Discussion paper series on investor impact mechanisms

Mechanism #6: send non-market signals

2° investing initiative

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Mechanism #6: send non-market signals

Presenting the mechanism

As said in the precedent discussion paper, investors can send market and non-market signals that they are committed to impact. Beyond market signals, investors can send other types of signals to alter the behavior of investors or company stakeholders through reputation and social norms. It is an indirect impact mechanism as targeted companies are affected only via the effect on third parties.

Several nonmarket signaling actions are possible, as described by Kölbel et al. (2020):

- **Endorsement:** investors can endorse companies for their social or environmental performance by publicly including them in their portfolio. Such endorsement may incent other investors to do the same and improve the reputation of a company, indirectly helping it gain customers or motivate employees.
- **Stigmatization:** investors can stigmatize a company by announcing its divesting from the company' securities or categorically excluding it from their portfolio. The action may be imitated by other investors or impact other relevant stakeholders of the company, for example by deterring employees from working at a company that is excluded by investors.
- **Benchmarking:** investors can spread sustainability indices/ratings by using or replicating them. Those induce companies to improve their ESG performance to outcompete peers while also helping companies to manage their ESG performance.[1]

Nonmarket signals operate via two pathways (i.e., through investors or through other stakeholder groups like medias, consumers or employees). The two pathways may reinforce each other and lead to a systemic effect, for example by encouraging political processes and governmental regulation.

Examples of products

We could not identify products that, by nature, intensively apply the mechanism.

Non-market signalling is more a side mechanism to be deployed to accompany other mechanisms, especially engagement (e.g., using public divestment threat in case of unsuccessful engagement) and market signaling (e.g., in support of positive or negative screening strategies).

But we could identify high-profile investors being vocal about their exclusions. An example of a public and influential divestment process is that followed by the Norwegian Government Pension Fund Global. There, an independent ethics council considers whether companies should be excluded from the fund because of business activities (such as the production of indiscriminate weaponry or thermal coal) or because of breaches of behavioural norms (the UN Global Compact standards). For example, in recent years the ethics council has recommended divestments based on a criterion adopted in 2016 – behaviour that leads to unacceptable carbon emission levels, including an assessment of companies' willingness and ability to change such behaviour in the future. The manager running the fund, Norges Bank Investment Management (NBIM), considers these recommendations, and can exclude companies on these grounds. It has, for example, excluded multiple companies involved in oil

[1] Investors can also communicate about their own ESG-grounded preferred list of investable companies, which is a systematic type of endorsement.

sands production as a result. NBIM makes the full list of its exclusions public and publicizes its decisions to exclude individual companies or to remove exclusions. This publicity forms part of an escalation process with the companies in question and also has a potential influence on other companies. The NBIM exclusion list is observed and replicated by a number of other investors.

Questioning the impact narrative

Several streams of research suggest the aforementioned actions could drive behavior change by companies.

First, many papers observe the significant effects of reputation on companies' capacity to operate and their financial performance. Companies that are heavily criticized in the media suffer from a bad image that often drives away suppliers, subcontractors, customers, and employees. This preference for socially responsible companies can, among other things, be reflected in wages. Companies with a very good environmental reputation seem to have an advantage in terms of salary expenses, of the order of -10% according to Krueger, et al. (2022). Workers with a preference for a socially responsible employer therefore demand additional compensation for working for a socially reprehensible company[2]. This is an important factor that needs to be considered by companies wanting to attract and retain talent, and thus remain competitive. A successful stigmatization movement could also result in a loss of political influence for the company and the industry in which it operates[3]. Affecting the target company's image and its relationship with stakeholders and the political world, such a movement could lead neutral equity and bond investors to reassess the company's future net cash flows downwards and thus create a long-term effect on the value of the company and an incentive for management to react to stigmatization[4].

Second, endorsement of companies' stocks by financial analysts or companies' products by celebrities[5] have been found to have a positive impact on stock prices, contributing to a decrease in the cost of capital for endorsed companies.

Third, boycott or divestment campaigns by investors have been found to have the opposite effect on stock prices. Dordi and Weber (2019) measured abnormal deviations in stock prices of the top 200 global oil, gas, and coal companies by proven reserves, on days of prominent divestment announcements. Many events experienced short-term negative abnormal returns around the event day and the effects were more pronounced over longer event windows following the New York Climate March, suggesting a shift in investor perception. Ding et al. (2020) examined the effectiveness of an international stock boycott by studying a large sample of institutional investor transactions in four emerging market oil major stocks (Sinopec, Petrochina, ONGC and Petronas) targeted by the Sudan divestment campaign from 2001 to 2012. They found evidence of a negative relationship between the intensity of the campaign and the ownership breadth of the stocks, suggesting the effectiveness of the campaign in encouraging investors to divest from targeted companies and discouraging new investors to initiate a long position. Additional analysis indicated that investors in countries that are sympathetic towards CSR activities were more responsive to the divestment campaign and that higher campaign intensity was associated with depressed stock prices.

