Comments on “Nordic Ecolabelling of Investment funds for consultation”

These comments are a joint statement from researchers affiliated with the Mistra Financial Systems research program, housed at the MISUM center at the Stockholm School of Economics.[1] *The comments are intended as input for Svanen’s consultation about Nordic Ecolabelling of Investment funds. This text represents the view of the individuals signing it, not MIUSM or MISTRA.*

Summary

Svanen’s plans to provide a well-known and trusted rating of mutual funds, constitutes an important and timely initiative. Retail investors choosing investment and savings vehicles face a complex and high-dimensional decision problem, with considerable uncertainty (Campbell 2006). While many households have a strong interest in sustainable investment (see Sandberg and Nilsson 2011 for Swedish household data) but a low degree of knowledge about both finance and sustainability (e.g., Lusardi and Mitchell 2014). Extending Svanen’s trusted eco-label, familiar from consumer goods, provides a great opportunity to make it easier for Swedish households to make meaningful choices in mutual funds.

We want to point to areas in the draft proposal where we have identified room for improvement, and suggest possible directions of improvement based on the body of academic research on related issues. In the interest of being clear and operational, we organize our feedback into a background section followed by a few suggestions related to the specifics of Svanen’s proposed mutual fund eco-labelling scheme.

Our main recommendations are to focus on clear and detailed criteria for securities owned (exclusion, inclusion), and avoid regulating investor processes (which leaves considerable discretion to mutual funds, may stimulate ineffective but costly activities). We also recommend focusing on the core environmental issue, leaving unrelated aspects of sustainability to others. We discuss our main arguments below, and relate to some key academic research.

Background: financial markets and firms

Financial markets are tremendously important to firms. By far the most important connection between firms and markets is the set of terms on which a firm can fund its operations. This is reflected in stock price, interest rates, covenants and other terms. In essence, however, all these parameters produce one key item for a firm: its cost of capital. For sustainable investing to have long term impact on the activity of firms, it must impact the cost of capital.

Stock prices and the cost of capital

When enough equity investors avoid a stock, the price falls. This is equivalent to a higher cost of capital for the firm (conversely, equity investors reduce a firm’s cost of capital when they buy the stock in such numbers that the stock price rises). This is an uphill battle: when one investor decides to not hold a particular share, thereby putting downward pressure on price, some other group of investors (which like

[1] See https://www.hhs.se/en/Research/Institutes/misum-startpage/misum-research/sustainability-and-financial-systems/mfs-research-areas--projects/

the lower price and don't care about the factors that made some investors avoid the share) may be happy to hold them. Thus, share price impact (and the cost of capital impact that it implies) requires that a large number of investors jointly make decisions to favor or avoid a set of shares.

Ratings can help by coordinating investor behavior. There is some indication that this mechanism is at work in "sin" (alcohol, tobacco, gaming) stocks (Fabozzi, Ma and Oliphant 2008; Hong and Kacperczyk 2009), where investor avoidance has been universal and focused enough that prices have changed, thereby putting downward pressure on the size of the sin sector. However, academic studies have found weaker effects or no effect in other settings.[2] Tangible effects of exclusions likely require that large investor groups make correlated choices.

The effect on prices is likely to be stronger with regards to shares that are less popular on the market, such as the shares of unlisted, new or small-scale companies. It has been noted that there are many such companies with a green profile that may be good candidates for inclusion (Sandberg 2015). However, large UCITS funds are normally unable to invest at the needed levels of risk, so this observation may be less helpful in the present case.

It is important for the industry to confront the fact that impact and returns are, in general, negatively associated. Just like eco-friendly detergent or low-emission cars will have worse properties on non-environmental dimensions, sustainable mutual funds may be somewhat worse financially than equally risky non-sustainable funds. Retail investors will find this out sooner or later. The success of the sustainable mutual fund asset class will be helped if investors can trust that there are real benefits that come with sustainable investment. By providing convincing indication of these benefits, reliable eco-labels can be a key success factor for this asset class.

