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Strategies for Responsible Investing: Emerging Academic Evidence*

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Abstract: We contrast and evaluate two of the most popular responsible investing strategies employed at present: negative screening and engagement. As a backdrop, we consider the challenges faced by the University of Cambridge, which mirror those experienced by institutional investors worldwide. Specifically, we make use of issues raised at the recent "Divest or Engage?" conference at the University. We discuss emerging academic evidence from recent, and hitherto unpublished, papers in order to provide an up-to-date perspective. We describe the challenges in excluding undesirable assets from investment portfolios and present evidence on the effectiveness of engaging with investee companies. The strategies of divestment and engagement are often employed as complements to each other and this can be advantageous. We caution that investors need to be aware of the disquieting evidence that ESG metrics differ considerably across rating services, and the choice of data provider can have a fundamental impact on the ESG credentials of institutional portfolios.

Key takeaways:

Engagement: On average, companies that have successfully been engaged have subsequently had enhanced financial and stock-market performance.

Divestment: Responsible investing strategies often incorporate both exclusion policies and engagement. Support for exclusion can vary based on its motivations.

Ratings: ESG scores from different providers have low correlations among one another. Choosing an ESG provider involves buy-in to their choice of methodology.

Keywords: ESG; Responsible investing; Divestment; Engagement; Climate change; Portfolio investment; Voice and exit; Coordinated engagement

JEL codes: G11; G15; G23; G39; G40; M14; Q54

Strategies for Responsible Investing: Emerging Academic Evidence

The University of Cambridge, an institution dating back to 1209, has recently found itself in the centre of one of the more prominent responsible investing debates taking place at present. In a series of events described by Chambers, Dimson, and Quigley (2020), the University lost most of its investment team in 2019 in the midst of deliberations on its holdings in fossil fuel companies. A new CIO was recently appointed and additional members of the team are being recruited. However, the dilemma remains regarding how best to incorporate responsible investing practices into what is one of the largest academic endowments in the UK. In total, the University has £8 billion in endowment assets, of which the Cambridge University Endowment Fund (CUEF) has £3.4 billion while the remaining part represents assets belonging to the University's 31 constituent colleges. In brief, Cambridge's assets are of a significant size, even by US endowment standards.

A substantial number of current students, prominent alumni and eminent scholars advocate for divestment (zerocarbonsoc.soc.srcf.net). The University's science departments have established links with companies in the energy industry, which campaigners argue has resulted in a reluctance to divest fossil fuel companies from the University's investment portfolio; see Morison et al. (2019). On the other hand, research from respected universities and business schools shows that engagement with companies on environmental and social issues can achieve a significant level of impact, as documented by Dimson, Karakaş, and Li (2015, 2019) and Hoepner, Oikonomou, Sautner, Starks, and Zhou (2019).

The University provides a special setting for this debate not only because of its size but also because of its research centres with a focus on climate change and responsible investing. Based in Cambridge Judge Business School, the Centre for Endowment Asset Management has faculty with research specialisations in ESG and investing for the long term. Over the period since 2013, the Centre for Endowment Asset Management has hosted a variety of research conferences on divestment and engagement. The Cambridge Institute for Sustainable Leadership focuses on providing research and solutions for sustainability within the financial sector and the real economy. The Cambridge Centre for Climate Science (CCfCS) aims to promote climate science research projects (climatescience.cam.ac.uk).

Many other Cambridge teams work in this area. The Cambridge Conservation Initiative (CCI) combines academic research and non-profit work on biodiversity and conservation. The Bennett Institute features a work stream on climate policy issues. The Centre for the Study of Existential Risk (CSER) includes a research focus on climate collapse and sustainable finance. The Engineering Department boasts a group that works on the circular economy. Cambridge Zero helps disseminate the knowledge on climate change and green technologies. With the wealth of knowledge and expertise held within the University, and the passionate debates

provoked by activists, the institution serves as a microcosm of the responsible investing challenges faced by other investors.

In this article we provide an overview of research presented in a recent conference entitled *Divest or Engage? Strategies for Responsible Investing*. We address the challenges faced by practitioners who seek to invest responsibly, and highlight some of the evidence-based insights that academics can provide. We emphasise recent studies that have not yet been published but which make a meaningful contribution to the debate. Organised by CEAM (ceam.jbs.cam.ac.uk) and the European Corporate Governance Institute (ecgi.global), the conference was held in October 2019 (see jbs.cam.ac.uk/ceam-divestorengage). The event's structure, speakers, papers and discussants are presented in Exhibit 1.