Fourth, there is much behavioral evidence of herding effects and cascades among investors. Decisions by expert investors are often mimicked by other investors.

Fifth, it has been observed that investors and market prices do react to ESG news. Using TVL database to track ESG news, Serafeim and Yoon (2022) find a positive market reaction to positive ESG news and negative reaction to negative news. De Vincentis (2022) confirms an effect of ESG news on market prices but observes that ESG news are interpreted differently in different geographical

[2] Nyborg and Zhang (2013)
[3] Braungardt et al. (2019)
[4] Ansar et al. (2013)
[5] Ding et al. (2011)

areas. In Europe, bad news matter more than good news and produce a negative price impact. In the USA, a mirror picture emerges: good news matter more than bad news and produce a negative price impact. In the APAC area, ESG news are no news and are not correlated to significant extra returns.

Aggregately, it seems clear that information drives investors and stakeholders' behavior changes. The question here is to know if i) information about specific investors' ESG-based endorsement of stigmatization is considered by investors and stakeholders outside the investor community and ii) their consequential actions are significant enough to alter decisions by companies.

Regarding the former, it is not obvious that public communications by (even large) investors can influence other stakeholder groups. King (2011) examined factors associated with social movements' abilities to disrupt corporate targets. He identified two kinds of disruption: market disruption and mediated disruption. Market disruption deters the ability of the corporate target to effectively accrue and use market resources, while mediated disruption occurs as a tactic communicates a movement's claims about the target through third party intermediaries, like the media, thereby disrupting the target's image and reputation. Using data on corporate boycotts in the United States from 1990 to 2005, he observed that the two kinds of disruption are interrelated. But market disruption has only a marginal effect on the intensity of subsequent media coverage while ongoing media attention accentuates further market disruption. It is far from being sure that the announcement of divestment by a prominent investor will make customers, employees or suppliers avoid the targeted company.

One can also discuss how companies would react to public stigmas. The effectiveness of stigmatization remains uncertain because of the responses that may be embedded in the culture of the target industry. Several types of responses may be employed: companies may admit their wrongdoing and commit to taking corrective action (conform), they may choose not to react to the stigma (avoid), or they may respond in a counterproductive manner by attempting to change social values (alter) or shape public perceptions (shape). For example, it has been argued that the fossil fuel industry seems to prefer "alter" and "shape" techniques[6]. Companies associated with stigmatized industries can also divert public attention and dilute stigma by diversifying into more socially desirable activities (e.g., renewable energy for oil majors). This mechanism, known as "stigma dilution"[7].

The observed outcomes

Outcomes of ESG stigmatization

A few studies have obtained that collective stigmatization leads to positive transformation by targeted companies.

Using international data on negative news coverage of corporate E&S risks by Reprisk which screens daily over 80,000 media, stakeholder, and third-party sources, Gantchev et al. (2020) show that E&S-conscious investors divest firms with heightened E&S risk. They also find that these firms' sales in E&S conscious countries decrease. As a consequence of investors' and customers' reactions, firms with more E&S motivated investors and customers experience temporary declines in valuations and subsequently improve their E&S policies as captured by future negative E&S incidents, ESG ratings, carbon intensity, and employee controversies. Notably, the effects on the firms' E&S policies appear to be largely driven by investors rather than customers.

Focusing on the effects of the Sudan divestment campaign on four oil major stocks, Ding et al. (2020) find evidence about the effects of the campaign on the targeted companies' corporate policies and activities in Sudan. The divestment campaign seems to prompt targeted companies to invest in and carry out significant CSR initiatives in Sudan, as Sudan was frequently mentioned in CSR reports, with

[6] Verdure (2019)
[7] Vergne (2012)

references to various local social activities including education/training, community development, healthcare/medical facilities, environment protection, and charity donations, among others.

We could find only one study addressing the real-life effects of individual stigmatizations (e.g., divestment or exclusion announcements). This only study[8] focused on exclusion announcements by the Norwegian Government Pension Fund Global. The author documents that firms increase their overall ESG scores (especially the E component) following GPFP's exclusions, especially after adjusting it for firm industry affiliation. There are also plenty of examples of companies that were removed from GPFP's exclusion list after complying with the fund's requests. The conclusion of this study could hardly be transposed to commercial funds as the GPFP is among the largest global sovereign wealth funds (with assets under management equivalent to 1,2 trillion USD as of end 2021).

Outcomes of ESG endorsement

To our knowledge, there has been no study addressing the real-life effects of (individual or collective) endorsements of companies by investors.

Outcomes of ESG benchmarking

Several studies have investigated the effects of a firm's addition, continuation, or deletion in major sustainability indices. Two studies obtained that index events had little impact on stock market reactions (Hawn et al., 2018; Durand & Stolowy 2019), in terms of stock price or trading volumes. But market reaction to those events seems to have increased in the most recent years. They also find that sustainability events attract more attention from financial analysts and lead to an increase in the percentage of shares held by long-term investors indicative of a trend that professional investors pay more attention to CSR-visible firms over time.

