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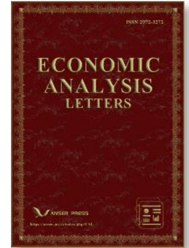

ESG-focused hedge fund activism

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ABSTRACT

Investment funds are increasingly focusing on ESG issues, seeking to contribute to improving environmental, social, and governance concerns. ESG-focused investing involves promoting good ESG performance and may result in a decrease in expected financial returns. This may lead to a conflict between solely profit-focused shareholders and ESG-focused investors, who may respond accordingly. As such, a firm's ESG commitment may trigger several events that can affect the stock price. A firm's ESG commitment may increase its stock price; however, the end of such commitment may also positively affect the stock price. Hedge funds may consider this in their activism which may reshape the way hedge funds target firms and influence their actions accordingly.

KEYWORDS

ESG; stock price; systematic risk; hedge fund; activism

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1. Introduction

As a consequence of human-induced climate change, some corporate entities with an outsize impact on climate change due to their carbon emissions have announced plans aiming at reducing carbon emissions (Armour et al., 2022). On top of that, a growing number of investment funds are focusing on Environmental, Social, and Governance (ESG) issues. In addition to generating a financial return, these funds seek to contribute to improving ESG concerns. ESG-focused investing increasingly involves exercising voting rights associated with promoting good ESG performance. ESG-focused firms may even deliver equivalent financial performance to those that do not employ ESG criteria depending on whether ESG performance and financial performance are aligned (Armour et al., 2022). Where this is not the case, investors have to accept a decrease in expected financial return as a trade-off for other gains stemming from their ESG commitment. For ESG-focused investors, the objective is not solely centered on financial gains; they may be interested in investing in firms that prioritize and enhance ESG concerns, even if such commitments do not necessarily yield surplus financial returns. This may be an undesired outcome for solely profit-focused shareholders that hold stocks along with ESG-focused investors in the same firms. The potential decrease in financial returns and increased popularity among ESG-focused investors may lead other profit-only focused shareholders to respond accordingly. This dynamic shows that a firm's decision to commit to ESG may trigger several events that may affect the stock price. Consequently, a firm's announcement to commit to ESG may drive financial actors to respond, and thus not only long-term but also short-term effects on the stock price may occur. An ESG commitment may improve or even worsen the stock price. When it increases the stock price, it may not necessarily increase the firm's value as will be later shown This brings forth the consideration of hedge fund activism, which typically focuses on short-term gains. As ESG criteria start to play a more prominent role, it is likely to reshape the way hedge funds target firms and influence their actions accordingly. Based on the findings of Baker in its paper, such ESG criteria do not appear to have been considered in hedge fund activism prior to 2016 (Baker 2023).

Hedge funds may consider incorporating ESG factors into their decision-making process when selecting firms for their activism. Transforming a profit-only-focused firm into an ESG-focused one may potentially increase its stock price; also optimizing the ESG commitment of a company can positively impact profits gained through hedge fund activism. Conversely, a firm may reduce or even abandon its ESG commitment by transitioning it into a profit-only entity, which could also boost profits. By strategically integrating one of these approaches with their regular activism, hedge funds may be able to improve their profits, too.

Such ESG-focused hedge fund activism may, however, face practical challenges stemming from uncertainties revolving around ESG, particularly climate change. For instance, climate risks may not be accurately incorporated into asset prices as a result of, among others, shareholders' and analysts' lack of required asset-level data to make climate-risk assessments, outdated assessment methods, and the short-term focus of managers (Condon 2022).

In the following, it will be examined how hedge funds may enhance their profits through ESG-focused activism and which firms would be the most suitable for improving profits. First, it will be examined what effect a firm's ESG commitment may have on the stock price (II.). Based on these findings, it will be demonstrated how hedge fund activism may be affected by the potential effects of a firm's ESG commitment (III.). Lastly, it will be briefly addressed whether a change in policy may be needed in response to ESG-focused hedge fund activism (IV.).

2. Effect on Stock Price

2.1. Effect on Firm's Earnings

If a firm may want to make ESG compliant investments these investments tend to have smaller net present value

(NPV) than those that are not ESG-compliant; this particularly may hold true in the context of climate-friendly ("green") investments. Simply put, the firm may generally expect fewer financial returns if it opts for ESG compliant investments. In this case, the firm's overall earnings through investments would be decreased by ΔNPV_1 which is the overall NPV of its investments if they were non-ESG compliant deducted by the overall NPV of its project if some or all were ESG-compliant. The stock price would thus decrease by $\frac{\Delta NPV_1}{n} = \mathcal{B}$, where n is the number of outstanding shares.