[Insert Exhibit 1 about here]

DIVEST OR ENGAGE?

Academic research on finance can sometimes appear ethereal, addressing questions that appear far removed from the issues of the day. But investment policy is an important, contemporary challenge, and we chose to start the conference by focusing on the debate within the University. The key topic for our meeting – whether the endowment should divest from or engage with some of its holdings – set the scene for the day. This was followed by research presentations weighing in on this discussion. Finally, a panel session allowed practitioners to address issues that resonate most with them and to share their insights with academic attendees.

The main takeaway from the event was that there is an expanding body of evidence that engagements can affect company behaviour and lead to improved outcomes. However, there are also occasions when traditional methods such as divestment can be employed. Preliminary survey findings were shared, documenting the relative support of different motivations for sector exclusions among investment professionals from a variety of countries. Crucially, it was stressed that ESG metrics have been found to vary significantly across providers, and practitioners consequently need to be aware that their decision on an ESG data provider has broader implications. Investors are not only purchasing an ESG data source; they are also having to buy in to a particular methodology for interpreting existing data.

In the following sections of this paper we describe in more detail the discussions that took place. We present evidence on negative screening and on company engagement. We then examine the disquieting disagreement between alternative providers of ESG metrics. We end with a brief summary and conclusion.

Divestment: Evidence and Concerns

Marco Becht, from Université libre de Bruxelles, opened the conference, stressing the importance of sound research for informing policy debate. Then, David Chambers, from the University of Cambridge, presented a case study of the challenges faced by his university in the responsible investing space. The case, "To Divest or to Engage? A Case Study of Climate-Change Activism," is by Chambers, Dimson, and Quigley (2019). He explained that the University has a wide variety of stakeholders, including current students, staff, faculty, alumni, future students, and donors. Furthermore, some assets are held by the University, while others belong to its 31 constituent colleges, further complicating the coordination of a consistent policy. Increasingly stakeholders are expecting the University to invest its endowment in a responsible manner. Specifically, at present there is heated debate on whether the endowment should exercise divestment or engagement.

David provided some context for deliberations on exclusion of targeted companies from institutions' holdings. The last major divestment campaign was related to companies involved with the South African regime during the Apartheid era. Teoh, Welch, and Wazzan (1999) found that the direct effect of divestment on share prices was negligible. More recently, Atta-Darkua (2019) has documented that ethical exclusions by the Norwegian Sovereign Wealth Fund can adversely affect firm equity values in the short run. A complementary view, proposed by some conference delegates, is that divestment could be regarded as a tool to influence government policy and public opinion, possibly making financial considerations secondary.

At the same time, investors could face financial costs due to exclusions. Hong and Kacperczyk's (2009) seminal study found that "sin stocks" tend to outperform. Dimson, Marsh, and Staunton (2015) examined sector returns over a period of more than 100 years and demonstrated that the highest-performing sectors have been Alcohol in the UK and Tobacco in the USA – both sin sectors. Exhibit 2 presents an update on their results from Atta-Darkua, Chambers, and Dimson (2019). Furthermore, divestment can have unintended consequences. Davies and Van Wesep (2018) build a model in which black-listing can in effect benefit the managers whose companies are being targeted as it may increase the value of the some of their compensation packages. Finally, reflecting the rising popularity of responsible investing, some organisations may use negative screening to attract investors to ESG-branded products. Consistent with this, Hartzmark and Sussman (2019) and Ceccarelli, Ramelli and Wagner (2019) report that funds labelled by Morningstar as Sustainable or Low Carbon experience fund inflows.

[Insert Exhibit 2 about here]

Vaska Atta-Darkua, also from the University of Cambridge, presented new evidence on the merits of sector exclusions. Her presentation on "Survey on Sector Exclusions" by Atta-

Darkua and Dimson (2019), indicated that financial professionals are aware of these issues. She aimed to shed light on the deliberations that underpin divestment policies – a process that often happens behind closed doors. Initial results showed that professionals were relatively sympathetic towards using exclusions as a branding tool to attract investor funds, and least sympathetic towards a risk management motive for divestment. The paper found heterogeneity in the exclusion preferences of professionals. Some are "sceptical" about exclusions, some are supportive for some reasons but not others ("questioners") and some favour divestment strategies ("devotees"). However, despite differences in support for sector exclusion, few respondents are climate-change deniers. Among all clusters, there is almost universal belief that global warming is happening and the large majority consider human activities to be the main contributor. Therefore, it did not seem to be the case that climate change scepticism is the cause of divestment scepticism.

