Investissement Responsable:
Y a-t-il une prime de risque ?

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Agora de la Gestion avec l'AFG et la SFAF, 7 septembre 2016

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Responsible Investments:
Is there a a premium?

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Context

- **Responsible investments** represent a **significant fraction** of assets under management
  - In Europe in 2013, €9.9 trillion (Eurosif) out of €16.8 trillion (efama)
  - Around 59%!

- The **business case** for responsible investments is **not always clear**
  - Is it a passive or an active strategy?
  - What type of financial performance/premium to expect?
  - What impact on corporate behavior?

Objective and Method

- Propose a business model for **responsible investment funds** that associates **financial performance** and **changes in corporate behavior**
  - Within the responsible investment industry, engagement strategies can display *abnormal returns at equilibrium*
  - The *"washing machine"* investment strategy (Gollier and Pouget, 2016)

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- **Extend** the standard **Capital Asset Pricing Model**
  - *Differences of opinion* regarding the materiality of Environmental, Social and Governance (ESG) factors among investors
  - Endogenous *strategic decisions* by companies' shareholders

Passive Responsible Investments

- **Passive responsible investments** screen assets on the basis of
  - Activity types: negative screening
  - ESG performance: best-in-class or positive screening approach
- **Insufficient diversification**
  - Loss of performance due to foregone profits (you may miss the next Google)
  - Loss due to excessive losses (you may end up with too many bad apples)
- **Better valuation for responsible firms**
  - More investors focus on similar assets

Passive Responsible Investments

- Business case
  - Performance controlling for the investment universe is similar to traditional funds
  - Overall *financial performance* is *lower*…
  - … But *clients are protected* from moral or reputational issues

Relation to empirical evidence

- Hong and Kacperczyk (2009) on sin stocks
  - Sin stocks have 19% of institutional investors compared to 22% for comparable firms in other industries (data 1980-2003)
  - 2.1 analysts vs 2.5 (data 1976-2003)
  - 4% per year more return controlling for risk after 1965 (data 1926-2003)
  - Market-to-book ratio 15% lower (data 1965-2003)

- Bauer, Derwall, and Hann (2009) on employee relations and stock returns (KLD ratings, data 1995-2006)
  - Lower cost of debt and higher credit ratings for stronger employee relations

Relation to empirical evidence

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- Chava (2011) on green companies (data 1992-2007)
  - Enjoy lower cost of debt
  - Have larger syndicates
  - Enjoy lower cost of equity
  - Have more institutional shareholders

- Empirical results suggest that:
  - There is a *responsibility premium* in firm valuation
  - Passive responsible strategies *underperform on average*

Premium from Responsible Investments?

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- Proposing a business model in which responsible investors outperform traditional ones is **challenging**
- Outperformance may only derive from **active investment**

Premium from Responsible Investments?

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- Consider that CSR pays at the company level

Premium from Responsible Investments?

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- Consider that CSR pays at the company level

- If financial markets are **informationally efficient**
  - Both responsible investors and traditional funds overweight virtuous firms
  - These funds display *identical performances*

- If one considers that financial markets are **inefficient**
  - Both responsible investors and traditional funds collect information and find mispricings
  - Again, these funds may display *identical performances*

Three Drivers of Premium for RI

- Superior securities’ selection
- Better market anticipations
- Engagement

Superior Securities' Selection

- A fund may implement active responsible investments to bet on the **ESG factors that are expected to impact** future returns and risks
  - Focus on relatively low number of firms (as traditional speculators)
  - Bet that some ESG-related information will become incorporated into market prices
- **Short-term trading** that enhances market efficiency
- Key premium driver: **superior ESG analysis skills**

Better Market Anticipations

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- A fund may implement active responsible investments to bet on the fact that a given **ESG issue is going to become more salient**

- **Medium-term trading** that may enhance market efficiency
  - Increases efficiency if the issue was overlooked by traditional investors
  - Decreases efficiency if the issue was already well accounted for

