Sustainable

Comment

Investors should be encouraged to tilt towards improving brown companies, not exclude them

By Alex Edmans
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New research makes the case for holding capital in brown companies that are transitioning to a more sustainable business model – despite regulatory incentives against doing so.

What is the most effective way for sustainable investors to change company behaviour?

Common wisdom is to sell out of 'brown' sectors, such as fossil fuels and alcohol, and invest instead in 'green' industries, such as renewable energy and healthcare. According to the argument, this starves brown companies of funds – preventing them from expanding and creating more harm – while financing the expansion of green firms.

This type of strategy is often likened to customer boycotts. In the past, consumers that refused to buy eggs produced by caged hens and instead favoured free-range eggs, for example, successfully forced many producers to change their methods.

The analogy is a false one, however, since an investor can only sell shares if someone else buys them – so divesting does not defund a company. Conversely, you can only buy if someone else sells, so your actions don't actually inject new capital. This is very different from a customer boycott scenario, where shunning a firm deprives it of revenue and switching custom gives the competition fresh funds.

Effect of divestment

OK, so perhaps divestment doesn't pull the plug on a company immediately – but doesn't it lower the share price and make it harder to sell shares in the future? Not necessarily. Brown companies don't raise much capital to begin with as they are usually in older industries that have few growth opportunities. Evidence suggests that the cost of capital has little effect on investment; instead, investment decisions are driven primarily by forecasts of future cash flows, which in turn are affected by factors such as the economic outlook.

Now the stock price might matter for many other reasons than the cost of capital: even if a company isn't raising capital, a low price reduces the value of the CEO's shares and worsens his or her reputation. But if it is the case, my new paper, 'Socially Responsible Divestment' (with Doron Levit of the University of Washington and Jan Schneemeier of Indiana University) shows that the best strategy is *tilting* (leaning away from a brown sector but being willing to hold a company that's best-in-class in sustainability), rather than *exclusion* (boycotting that industry outright).

Central to our conclusion is the fact that even brown companies can take corrective actions: fossil fuel firms can develop renewable energy, for example, and alcohol companies can promote responsible drinking, develop low alcohol beers, and reduce water usage and carbon emissions. But doing so won't change its sector – an alcohol company remains an alcohol company.

Thus, if a company knows that it will be dumped whatever it does, because investors are conducting a blanket exclusion of controversial industries, it has no incentive to reform. But if a company will be bought if it is considered best-in-class, this motivates it to ensure it is ahead of all its peers.

Rewarding reform

We recognise the value of rewarding reform in many other walks of life. For example, a company might claim that it's so pure that it refuses to hire any employees with a criminal record. But most

people would think more positively about firms that are willing to provide jobs to ex-offenders with a serious commitment to rehabilitation, such as New Ground Coffee.

Yet we don't apply such nuances to how we assess asset managers. Sustainable funds that invest in controversial sectors are often accused of greenwashing, which can harm their reputation and lead to a client exodus. The consequences can be even more extreme. In 2020, Extinction Rebellion protesters dug up a lawn outside Trinity College, Cambridge.

By contrast, fund managers that won't touch problematic industries or tout a 'net zero' portfolio are praised for being pure. Such lack of nuance may only worsen with taxonomies, such as those that the EU has introduced and the UK is developing, which tend to take a black or white (or brown or green) approach. They risk judging funds on only a snapshot assessment of the sustainability of the companies they hold, rather than their direction of travel or ranking relative to peers.

Our findings on the effectiveness of divestment are quite different from the common concern that "if you don't own stock, you can't engage". While true, some investors rarely engage to begin with – their expertise may be stock selection rather than engagement, or they lack the substantial financial resources needed. For example, Engine No. 1 spent $30mn electing three climate-friendly directors onto ExxonMobil's board in its proxy fight with the oil giant – a huge outlay compared to its $50mn stake.

Engagement is indeed a powerful tool to enact reform. But the most effective sustainable investors have multiple tools in their box, and tilting is one of them that must not be cancelled through black-or-white assessments.

Alex Edmans is professor of finance at London Business School and author of 'Grow the Pie: How Great Companies Deliver Both Purpose and Profit'

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