Marco Becht discussed Vaska's presentation and proposed distributing the survey digitally in order to increase the sample size, while also adding a higher number of behavioural finance questions to it. Comments from other individuals echoed the research findings. One argument focussed on the heterogeneity of the beneficiaries whom trustees and investment managers serve. In such a setting, there can be disagreement on whether divestment should be employed and, if so, which sectors or companies should be targeted. Strong concern was expressed about the uncertainty of professionals as to whether outspoken critics and public protestors are representative of the silent majority.

An issue raised by discussant Carole Ferguson from CDP (cdp.net) was whether exclusion activists are targeting the companies most responsible for carbon emissions. She explained that emissions comprise both Scopes 1 and 2 (direct firm emissions and indirect emissions stemming from energy inputs) and Scope 3 (indirect emissions in the company's value chain) and displayed Exhibit 3. It was apparent that while Oil & Gas and Mining have high Scope 3 emissions, companies in the Cement and Steel industries are top contributors when looking at revenue-adjusted Scope 1 and 2 emissions. Therefore, the Scope 3 emissions of Oil & Gas companies are intrinsic to products on which society is heavily reliant. These industries have so far escaped the attention of most divestment campaigners. Furthermore, she cautioned that wholesale divestment of Oil & Gas may have greater impact on firms whose shares are more widely held. Yet those public companies may be lower polluters than less widely held or privately owned companies. Consequently, Carole argued, engaging with Oil & Gas companies on the direction of their capital expenditure may provide a better outcome for climate change.

[Insert Exhibit 3 about here]

Evidence on Engagements

The emerging evidence on the impact of engagements and how they can be complimentary to exclusions was a major theme in the conference. Industry practitioners often note that divestment can be employed as a last resort following unsuccessful engagements, and as a credible threat to firms. Julian Franks, from London Business School, described work with his co-authors that provides support for the use of this channel and shows that it can also be profitable for investors. Their paper is "Corporate Governance Through Exit and Voice" by Becht, Franks, and Wagner (2019). It makes use of proprietary data from Standard Life Investments (SLI; today Aberdeen Standard Investment), a large asset manager in the UK, to examine the relationship between an active asset manager's engagement and trading decisions for portfolio firms. Private engagements on governance and other issues with UK-based firms were shown to be powerful in driving trading decisions. SLI engaged more intensely with firms placed on a watch list and was more likely to abstain or vote against management proposals at such firms. Consequently, a higher proportion of SLI's funds became net sellers after an analyst switched to a sell recommendation or after a shareholder meeting at which SLI failed to support management. The paper therefore provides support for engagement (the use of "voice") influencing divestment ("exit").

Drawing on his experience with Hermes Investment Management, Michael Viehs' discussion of the paper raised the possibility of exploring the nuances of disagreements in engagements. He also added that it would be beneficial to examine whether engagement meetings are used primarily for information gathering or as tools to promote behavioural changes. Engagements with diverse primary purposes could have a differential impact on analyst recommendations and the fund manager reactions to them. Julian compared the information released in an engagement to "the last tile in a mosaic". If the severity of disagreement exhibited in a meeting was too large, the outcome could be a complete divestment from the portfolio company. An example he used was when in 2017 SLI terminated all positions in the London-listed company, Sports Direct. He also added an information gathering meeting could reveal private information about how a portfolio company internally thinks of the ESG issues.

Engagement has also been shown to affect firm behaviour. Vicente Cuñat, from the London School of Economics, presented a clinical study on how firms react to changes in the governance preferences of a large institutional investor. The paper "The Firms' Reaction to Changes in the Governance Preferences of Active Institutional Owners", by Aguilera, Bermejo, Capapé, and Cuñat (2019), used the sudden change in governance preferences of Norway's sovereign wealth fund. The overall governance index of the fund's portfolio firms increased after the announcement compared to firms outside the portfolio. However, not all portfolio firms improved their governance. Specifically, larger and more liquid firms with good financial performance did not react to the announcement. Similarly, firms in countries with poor pre-

existing governance also did not enhance their governance index. Overall, the study showed how large funds can systematically impact their portfolio firms' corporate governance. The paper was discussed by Ola Mestad, who was the chair of the Council on Ethics for the Norwegian Government Pension Fund at the time of the governance announcement, and as such was uniquely placed to comment on it. He made helpful suggestions for further tests to evaluate the robustness of the findings, such as exploring potential relationships with the 2008 Global Financial Crisis or governance developments in the affected firms' countries.