When a firm commits to ESG, it may have or may not affect the firm's operational performance; such commitment could nevertheless result in costs for the firm. For instance, if a firm plans to reduce its climate change risks exposure, it may need to conduct a comprehensive analysis to identify the risks and the adequate actions for reducing the risk exposure. This can be difficult given the great uncertainties revolving around climate change. Consequently, such analysis may incur significant information costs (I_C) for acquiring, processing, and verifying information. These costs may be reoccurring due to the need for continuous reassessing as a consequence of the changing circumstances or information concerning climate risks. Suppose the firm decides to act on the information it has collected and thereby enforce its ESG commitment. In that case, it could either make ESG compliant investments or take actions (that are not investments) to reduce its risk exposure or both. The latter may also be associated with costs (A_c). The firm's total cash (C_0) would thus be reduced by these commitment costs $(C_1 = C_0 - I_C - A_c)$.

In case of reoccurring commitment costs, a firm would have ΔC $(= C_0 - C_1)$ fewer earnings which it could use for investments or the distribution of dividends. If a firm were to use all of its earnings to distribute dividends, its earnings per share $(EPS = \frac{Earnings}{n})$ would be reduced too: $EPS_1 = \frac{Earnings - \Delta C}{n}$ (n being the number of outstanding shares). The stock price (P_S) itself is determined by the firm's projected future earnings per share discounted by the firm's capitalization rate $(E(R))$: $P_S = \frac{EPS}{E(R)}$. The stock price would thus decrease in the amount of $\frac{\Delta C}{n \times E(R)}$ if the costs are reoccurring in terms of a perpetuity. If they are expected to occur in a certain time period t only, the stock price would be reduced by $\sum_0^t \frac{\Delta C}{n} \times \frac{1}{(1+E(R))^t}$. If they are not reoccurring, the stock price would be reduced by $\frac{\Delta C}{n}$. It may be more realistic to assume that the commitment costs will decrease over time and remain constant after a certain time period. As such, it may be appropriate to account for this decline – for simplicity – through a constant factor (ε). The decrease in stock price would thus be $\Upsilon = (\sum_0^t \frac{\Delta C_{t=0} \times (1-\varepsilon)}{n} \times \frac{1}{(1+E(R))^t}) + PV \frac{\Delta C_t}{n \times E(R)}$.

If, on the other hand, the firm uses all of its earnings for investments, then the sum of all of the firm's net present value (NPV) projects would be reduced by the NPV of an investment using ΔC:

$\Delta NPV_2 = -\Delta C + \sum_1^t \frac{C_t}{(1+r)^t}$ where $\sum_1^t \frac{C_t}{(1+r)^t}$ is the sum of all future cash flow discounted to the present value and generated through an investment of ΔC. Thus, the firm's market value would be reduced by ΔNPV_2, and the stock price will decrease by $\frac{\Delta NPV_2}{n} = \mathcal{R}$. If a firm uses some of its earnings for paying out dividends and some for investments, then ΔC may be distributed accordingly among these two and Υ and $\mathcal{R}$ change respectively by using ΔC_D or ΔC_I instead of $\Delta C (= \Delta C_D + \Delta C_I)$.

If a firm uses a part of its earnings for investments and a part for distributing dividends, a commitment to ESG

would reduce the stock price by $\mathcal{R}+\mathcal{B}+\Upsilon$. The higher the firm's commitment costs C_1 are and the less future cash flow it expects due to its ESG-compliant investments (ΔNPV_1) the more it will negatively affect the stock price.

2.2. Effect on Systematic Risk Exposure

If a firm commits to ESG, it may also effectively reduce the systematic risks it is exposed. This would in turn positively affect the stock price as such a firm's stock would be less sensitive to market movements, thus the firm's Beta (β), which indicates a firm's market sensibility, may decrease. Less risk exposure will then be rewarded with a higher stock price. A decrease in a firm's Beta would result in a decline of the firm's capitalization rate ($E(R)$) given that: $E(R)=r_f+\beta(r_m-r_f)$.

If the firm's capitalization rate before the reduction of systematic risk $E(R)_0$ is greater than after $E(R)_1$ the more the stock price will go up. Consequently, the stock price will change by $\Delta P_S=EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$ given that $P_S=\frac{EPS}{E(R)}$.

2.3. Potential Development of Stock Price

While the reduction of systematic risk exposure may positively affect the stock price, the costs for the ESG commitment, and loss of future cash flow may negatively affect the stock price. It is thus possible that the stock price may either not change, go up, or go down.

If the firm commits to ESG and does not reduce its systematic risk exposure, then the price change will be: $\Delta P_S=-\mathcal{R}-\mathcal{B}-\Upsilon$ where $\Delta P_S<0$, if $C_1>0$ or if $\Delta NPV_1>0$.

