AEGON Asset Management

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AEGON **INSIGHTS**

Divestment: Dynamic or Distractive?

Excluding is certainly a popular way to address investors' ESG preferences. When the exclusionary approach is well defined, it has the benefit of being simple to understand while allowing investors to feel some certainty that they are not profiting from an undesirable activity or behavior. But does divestment or exclusion change the world?

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We, in the responsible investment industry, like to talk about how applying an exclusionary approach is a bit of an outdated, unsophisticated way to approach ESG investing. But despite being the oldest documented ESG-related investment approach dating back to religious movements in the 19th century, exclusions (also called negative screening) remain the most widely adopted approach to ESG investing. They also remain popular among civil society groups urging activists to 'follow the money'. Divestment is usually proposed as the most appropriate escalation to engagement efforts that don't appear to be working – most recently in the oil and gas sector.

But does divestment change the world? It is often argued that it can achieve real-world impact by increasing the cost of capital for the excluded issuers. Academics have been trying to ascertain whether this mechanism works for some time, with mixed results. In his 2000 paper "Socially Responsible Mutual Funds", Statman noted that an exclusionary approach has difficulty resulting in real-world change because it can only increase cost of capital if the supply of capital is less than perfectly elastic[1], but noted that in liquid global markets, it is "probably very elastic". In "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott" (1999), Teoh, Welch and Wazzan examined the South African divestment movement and concluded that there were no direct effects from the movement on the affected firms' share prices, their cost of capital, or the South African financial markets.

Nine years later in "The Wages of Social Responsibility" (2009), Statman and Glushkov constructed a long–short portfolio in which they shorted typical "sin" stocks[2]. Using equally-weighted portfolios, they found that these sin stocks outperformed other stocks, but the outperformance was much weaker when they used value-weighted portfolios. In "The Price of Sin: The Effects of Social Norms on Markets" (2009), Hong and Kacperczyk found similar results, concluding that sin stocks are relatively undervalued due to their systematic exclusion from investor portfolios. The authors did not get as far as finding the tipping point, or the scale of divestment or exclusion necessary to achieve this cost of capital effect. Nevertheless, it seemed to be good news for social and environmental impact, if we believe driving up the cost of equity capital delivers real-world impact.

1. A perfectly elastic supply of capital means that the cost of capital does not change if you increase or decrease the supply.
2. Shares of companies involved in alcohol, tobacco, gambling, firearms, military, or nuclear operations.

Does a higher cost of capital lead to real world impact?

Looking at the tobacco industry, its profitability has remained relatively high and stable over the last 20 years, despite any relative cost of capital effects resulting from investor exclusions. Global cigarette consumption peaked in 2009, and while sales of Philip Morris cigarettes have declined over 30%[3] in the last decade, their revenues and profitability have remained somewhat stable as they diversify into other smoking products. Consumption reduction is typically attributed to government-led actions like taxes, smoking bans, and advertising restrictions. At best, the relatively higher cost of equity capital experienced by tobacco companies can be argued to have hindered tobacco production expansion (global tobacco production has remained relatively stable since 1991), but it has not prevented corporate investments in developing other smoking products like electronic cigarettes.

There is some academic work to address this question too. In "The Unintended Consequences of Divestment" (2018), Davies and Van Wesep examined very large divestment campaigns and their potential impact on corporate management responses. They concluded compensation structures would not typically provide incentives to respond and change because divestment campaigns affect short-term rather than longer-term stock prices, profitability, or returns, and speculated that successes are more likely attributable to social pressure rather than any financial pressure divestment might bring. Statman also argued that divestment may be more effective as a lobbying tool or signal for further political action. Many would argue investor boycotts played such a role in bringing down the apartheid regime despite perhaps not having an effect on cost of capital.

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But divestment may also come with an impact cost: investors dumping their shares obviously are deprived of a seat at the table. Frustration with the receptiveness and pace of change at the companies of concern can and sometimes should lead to a divestment decision. It is often a reasonable response to judge the sustainability risk or impact of the issue at stake to be unacceptable for any longer than a defined holding period. However, the divestment decision can also have the unintended consequence of making it easier for corporate management to reverse course and listen solely to the opposing shareholders' views. An ex-colleague working at a major oil firm recently noted that the firm's change in tone regarding further investment in exploration came merely weeks after large institutional investors publicly announced divestment due to their frustration with slow progress on transition plans.

This serves as a cautionary tale to emphasize the importance of strong stewardship and persistence, even among stakeholder demands for clear-cut, bold, headline-grabbing action like divestment. Engagement is a marathon, not a sprint. Without careful consideration and a strategy employing multiples levers of influence including advocacy for political change, divestment may serve to deliver only the "feel-good factor" as one of my colleagues likes to call it.

3. Source: Leading tobacco companies worldwide based on net sales 2022 | Statista

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