WORKSHOP ON ENGAGEMENT:

Making Investment Profits by Improving Corporate Behavior

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Why doing engagement?

Toulouse School of Economics

- Two major motivations
- Investors (institutions and individuals) demand real impact of their responsible investments
- Engagement can also generate investment returns
- Gollier and Pouget (2014) explain why and how engagement can be profitable with “The Washing Machine Strategy”
  - Invest in dirty companies at low prices
  - Turn them into clean
  - Sell back at a premium

Profitable responsible investment?

- For a responsible investor to outperform traditional ones is challenging (Pouget, 2014)

- Consider that CSR pays at the company level, i.e., virtuous firms display higher earnings than vicious firms

- Invest in virtuous companies before the rest of the market

- Invest in dirty companies and turn them into clean

Undervaluation of dirty firms?

- Dirty firm trade at a discount if the controlling shareholders along with the executives are into traditional dirty companies:
  - Do not believe that ESG factors will materialize
  - Do not have the skill or the resources to make their companies clean

- Depending on the relative weights of responsible and standard investors on the market the firm might well be dirty

Engagement strategy

- A standard short-term investor could be tempted to by the Washing Machine strategy: acquire a dirty company, claim that it is going to become clean and resell it to the market

- This strategy is not credible because the market anticipates that:
  - When sold back on the market, the company will revert to dirty
  - The standard investor will not orientate the firm towards more responsibility

- A standard investor thus cannot sell high because the market anticipates that the firm will stay dirty – there is thus no responsibility premium

- Only a long-term responsible investor can profit from engagement

Conditions for success in engagement

- Identify targets in which:
  - Major ESG issues exist but can be fixed
  - Control can be acquired
- Set up appropriate investment funds (private equity or hedge funds) or coordinate various funds (mutual, pension or sovereign wealth funds)
- Be able to invest in dirty firms without to much reputation damage

Relation with empirical evidence

- There is a responsibility premium:
  - Hong and Kacperczyk (2009) on sin stocks
  - Bauer and Hann (2010) on green companies and credit spreads
  - Bauer, Derwall, Hann (2009) on employee relationships and spreads
  - Chava (2011) on green companies and bank loans
- Dimson, Karakas and Li (2012) show that investment strategies based on engagement on environmental and social issues can generate positive abnormal return
- Activism profitable on strategic and governance issues: Brav et al. (2006), Becht et al. (2009)


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An emerging strategy

- The “Washing Machine” strategy has not yet been implemented
- However, a fund, Tau Investment Management, is currently being set up in New York that follows the same principles
- Objective (“*NY firm sees investment opportunity in garment factories*”, Reuters, 9/27/2013):
  - Invest in garment factories in emerging countries (i.e., Bengladesh, Vietnam…)
  - Be a very active minority shareholder
  - Transform companies mainly by improving labor conditions (compensation, security, training…) and supply chain organization
  - Resell shares on stock markets

Conclusion

- To benefit from the “washing machine” strategy, SRI should:
  - Invest in non responsible firms and turn them into responsible
  - Have a long-term orientation
  - Have a credible orientation towards social responsibility
- Strategy can be implemented
  - Alone by SRI private equity or hedge funds
  - In group by SRI mutual funds or pension funds
- Caveat:
  - Investing in non responsible firms raises a reputation issue for SRI