Prior research by Dimson, Karakaş, and Li (2015), using US data, had shown that successful engagements can be financially advantageous for firms and investors (see Exhibit 4). Extending from a single-country, single-investor perspective to a global setting, Elroy Dimson, from the University of Cambridge, presented research on international collaborative engagements using the platform of the UN PRI, the Principles for Responsible Investing (unpri.org). The paper, "Coordinated Engagements" by Dimson, Karakaş, and Li (2019), confirmed the post-engagement outperformance of their US study for successful dialogues. He reported that coordinated engagements are especially likely to be effective when there is a local lead investor and supporting investors from around the world. A high degree of participation by pension plans was also found to improve the chance of executing a successful collaborative engagement. Furthermore, engagements were more likely to be successful when they involve influential investors, with higher assets under management, larger aggregate holdings in the target company, and more satisfied employees. It was interesting to learn that investors' decisions to engage and lead are shaped by home bias (cultural similarities) and free-riding concerns outside and within a coalition.

[Insert Exhibit 4 about here]

Jocelyn Brown, of the Railways Pension Scheme, discussed this presentation. She suggested that future research could extend the analysis to investigate how other models of engagement influence the effectiveness of collaboration, such as where support is provided by an external secretariat versus collective engagements managed by the investors themselves. She provided the example of certain collaborations specialising in a specific market or theme of engagement, climate change being an example. She also noted that coalitions which require substantive dialogue with companies are more likely to be successful with a focussed target list. Jocelyn remarked that engagements tend to peak either just before an Annual General Meeting (AGM) or in the off-season, for instance, when a company consults on a potential remuneration policy scheduled for a vote at the next AGM. A future area of research could be how outcomes are affected by the timing of an engagement, such as whether it follows an AGM, with a high degree of investor dissent. It could also be interesting to model the impact of public AGM statements and shareholder resolutions on engagement outcomes.

Conference participants expressed the view that they were encouraged by the empirical evidence on the effectiveness of the engagement channel in changing firm behaviour. However, some noted that engagements can have limited impact in the case of majority state owned companies, many of which are in the oil and gas industry.

RATINGS DISAGREEMENT

An additional source of concern relates to the widespread and growing use of ESG ratings. Increasingly, investors incorporate ESG metrics into the portfolio management process. However, there are multiple providers and an emerging body of evidence demonstrates that ESG scores may not be consistent with one another. Rajna Gibson, from the University of Geneva, presented the paper "ESG Ratings disagreement and stock returns" which highlighted the issue of ESG rating disparities. With her co-authors, she has assembled data from six leading ESG services and examined how they compare against each other. The evidence, presented in Gibson, Krueger, Riand, and Schmidt (2019), is based on a sample of S&P 500 firms from 2013 to 2017. The authors' results, in Exhibit 5, show that the average correlation between the ESG ratings from the six ESG providers is 0.47. It is highest for the environmental (0.43) and lowest for the governance dimension (0.19).

Another study, done independently by LaBella, Sullivan, Russell, and Novikov (2019), finds similar correlations: 0.40 overall, and also highest for the environmental (0.29) and lowest for the governance dimension (0.16). Rajna's results are well corroborated. A member of the audience observed that the ESG rating discrepancies are in marked contrast compared to the strong observed correlations between Moody's and S&P ratings. Moreover, the disagreement is higher for larger, less profitable firms, and firms without a credit rating.

Rajna also reported a relationship with company returns. In common-law countries, large disagreement about governance related non-financial information is associated with low future stock returns, which is consistent with a mispricing explanation. In civil-law countries, large disagreement about social related non-financial information is associated with low future stock returns, which is similarly consistent with a mispricing explanation. In contrast, disagreement about environmental ratings positively correlates with stock returns, which is consistent with a risk-based explanation. The authors are continuing to investigate this intriguing observation.