Slager et al. (2015) used the archives of the FTSE 4 Good Index to examine the effects of several mechanisms on companies' ESG performance. He obtained that firms that faced an exclusion threat from the index or that are actively signaling their ESG performance by relying on third-party endorsements tend to comply more with the index provider ESG criteria and consequently display a higher ESG performance.

In the same spirit, Berk and van Binsbergen (2022) studied the effect of a firm either being included or excluded from the FTSE USA 4 Good Select Index which is replicated by several index funds, especially the Vanguard FTSE Social Index Fund (the largest ESG index fund by market cap) to infer the impact of SRI funds on cost of capital. They find that the difference in the cost of capital between firms that are targeted by SRI funds for their social or environmental costs and firms that are not is too small to meaningfully affect real investment decisions. They estimate that to affect by more than 1 pp the cost of equity capital of targeted firms, impact investors would need to make up more than 80% of all investable wealth.

Berg et al. (2022) examined the impact of ESG ratings on mutual fund holdings, stock returns, corporate investment, and corporate ESG practices, using panel event studies. Looking specifically at changes in the MSCI ESG rating, they document a negative long-term response of stock returns to downgrades and a slower and weaker positive response to upgrades. Regarding firm responses, they find no significant effect of up- or
downgrades on capital expenditure while observing that firms adjust their ESG practices following rating changes, but only in the governance dimension. They conclude that ESG rating changes matter in financial markets, but so far have only a limited impact on the real economy.

Finally, using interviews with managers of rated Italian companies, Clementino and Perkins (2020) provided evidence of considerable heterogeneity in how firms respond to ESG ratings. They documented four types of responses:

[8] Atta-Darkua (2020)

- **Passive conformity**: firms adjust to ratings, albeit largely by changing aspects of their external disclosure and reporting practices to meet the rating agencies' requests,
- **Active conformity**: firms actively respond to ESG ratings, seeking to improve their scores through external reporting, but also through internal changes in processes,
- **Passive resistance**: firms resist ratings by largely choosing to ignore them outright,
- **Active resistance**: firms minimize the impact of ratings or discard their methodologies.

In total, those studies demonstrate a poor effectiveness of benchmarking by ESG rating providers for significantly moving market prices and altering companies' behaviors in the expected direction. Benchmarking would likely be more effective were different ESG benchmarks and ratings consistent—that is, if they identified the same laggards and leaders.

At investor level, the existing literature provides no evidence of investors' indirect impact exercised via their support for ESG ratings or indices. Under existing conditions (i.e., the coexistence of multiple ESG ratings and indices with inconsistent methodologies[9]), it is not clear whether additional investors buying or using ESG ratings will further strengthen the impact of these agencies' benchmarking activities.

The moderators

When does nonmarket signaling lead to the expected impact? We have identified a list of success moderators for the various types of actions.

Moderators of stigmatization/endorsement

- **Investor salience:** a drop in the share price of stigmatized companies and consequential actions by the targeted companies is only possible if the announcing stakeholder is powerful or owns legitimacy[10]
- **Coordination:** the effect of any individual stigmatization/endorsement is enhanced when done in coordination with other investors
- **Importance of social norms among investors:** the effect of collective stigmatization/endorsement movements on market prices is even stronger in financial markets with higher social norms. The performance of sin stocks, for instance, varies considerably between markets with high and low social norms. The stigmatization of fossil fuel stocks by prominent investors will affect alter other investors' decisions more in markets with high social norms and/or with high concern about climate change[11].
- **Importance of companies' ESG reputation to stakeholders:** if stakeholders prefer to work with suppliers or employers who are more concerned about their sustainability, the targeted company will have more incentives to respond to stigmatization by implementing new or better practices to retain its customers or employees.
- **Cost of reform:** when stigmatized, companies will comply more with demands which will entail relatively low costs.

Moderators of benchmarking

- **Consensual methodology:** institutional investors will magnify their individual impact by publicly stating they will follow an ESG benchmark when the benchmark is already widely used by investors or shares the same methodology with other benchmarks.

[9] Berg et al. (2022b)
[10] Mitchell et al. (1997)
[11] Fauver et McDonald (2014)

Conclusion

The mechanism is poorly backed by both theoretical and empirical evidence. The supporting evidence mostly comes from actions by ample social movements or by trillion-large investors and, thus, is not very useful for individual organizations.

As market signaling, the mechanism targets an indirect impact and therefore suffers from being dependent on other stakeholders' actions to be effective.

In total, the mechanism seems too shaky to be used in isolation. Instead, it is doomed to be a complement to other mechanisms. Public endorsement harmoniously complements positive/thematic screening while public stigmatization would enhance exclusion/divestment. The mere possibility of stigmatization (in the form of a threat of divestment) also contributes to the effectiveness of engagement[12] by representing a final step in an escalation policy.

[12] Dimson et al. (2021)

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