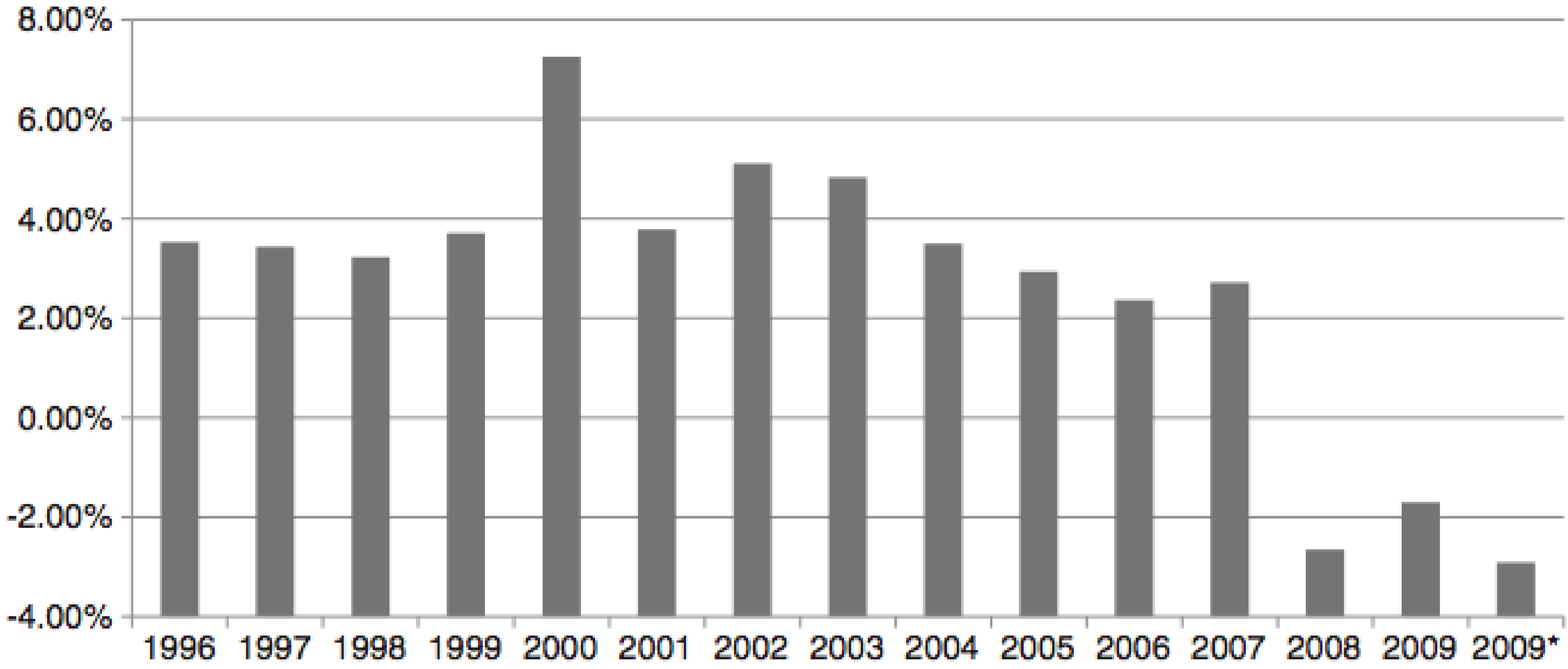
- Key premium driver: **better market-wide ESG trends' perception**