Activism, voting and dialogue

For public firms, the cost of capital is tremendously important. The cost of capital expresses capital markets' view of the firm. Relative to the cost of capital, other mechanisms that express investor views are generally less important. This includes activism and voting. An illustration of this fundamental fact is that firms do not actively seek to learn or to incorporate investors' views in their operating decisions. Among reasons to not pay too much attention to expressions of investor views are: lack of representativeness (owners have diverse views, and the most vocal may not be representative of the overall group) and lack of relevance (the shareholders change over time). Owner activism faces an additional hurdle when it concerns sustainability: investor views may disagree with price signals. Here is an example: suppose one investor wants SCA to stop producing paper-based diapers because they believe washable diapers are environmentally superior. SCA's management must consider the possibility that ceasing diaper production will reduce current and future profits. This will likely reduce the stock price, i.e. be bad in the eyes of the owners at large. The example illustrates a fundamental challenge in interacting with companies: when the views expressed agree with price signals from the stock market ("take action that maximizes share price") they are most often superfluous (management is already trying) and when they disagree with price signals ("invest in costly low emissions technology"), they are mostly futile.

There are some empirical studies that document how shareholder interaction with companies on sustainability issues has actually been successful at times in impacting firm behavior (Carleton et al. 1998, Hoffman 1996). Fund managers report that their dialogues have impact. However, it is difficult to determine cause and effect in these cases.

Academic research tends to suggest that companies are most likely to listen to investors when investors either hold large stakes (so that their threat of divestment is strong) or are able to demonstrate the business case for environmental policies (along the above lines) (Gifford 2010). Thus, it seems that

[2] See, for example, Teoh et al.'s (1999) study of the divestment campaign against South African companies, the largest coordinated divestment campaign. Teoh et al find no impact on stock prices.

pushing investors to engage on issues where the market does not reward sustainability will only very seldom have an impact on firms.

Identifying the rare opportunities when it is possible to have meaningful impact on firms (via one of the techniques above) is itself hard, and by its nature, much of the activity would be unmeasurable. This means that measuring engagement (identifying investors that are engaged in a way that produces results) would be very difficult for Svanen. It is also a challenge unrelated to Svanen's experience and expertise, and unconnected to how its brand is understood by households.

The current proposal does not really attempt this massive challenge. Instead, documenting fund processes and the quantity of interactions (as the current proposal would lead to) is most likely to push funds to a high quantity of documented interactions and possibly window-dressing, leading to unnecessary costs. These costs would be born by investors, making labelled mutual funds less attractive to investors.

SUGGESTION 1. Focus on a limited number of well-measured goals related to Svanen's environmental expertise

Our first suggestion is to take more care with the trade-off between coverage (broad goals) on the one hand, and precision of measurement, on the other. Sustainable investing in equity markets is difficult, because it is difficult to accurately measure the overall environmental impact of a given firm.[3] This fundamental challenge is the cause of confusion and disagreement about which stocks are "green" and to what extent. For example, Cohen et al (2014) identify 557 distinct sustainability measures. This disagreement is itself a major challenge to the future of sustainable investment products directed at households, since it indicates that sustainability is poorly measured, and thereby possibly unattainable (with reasonable confidence for the typical retail investor).

The Svanen eco-label has a unique value as an identifier of environmentally friendly products. By extending the proposed mutual fund labelling to cover much wider territory, consumers may be confused about the content of the brand. Confidence may be reduced in the label's value overall. For example, what about holding the shares of a company that is exceptionally well governed, contributing to society around it (let's say caring for employees, supporting the arts, contributing to local society), *but* which emits a lot of carbon dioxide? It may be better to let households make their own decision. By focusing on what the brand is known for, and the organization has long experience, the relevance of the label will be enhanced.

SUGGESTION 2. Avoid vague criteria about process and goals

The poor measurement of environmental impact discussed above has led many raters to using vague criteria. Instead of measuring the environmental impact by assessing the total environmental impact of portfolio firms, raters may resort to vaguer criteria relating to investor internal organization, process, public reporting, effort and activity, or documentation. These are only very indirectly related to environmental results in firms whose securities are owned. Such criteria raise the risk of funds following the letter of the law, without actually selecting environmentally friendly stocks.

