index reconstitutions
(exogenous shock to institutional ownership)

- Quasi-random (surrounding the 1-1000/1001-3000 threshold): For example, a firm ranked 1000 on May 30th might be ranked 1001 on May 31st.

- The implications for institutional ownership
  - As each Russell Index is value weighted such that firms at the top of either index receive the highest weight.
  - Therefore, the 1000th largest stock at the end of May, which is just included in the Russell 1000 Index, has a trivial portfolio weight, whereas the 1001st largest stock just included in Russell 2000 Index will be given a large index weight.
  - The significant jump in index weights at the cutoff gives rise to a large discontinuity in institutional ownership around the threshold.
Institutional investors: A driving force behind E&S performance

- Given that switching from the Russell 1000 to the Russell 2000 Index results in an increase of 12.8% in institutional ownership, inclusion in the Russell 2000 could on average cause firms to increase 0.58 point higher CSR ratings.

- This increase in CSR performance rating is economically significant, which represents 27% of the standard deviation of ESG ratings for firms in the Russell 1000 Index.

- The increased CSR performance around the 1000/2000 threshold is mainly generated by a reduction in Concerns. (ESG=Strength – Concern)

Institutional investors: A driving force behind ES performance

- Local institutional investors: Stockholdings by institutional investors located within 150 miles of the emitting facility.
- Data: Toxics release data on disposal and other releases of over 650 toxic chemicals from more than 50,000 US industry facilities.
- Local influence hypothesis: Local institutional investors have a greater incentive than their distant counterparts to pressure facilities to reduce pollution because:
  - The former internalizes, to a greater degree, the harm of pollution due to emissions of nearby facilities
  - as well as the benefit of social prestige from acting prosocially in a local community.

Institutional investors: A driving force behind ES performance

How to test the local influence hypothesis?

- Institutional investor mergers (decreased LO)
  - Identify those facilities as the treatment group if one of their local institutional investors acquired by a distant institutional investor.
  - The control group consists of those facilities that were owned by the same parent company but did not experience any change in the composition of their local institutional investors.

- Facility relocation (increased LO)
  - Identify facilities that relocated, and their local institutional ownerships are higher in the postrelocation period than in the prerelocation period.

Institutional investors: A driving force behind ES performance

- Institutional investor mergers (decreased LO)
  - Toxic release is **higher** for the treatment facilities whose local institutional investors were acquired by distant institutional investors than for the control facilities that did not experience any merger event.

- Facility relocation (increased LO)
  - After moving to a location with a higher level of local institutional ownership, a facility emitted a **smaller** quantity of toxic chemicals into the environment.

Institutional investors: A driving force behind ES performance

- Local institutional investors have a significantly negative effect on toxic release by the nearby facility than distant institutional investors.

- The study finds a significantly more negative effect for local SRI funds and local public pension funds than for other types of local institutional investors.

- Ownership by local dedicated institutional investors (characterized by a low portfolio turnover rate and more concentrated holdings) is more negatively related to facility toxic release than ownership by their transient counterparts.

The real impacts of environmental activists

- Akey and Appel (2020) study activism campaigns by hedge funds: Engage in communication or otherwise try to influence the target.
- 218 events to targeted firms, after merged with the TRI database (i.e., toxic releases), 1994-2015.

The real impacts of environmental activists

- Treatment: activism campaign
  - Before: No evidence of a downward trend in pollution
  - After: Pollution was reduced and the reduction persists for several years.

The real impacts of environmental activists

- Firms can emit pollution through three types of media (i.e., air, water and ground). Most industrial pollution involve air emissions, although ground and water emissions non-negligible.

- The reduction of emissions after the initiation of an activist campaign:

<table>
<thead>
<tr>
<th>Media</th>
<th>Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Air</td>
<td>-15%</td>
</tr>
<tr>
<td>Water</td>
<td>-12%</td>
</tr>
<tr>
<td>Ground</td>
<td>-9%</td>
</tr>
</tbody>
</table>

The real impacts of environmental activists

- The reduction of emissions (related to only chemicals known to cause human harms) after the initiation of an activist campaign:

The real impacts of environmental activists

- The channels of reducing emissions:
  - First, activists may directly encourage firms to reduce pollution, perhaps to mitigate regulatory risks associated with future emissions.
  - Second, targeted firms may change in the production, consistent with the idea that activists enhance productive efficiency.

- Evidence suggests this change in environmental behavior stems from a drop in production rather than an increase in abatement activities.

The real impacts of environmental activists

- The New York City Pension System (NYCPS) publicly announced the Boardroom Accountability Project (BAP) on November 4\textsuperscript{th} 2014.

- The goal was to hold boards of the portfolio companies accountable to long-term shareholders and give pensioners a voice in oversight concerning board, diversity, climate change risk, and employee treatment.
  - The sample excludes firms targeted for non-environmental reasons by the BAP.

- The BAP posed a credible threat that made it difficult for boards to ignore:
  - First, the BAP was supported by three of the four largest pension funds in the United States ($650 billions AUM)
  - Second, the campaign was well-organized as the BAP and its partners coordinate with other shareholders and can garner broad support for their proposals.

## Activism events: Firms targeted by the BAP

<table>
<thead>
<tr>
<th>Industry</th>
<th># of Firms</th>
<th>Environment</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumer Nondurables</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Consumer Durables</td>
<td>5</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>Energy</td>
<td>30</td>
<td>27</td>
<td>3</td>
</tr>
<tr>
<td>Chemicals and Allied Products</td>
<td>6</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>High Tech</td>
<td>26</td>
<td>2</td>
<td>24</td>
</tr>
<tr>
<td>Tele and Communications</td>
<td>3</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Utilities</td>
<td>25</td>
<td>22</td>
<td>3</td>
</tr>
<tr>
<td>Wholesale and Retail</td>
<td>19</td>
<td>5</td>
<td>14</td>
</tr>
<tr>
<td>Healthcare, Medical Equipment, and Drugs</td>
<td>10</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Finance</td>
<td>32</td>
<td>1</td>
<td>31</td>
</tr>
<tr>
<td>Other</td>
<td>15</td>
<td>4</td>
<td>11</td>
</tr>
<tr>
<td>Full Sample</td>
<td>181</td>
<td>62</td>
<td>119</td>
</tr>
</tbody>
</table>

The real impacts of environmental activists

- Difference-in-difference
  - \( \text{dif} \): Before and after the targeting
  - \( \text{dif} \): Targeted firms and matched firms (i.e., similar in terms of observable characteristics)

- No differential pre-trends in the pollutive activities
- After the targeting, a significant and persistent improvement

The reduction of emissions of lethal greenhouse gases

The real impacts of environmental activists

- Investors interpret the benefits of increased sustainability against the costs associated with implementing them.

- The negative relation between environmental activities and firm financial performance, due to upfront capital expenditures.

Reading list

Reading list