Relation to empirical evidence

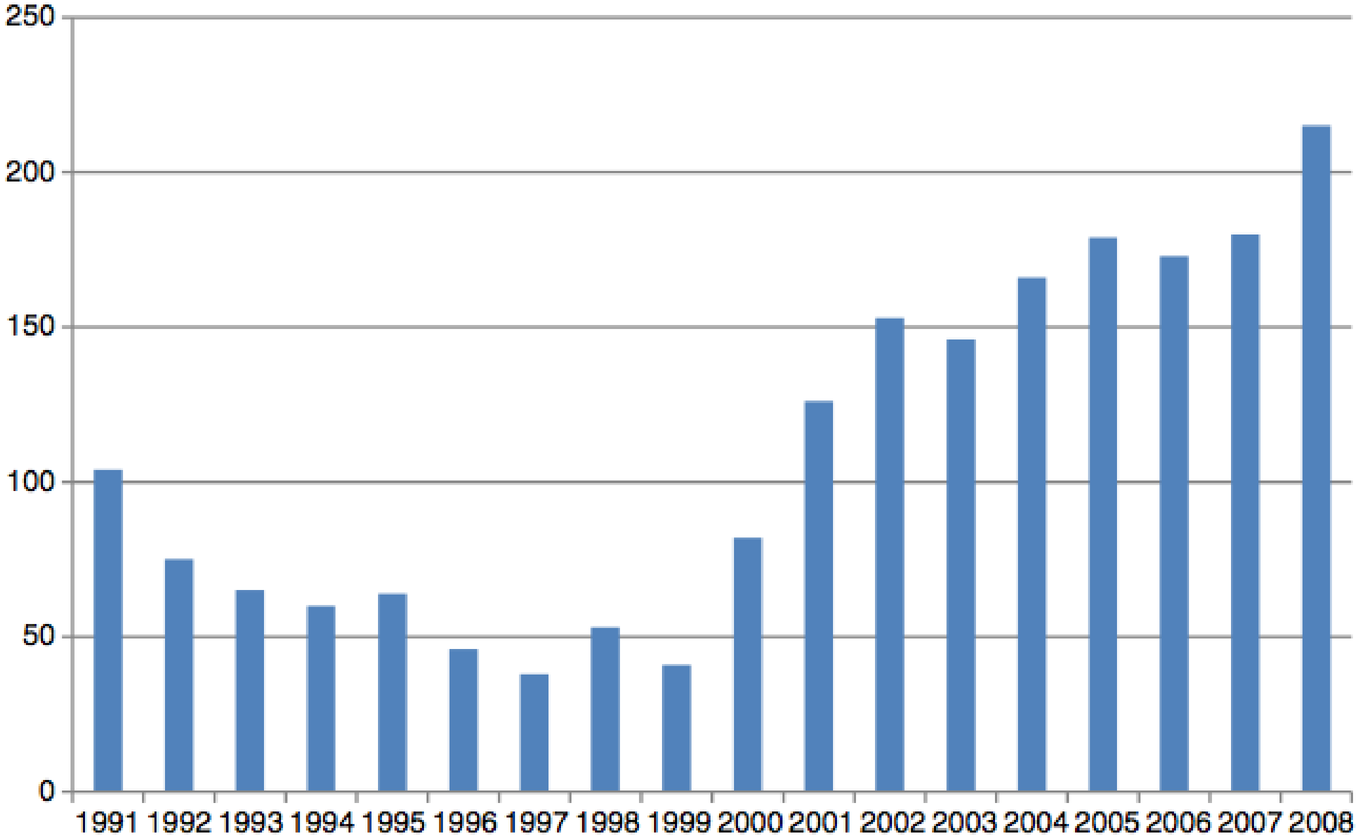
- Edmans (2011) on employee satisfaction and stock valuation (data 1984-2005)
  - Employee satisfaction is measured according to the list of “100 Best Companies to Work For in America”
  - Best Companies have more positive earnings surprises
  - Enjoy larger returns (4% positive alpha)…
  - … Until the market recognizes the value of employee satisfaction (on average, 4 years of abnormal performance)

Relation to empirical evidence

- Borgers, Derwall, Koedijk, and Horst (2013) on errors in analysts' forecasts related to ESG issues (data 1992-2009)
  - ESG information predicts errors in analysts' forecasts and greater returns…
  - … until attention to this information has increased (in the late 00's)



Year-by-year difference in risk-adjusted return between top- and bottom-ranked portfolios in terms of ESG performance (Borgers et al., 2013)