[Insert Exhibit 5 about here]

Oğuzhan Karakaş, from the University of Cambridge, discussed the paper. He queried whether the results could be related to the sorting mechanism which the authors employ, and wondered if there may be potential non-linear relations across or within ratings. He further suggested that "sin" stocks, and other characteristics such as short-sale constraints faced by firm

investors could be analysed to help calibrate the model. He asserted that heterogeneous beliefs play a key role in the value of corporate control, and highlighted that it could be useful to see if rating disagreements also related to the prediction of voting outcomes in shareholder meetings and to success of shareholder engagements with firms. Moreover, there could be value in examining the most critical or correct ratings among the six ESG ratings. He noted that while there seems to be no effect on stock return volatility, there could be one on firm downside risk. Finally, the fact that some of the S&P 500 firms do not have credit ratings was considered puzzling.

Overall, the inconsistency between different ESG ratings had a particular impact on conference participants. Several other teams of academics have noted the discordance between competing sustainability rating agencies, including work by Berg, Kölbel, and Rigobon (2019), Diebecker, Rose, and Sommer (2019), Doyle (2018), Kotsantonis and Serafeim (2019), and Yang (2019). The disquieting differences between raters have also been noted in the financial media. Most papers in this area offer explanations for their observations, but findings such as those reported by Gibson, Krueger, Riand, and Schmidt (2019) raise doubts as to whether, investment managers and asset owners have an adequate understanding of the dataset and analytics on which they rely.

The implications of these disagreements were discussed in more detail by the panel. Richard Robinson, from the Paul Hamlyn Foundation, chaired the discussion and guided deliberations on the topic. Aled Jones from FTSE Russell spoke in favor of having different ESG ratings stating that buying ESG ratings goes beyond purchasing standardized information and also encompasses having an understanding of the providers' unique methodologies. Jane Firth, of the Border to Coast Pension Partnership, agreed. She noted that the low correlation among different ESG ratings could stem in part from differences in emphasising each pillar (Environmental, Social & Governance). She also pointed out that we would expect portfolio managers to put resources behind making each investment decision rather than blindly following a specific ESG rating. In contrast, George Dallas, Director of the International Corporate Governance Network, noted that the low correlations can be viewed as discouraging since it indicates that we still do not have a common definition of ESG issues. In the same vein, Lesley Sherratt, Trustee of the Medical Research Foundation, noted that the Environmental ratings pillar can embrace issues beyond those of climate change, which can sometimes be overlooked given the current focus on the fossil fuel industry.

CONCLUSION

In this article we provide an overview of the emerging evidence for the two most popular responsible investing practices at present. We have made use of recent papers, the majority of which have not yet been published in finance journals, in order to bring to attention the latest

work in the field. The debate on the optimal responsible investing approach is still evolving. For many investors, a major decision is whether to choose exclusion, engagement, or both. Recently, the fossil fuel divestment movement has brought negative screenings back into consideration. However, engagement is also gaining traction, with professional organisations emerging to help facilitate collaboration among investors and dialogue with investee companies.

Empirical evidence has shown that engagement can be an effective tactic in some cases and can help enhance firm behaviour. The evidence for divestment having a direct impact on firms is more mixed. However, many view negative screening as a tool with wide-reaching impact on the political and societal stage, which they prize above immediate financial influence. In practice, at present, both strategies have a following among investors, with many opting for a combination of both. A survey conducted at the *Divest or Engage* conference had almost half (47%) reporting that in the case of fossil fuel companies they believe in pursing both divestment and engagement. More than half (57%) said the University of Cambridge should pursue a combination of the two strategies.

In either case, responsible investors need to be cautious about the data they use to make decisions. We have shown how ESG metrics from different providers have been found to exhibit substantial levels of disagreement, implying that the choice of an ESG data provider may have more far reaching consequences than many investors are aware of.