The problem of vague criteria is particularly acute in Svanen proposal for inclusionary criteria. These are less explicit and stringent than the exclusionary ones. Fund owners are allowed to define ESG in their own way, conduct an internal ESG analysis, and then have their own assessment of what constitutes positive ESG performance. The criteria are even more relaxed for index funds which can follow any external "ESG index" without submitting it to critical analysis. Points are given for ESG views which converge with Svanen's broad views, beyond what is commonly understood as environmentally friendly.

---

[3] This problem is even worse when sustainability more broadly, including the broader impact on diverse and dispersed stakeholders, is measured.

In order to guarantee that the label represents meaningfully sustainable portfolio choices, we suggest that Svanen should provide more guidance about how investments should be directed.

To the extent that this requires sacrificing some aspects of shareholder activism, this is probably a worthwhile tradeoff. It must be better to offer households a clear, externally determined, indication of environmental impact of securities held, than certifying that the mutual fund has particular internal processes and meets reporting requirements.

Additional suggestions

There are a number of moves that funds can use to increase the impact of their inclusions. E.g., they may focus on small- and medium-sized companies whose shares are less liquid on the market (and therefore in stronger need of financial support), or they can support companies' IPOs or "crowdfunding" efforts to make their financial support more direct. This could give additional points in the ecolabel's scheme.

Svanen's proposal's process for identifying exclusions appears somewhat arbitrary. It excludes all fossil fuel producers, but not agricultural companies that also create carbon emissions. Similarly, meat producers, car manufacturers and transportation firms are allowed? The proposal involves checking indirect holdings through funds and investment firms, but what about the lending practices of banks and the minor shareholdings of non-financial companies? Because firms change, industries change, and standards improve, this list will be dynamic. It may change more rapidly than in other areas where Svanen operates and it involves a very large set of industries, firms and securities. It is important that expected the rate of change of the set of exclusions, and the process for changing it, are completely clear. There is a trade-off here, because rapid change is costly to Svanen (requires more frequent updates) and generates lack of predictability for the labelled funds (who may find it costly to adjust portfolio compositions to updated criteria), whereas slow change may make the exclusions outdated and therefore less relevant.

Anders Andersson, Director, Swedish House of Finance
Bo Becker, Professor, Stockholm School of Economics
Andreas Hoepner, Associate Professor, Henley Business School
Hans Lööf, Professor, KTH
Gustav Martinsson, Associate Professor, KTH
Joakim Sandberg, Associate Professor, University of Gothenburg
Paolo Sodini, Professor, Stockholm School of Economics

References

Carleton W. T., J. M. Nelson and M. S. Weisbach, 1998, "The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF", *Journal of Finance* 53 (4), 1335-62.

Campbell, John, 2006, "Household Finance", *Journal of Finance*, 61(4), 1553-1604.

Cohen, Steven, Satyajit Bose, Dong Guo, Alison Miller, Kelsie DeFrancia, Olin Berger, Brian Filiatraut, Maureen Loman, Wen Qiu, and ChengHang Zhang, 2014, "The Growth of Sustainability Metrics", Sustainability Metrics White Paper 1.

Gifford EJ. 2010. "Effective shareholder engagement: the factors that contribute to shareholder salience". *Journal of Business Ethics* 92: 79-97.

Fabozzi, Frank J., K.C. Ma and Becky J. Oliphant, 2008. "Sin Stock Returns", *Journal of Portfolio Management*, 35(1), Fall, 82-94.

Hoffman AJ. 1996. "A strategic response to shareholder activism". *Sloan Management Review* 37(2): 51–64.

Hong, Harrison and Marcin Kacperczyk, 2009, "The price of sin: The effects of social norms on markets", *Journal of Financial Economics*.

Lusardi, Annamaria and Olivia S. Mitchell, 2014, "The Economic Importance of Financial Literacy: Theory and Evidence", *Journal of Economic Literature*, 52(1), 5-44.

Sandberg, Joakim, and Jonas Nilsson, 2011, "Conflicting intuitions about ethical investment: A survey among individual investors", working paper.

Sandberg, J. 2015. "Sparande för en bättre miljö? En studie av finansbolagens etiska produkter and hållbarhetsarbete". En rapport från Naturskyddsföreningen.

Teoh, S.H., I. Welch, and C.P. Wazzan, 1999, "The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott", *The Journal of Business* 72(1): 35-89.