”The results were not what we expected”

Associate Professor in Finance Andreas Hoepner and PhD candidate Lisa Schopohl from Henley Business School are the researchers behind the peer reviewed paper “*On the Price of Morals in Markets: An Empirical Study of the Swedish AP-Funds and the Norwegian Government Pension Fund*”. In the project they have investigated whether asset owners can meet ethical objectives through an exclusion based strategy without compromising financial returns. The study empirically analyses the exclusion of companies from investors’ investment universe through a time series analysis of performance implications of the exclusion decisions of two leading Nordic investors, Norway’s Government Pension Fund-Global (GPFG) and Sweden’s AP-funds.

Henley Business School is one of the research institute partners in the Mistra Financial Systems program hosted by Mistra Center for Sustainable Markets at Stockholm School of Economics.

 

# What do you make of the results?

Andreas Hoepner:
”It is highly unlikely that simple industry exposure in terms of over-weights, under-weights or even exclusion have a material financial impact in 21st century markets. These investment propositions are simply to easy with too many competitors having the same idea. Despite the consesus of previous papers believing, based on too simple statistics, that so called sin stocks might outperform, I had found in two previous papers (one with Stefan Zeume, one with Hampus Adamsson) that sin stocks are just average if you assess them with sufficiently advanced statistics.”

# Were the results what you expected, were there any surpirises?

Lisa Schopohl:

”When only judging based on the previous academic literature on exclusionary screening, the results were not what we expected. The consensus of those studies is that exclusionary screening significantly hurts portfolio performance. However, the approach to exclusionary screening adopted by the Swedish Ap-funds and Norwegian GPFG that we analyse in our study are remarkably different to the ones studied in prior research. Not only do these funds have a much more integrated responsible investment policy of which exclusions are only one part, but most importantly these funds have a strong duty of care towards their beneficiaries. This duty requires them to carefully balance their financial objectives with their ethical objectives. On this basis, we would have expected that the funds carefully assess the portfolio implications of their investment or in this case disinvestment decisions. Thus, looking at it from this more practical perspective, the results that the exclusions do not financially hurt fund performance do not come as a surprise to us. ”

# What do you think that your results mean for the Swedish AP funds’ investment strategies?

Andreas Hoepner:

”Our results show that the norms of conventions ratified by the Swedish Government provide a solid basis for their investment strategies that provides a benchmark performance when assessed with advanced statistical measures. That said, Swedish AP funds might prefer to excel beyond the international benchmark and (re-)establish themselves as recognised global leaders in sustainable investing by looking beyong our results in this study to sustainable industry classifications or Financial Data Science driven approaches such as Sustainable Smart Beta or Scientific Alpha.”

# What does this mean for active owners that prefer to engage with investees?

Lisa Schopohl:

”The Swedish AP-funds and the GPFG show that ethical exclusions and engagement do not need to be an ”either... or” question but that both strategies can naturally complement each other. Prior to an exclusion decision, the funds enter into a dialogue with the targeted company in order to proactively address the issue that the company is accused of and to initiate change. However, if the company is unwilling to cooperate and initiate change, then the exlusion of that company from the funds’ investment portfolios is the logical step. Not only to ensure that the funds’ investments are in line with the standards and moral code of the Swedish society, but also to increase their negotiating power during the prior engagements by showing that not addressing the funds’ demands leads to real consequences. I believe that in this way the Scandinavian asset owners are pioneers in combining different responsible investment strategies to increase their influence on companies.”

# How did you come up with the idea to do this study? Why did you think it was needed?

Lisa Schopohl:

”Our interest in a renewed look at the performance impact of exclusionary screening was sparked by the increased public interest in the social, environmental and ethical consequences of the investment and financing decisions of large financial institutions. Movements like Occupy Wallstreet and the Fossil Fuel divestment campaigns are just some of the most vocal aspects of a more general movement in society to demand greater accountability from the main financial actors. Nowadays, people do not want to see their future pensions invested in companies that exploit their workers, pollute the environment and whose business practices are not sustainable. Thus, large asset owners and financial institutions cannot afford to ignore the ehtical demands of the general public any longer but need to find ways to respond to these demands.