If the firm commits to ESG and reduces its systematic risk exposure, the price change will be: $\Delta P_S=-\mathcal{R}-\mathcal{B}-\Upsilon+EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$ where $\Delta P_S<0$, if $\mathcal{R}+\mathcal{B}+\Upsilon>EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$, and $\Delta P_S>0$ if $\mathcal{R}+\mathcal{B}+\Upsilon<EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$. A firm's announcement, however, may also attract ESG-focused investors that purchase the stock only or mainly because of ethical reasons. Due to this, the stock may become overvalued as "noise" (α) – particularly from the perspective of non-ESG-focused investors – is included in the stock price. The actual price change would thus be $\Delta P_S=\alpha-\mathcal{R}-\mathcal{B}-\Upsilon+EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$. The more ESG-focused stockholders exist, the bigger α becomes. If profit-only-focused investors know that some ESG-focused investors may purchase the stock for mere ethical reasons, they may be less inclined to purchase the stock when α reaches a certain point as the stock may be too "overvalued" from their point of view. In response, the profit-focused investors may short the stock resulting in a lower stock price. This may happen after the announcement at the time t_1 when the "noise" $\alpha(t_1)$ created through ESG-focused investors becomes too big. In that case, the highest payoff could be achieved by purchasing the stock before the announcement (t_{-1}) and by shorting it at t_1: $P_S(t_1)>P_S(t_0)>P_S(t_{-1})$.

In conclusion, the stock price may positively develop for a profit-only firm that commits to ESG if $\mathcal{R}+\mathcal{B}+\Upsilon<\alpha+EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$. On the other hand, a firm may also improve its stock price by changing from an ESG-focused firm to a profit-only one if $\mathcal{R}+\mathcal{B}+\Upsilon>\alpha+EPS\left(\frac{1}{E(R)_1}-\frac{1}{E(R)_0}\right)$.

3. Effect on Hedge Fund Activism

If a firm's announcement to commit to ESG may lead to a positive stock development, as displayed above, then profit may be generated by purchasing stock at t_{-1} and shorting it at t_1. Also, a firm's announcement to stop its ESG commitment may positively affect the stock price, as shown above, and thus allow for profit. These profit opportunities may affect hedge fund activism, particularly the criteria that determine their targets. For instance, if a hedge fund purchases stock of a non-ESG firm that could credibly commit to ESG without incurring much or even any costs associated with such commitment and at the same time reduces its systematic risk exposure, it could turn profit by turning a firm into an ESG-focused one. Also, hedge funds may target already ESG-focused firms whose stock price could increase by ending the ESG commitment. That would be the case for firms whose stock price gain by reducing systematic risk exposure does not outweigh the costs and loss incurred through an ESG commitment. It is also possible to turn a profit by making a firm's ESG commitment economically more efficient by reducing commitment costs and systematic risk exposure.

Hedge funds may solely focus on flipping the firm either into an ESG-focused or profit-only one, or they may combine ESG-related activism with their regular activism to even further enhance profits. Hedge funds may thus consider whether (more) profit could be generated through ESG-related activism. This may change the types of firms they usually target for activism.

4. Legal Implications

If a firm's strategy comprises turning an ESG-focused firm into a profit-only firm, it raises the question of whether such ESG-unfriendly activism should be allowed. However, as long as the prevailing view in the respective jurisdiction is that a corporation's purpose is to maximize shareholder wealth ESG-unfriendly activism may be permitted if it in fact would lead to an increase in stock value. This would limit boards' ability to adopt defense measures. Although such activism may face practical challenges if a significant amount of stockholders are ESG-focused, it would still be within the confines of the law. It may thus be complemented to reward a firm's commitment to ESG, making it less likely that hedge funds would stop firms' ESG commitments. At the same time, it would encourage ESG-enhancing activism. Rewards could be, for instance, in the form of reduced corporate taxes for ESG-committed firms – although this may be difficult to implement in practice. Alternatively, if firms and investors were explicitly required to incorporate ESG aspects into their investment decision-making processes, hedge funds may face hurdles in ESG-unfriendly activism. Mandatory disclosure in conjunction with comply-or-explain mechanisms could be used to encourage the companies to take relevant ESG factors into account in their investment decisions as part of their fiduciary duty to investors.

5. Conclusion

A firm's ESG commitment may have substantial impact on its stock price. While such commitment may increase the stock price by reducing certain commitment costs and systematic risk exposure, in most cases the stock price may go up due to a decrease of future cash flows that ESG compliant investments tend to offer. A shareholder of a firm may consequently earn profits if an ESG-focused firm ends its ESG commitment; also possible, yet less likely, profit may be generated if a profit-only-focused firm commits to ESG. Hedge funds may consider this when determining their targets to further enhance their profits. When it comes to turning ESG-committed firms into profit-only-focused firms in particular, the question arises whether this should be allowed without any legal restrictions. In jurisdictions where maximizing shareholder value is the corporation's purpose, such endeavors may not only be allowed but intended.

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Conflict of interest

The author claims that the manuscript is completely original. The author declares no conflict of interest.

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