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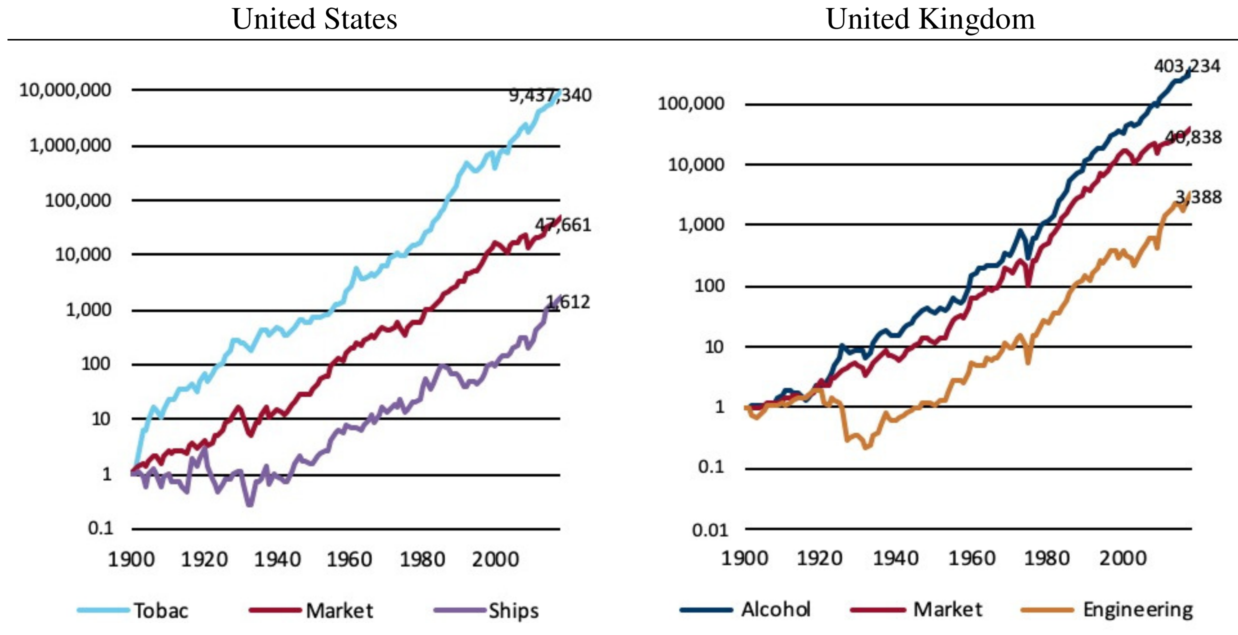
Exhibit 1: Conference Structure, Presenters, Papers and Discussants

Session	Presenting author*	Paper	Discussant
1: Setting the scene Chair: Marco Becht	David Chambers	To Divest or to Engage? A Case Study of Climate-Change Activism	Carole Ferguson
	Rajna Gibson	ESG Rating Disagreement and Stock Returns	Oğuzhan Karakaş
2: Responsible investing Chair: David Chambers	Vicente Cuñat	Firms' Reaction to Changes in the Governance Preferences of Active Institutional Owners	Ola Mestad
	Vaska Atta-Darkua	Survey on Sector Exclusions	Marco Becht
3: Voice and exit Chair: Bang Dang Nguyen	Julian Franks	Corporate Governance through Voice and Exit	Michael Viehs
	Elroy Dimson	Coordinated Engagements	Jocelyn Brown
4: Practitioner discussion Chair: Richard Robinson	Panellists: George Dallas, Jane Firth, Aled Jones, and Lesley Sherratt		

* Co-authors listed in the References

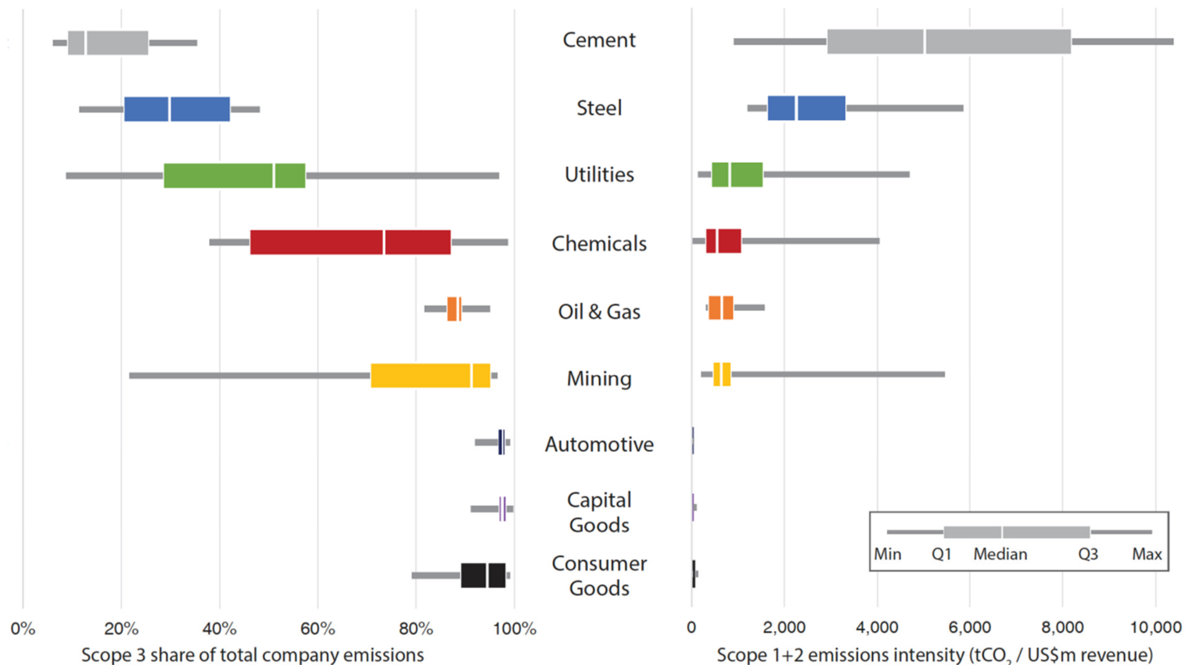
Exhibit 2: Cumulative total return from the market and from “sin” sectors, 1900–2019