On the other hand, these financial actors also have a duty towards their beneficiaries to invest their funds in their best financial interest and the funds should not engage in investments or divestments that are to the detriment of their beneficiaries. Thus, for large asset owners such as the Swedish Ap-funds it is a constant balancing act of meeting both their ethical and financial objectives. We were curious to analyse how well these funds are managing this balancing act. And so far, it appears as if they are doing a good job at it!”

# **How is your study different from other studies?**

Lisa Schopohl:
”Most of the previous academic studies on ethical exclusions are still based on the way exclusionary screening was practiced by the early pioneers of ethical investment, the ethical funds, in the 1970s. Back then, responsible investment was still a long way away from the sophisticated and intgrated strategies that it is known for today. These studies basically exclude entire industries that are regarded as ”sinful” such as alcohol, tobacco or adult entertainment. However, the type of ethical questions that the asset owners studied in our paper are confronted with are rather whether they invest in companies that violate fundamental human rights, that exploit their workers and that pollute the environment. We call these type of exclusions norm-based exclusions. While there is an abundance of research on the prior industry-based exclusions, very few studies have provided empirical evidence on the performance impact of norm-based exclusions. Additonally, there is also a lack of research on exclusions by large asset owners for which portfolio screening becomes more and more important in order to respond to the increased public pressures and scrutiny. And finally, in our study, we put greater emphasis on the practical relevance of the exclusion strategies than what has been done in most prior research. This is important to make sure that we capture exclusions that are actually made by real world investors instead of applying industry-based screens to a hypothetical investment universe.”

Andreas Hoepner:
”Beyond the points mentioned by Lisa, I would only raise one further point on the statistics: We live in times of Big Data when the ability to draw inferences from these large datasets via precise statistical analysis is crucial. Previous studies had theoretically assumed following the standard model of Fama and French that those factors driven investment performance are equivalent across industries. Jointly with a Swedish researcher Dr. Hampus Adamsson, I had previously shown that this theoretical assumption is incorrect. Hence, Lisa and I are controlling for industry specific drivers of investment performance here, which allows us to arrive at more accurate results.”

# Who do you think should be interested in your findings?

Andreas Hoepner:

”The simple conclusion for the general public is that forward looking views on sustainable economic developments expected for the 21st century can be integrated into investment portfolios without compromising benchmark investment performance.”

# What would you like to do next to follow up?

Lisa Schopohl:

“There are several ways that we could expand the research. On the one hand, the current study mainly looks at the implications for (risk-adjusted) portfolio returns and we only provide a preliminary analysis of the risk implications of these exclusions. Thus, it would be interesting to look at the risk side in more detail, especially as we believe that investing in companies that violate basic social, environmental and ethical standards bears great financial risk so excluding them from one’s investment universe should have a positive effect on portfolio (downside) risk.

On the other hand, standards and norms of sustainable business practices are constantly changing and several new topics and grounds for exclusion have emerged lately. To name only one, the Norwegian GPFG has recently started to exclude companies that are heavily involved in the production of coal or coal-based energy. Thus, it would be interesting to extend our study to new forms of exclusionary screens to provide further guidance on potential performance implications of such exclusions.“

Andreas Hoepner:
”Beyond the points raised by Lisa above, I would only add that we are very keen to study pension funds going forward, which self identify as universal owners. This means that these pension funds are exposed to the vast majority of the investable securties globally and hence have a strong incentive to foster collaborations in order to reduce standard market risk. Please note that by standard market risk I do not mean beta, which includes downside and upside swings, but define standard market risk purely based on downside deviations of the market return.”

# Anything else that you would like to emphasize?

Lisa Schopohl: “While we are confident that our results provide solid evidence that exclusionary screening can be conducted without hurting portfolio performance and, we would like to point out that the performance implications of exclusionary screening depend on the particular strategies adopted by each investor. Our results are derived from the past exclusion of the GPFG and the Swedish Ap-funds and the performance implications might differ for other investors, especially if these investors base their exclusion decisions on different grounds than the GPFG and the Ap-funds. Nevertheless, our study can serve as a guidance to other global asset owners that are considering whether to integrate exclusionary screening into their responsible investment strategy.“

Andreas Hoepner:
“We would like to thank all those who worked for and with the AP funds in their exclusionary screening over the last decades for their efforts, as only these efforts made our study possible. Reflecting on recent developments in responsible investment, I would also like to encourage the AP funds to foster further innovations in sustainable investing, both in terms of engagement and in terms of integration.”

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