Number of shareholder proposals on ESG-related issues for S&P 1500 firms (Borgers et al., 2013)

Relation to empirical evidence

- Overall, the literature suggests that **ESG issues are now better taken into account** by financial analysts and priced by the market

- Active strategies based on ESG factors can thus be profitable for investors with superior **anticipation skills**

Engagement as a Premium Driver

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- **Engagement of companies towards better ESG performance** can lead to superior investment performance
- **Long-term investment** strategy that enhances corporate social responsibility
- This is the idea of the “Washing Machine” strategy (Gollier and Pouget, 2016)

The “Washing Machine” Strategy

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The "Washing Machine" Strategy

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The “Washing Machine” Strategy

- Invest in **dirty** companies at **attractive prices**
- Turn them into **clean** companies
- Pocket in the **responsibility premium** when reselling shares

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  - Acquire shares to be influent enough
  - Believe in CSR materiality
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- Turn them into **clean** companies
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- Pocket in the **responsibility premium** when reselling shares
  - New corporate strategies attract responsible investors
  - Keep a large enough stake to ensure that companies stay clean

Relation with empirical evidence

- Dimson, Karakas and Li (2013) calculate a 2% abnormal return based on CSR engagement by a large UK institutional investor between 1999 and 2009
- Becht, Franks, Mayer, and Rossi (2009) estimate that Hermes UK Focus Fund generates a 4% abnormal return thanks to corporate governance engagement on the 1998-2004 period
- Brav, Jiang, Partnoy, and Thomas (2008) document a 7% stock price reaction around activism announcement by hedge funds in the US (data 2001-2006)

Relation with empirical evidence

- Cunat, Gine, and Guadalupe (2012) document a 2.4% increase in stock price in the week following close favorable votes on corporate governance shareholder proposals compared to proposals that did not pass (US data 1997-2007)

- Flammer (2015) documents a 1.9% increase in stock price in the two days following close favorable votes on ESG shareholders' resolutions (US data 1997-2010)

- **Engagement** strategies are used and **beneficial** (at least gross of engagement costs)

Tau

Capitalist Solutions to Capitalism's Failures

Tau Investment Management, LLC - 405 Lexington Avenue, 29th Floor - New York, NY 10174. info@tau-investment.com. 646-797-4700.

NY firm sees investment opportunity in garment factories

BY JESSICA WOHL
Fri Sep 27, 2013 4:20pm EDT

(Reuters) - Outdated, poorly managed factories can be fixed in ways that help workers, the environment and socially conscious investors willing to provide the funding, according to a new firm that plans to invest in Bangladesh and elsewhere.

Oliver Niedermaier, the founder and chief executive of New York-based Tau Investment Management LLC, said he saw a need for equity-style investments in rundown factories including those in the garment industry well before the April collapse of the Rana Plaza factory and the November fire at a Tazreen Fashions factory in Bangladesh.

Tau Investment Management

- Objective: raise $1 billion of assets under management
- Strategy:
  - Invest in garment factories in Bangladesh and other developing countries
  - Be an active minority shareholder
  - Transform firms by improving working conditions (salaries, security, training) and supply-chain conditions
  - Sell back the companies after 7-10 years
- Backed by the Global Emerging Markets group of Alexander Soros

Key Drivers for Successful Engagement

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- Financial success and corporate change are intimately related
- To benefit from ESG engagement strategies:
  - Invest in **non-responsible** firms and turn them **into responsible**
  - Have a **credible** orientation towards social responsibility
  - Have a **long-term** orientation
- Engagement strategies can be implemented
  - **Alone** by responsible private equity funds or hedge funds
  - **In group** by mutual funds or pension funds

Conclusion

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- To benefit from responsible investments, three drivers of performance
  - Superior ESG analysis skills
  - Better market-wide ESG trends’ perception
  - Engagement for change in CSR
- Bonus: responsible investors **enjoy more loyal clients** thanks to a good ESG performance (Henke, 2014, Bialkowski and Starks, 2015)