[Copyeditor: this chart will be reformatted when it is updated to end-2019]



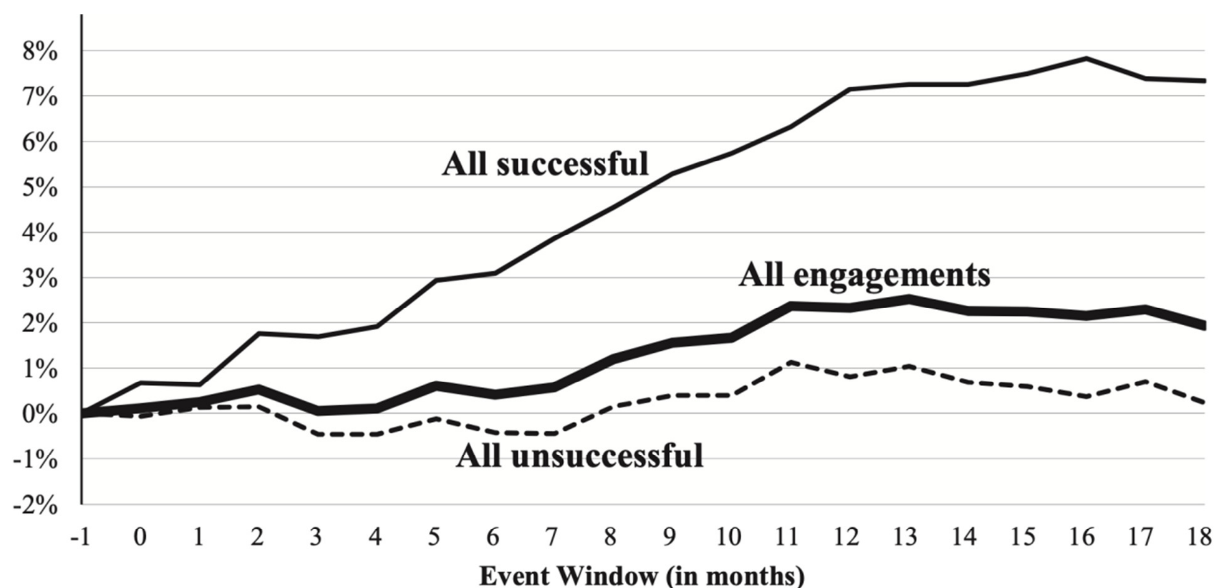
Sources: Dimson, Marsh, and Staunton (2015), extended in Atta-Darkua, Chambers, and Dimson (2019).

Exhibit 3: Sector comparison - share of Scope 3 and Scope 1+2 emissions intensity



Source: CDP Investor Research

Exhibit 4: Cumulative abnormal return after engagement with US companies



Source: Dimson, Karakaş, and Li (2015)

Exhibit 5: Correlation between ESG ratings from six ESG rating providers

	Asset 4	Sustainalytics	Inrate	Bloomberg	KLD	
Asset 4						
Sustainalytics	0.77					
Inrate	0.23	0.30				
Bloomberg	0.75	0.72	0.12			
KLD	0.59	0.62	0.29	0.54		
MSCI IVA	0.43	0.47	0.32	0.32	0.47	
Average correlation						**0.47**

Source: Gibson, Krueger, Riand, and Schmidt (2019).