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Social Preferences and Corporate Investment Decisions

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Introduction to investor preferences

- Social investor preferences (including green preferences) are very important in the SF debate.
  - Do investors care *explicitly* about ESG considerations?
  - If yes, to what extent do they and are they willing to give up financial performance in exchange for "social utility"?
- Why is this important?
  - If investors have not developed strong social preferences, the shift of capital towards ESG-funds will not be long lasting, as investors might just be chasing green returns (e.g., greenium, doing well by doing good).

Introduction to investor preferences

- **Popular alternative view:** ESG is inherently profitable in economic terms (i.e., investing in ESG also increases financial returns).
  - Examples for this exist: e.g., increased customer loyalty, better employee productivity.
  - **However:** if this were systematically the case, then why do we have a problem with climate change? Why are firms not transitioning to net-zero if this maximizes shareholder value?

→ Transitioning to a more sustainable world will (most likely) be costly.

What do we know about investor preferences?

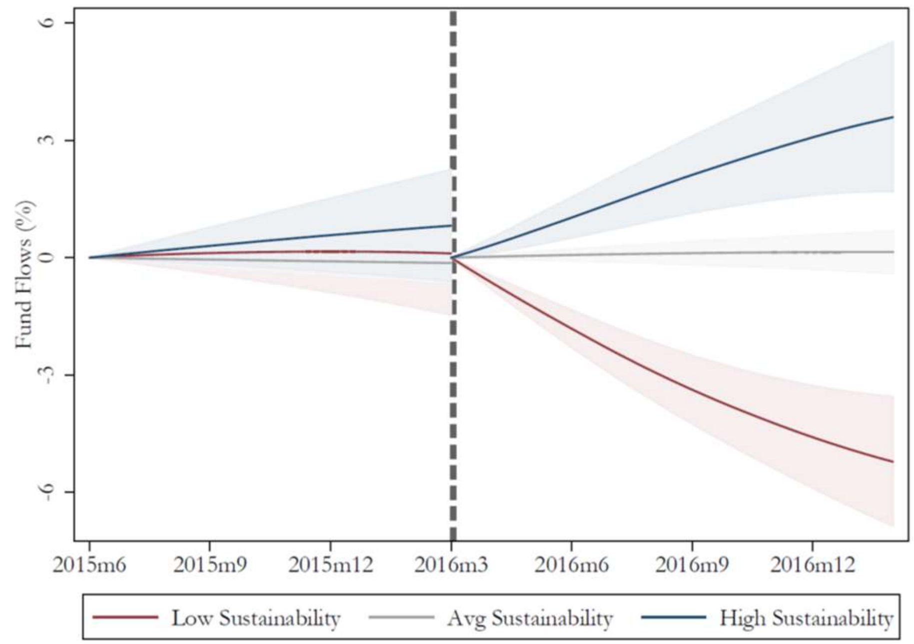
- It seems industry knows relatively little about the type of preferences investors actually have: e.g., only a small fraction of investors – in response to MiFID II – actually seem to indicate that they have "sustainability-oriented preferences".

- Examples of academic evidence:
  - *Krueger, Sautner, and Starks (2020)* surveyed 400 large institutional investors and found that the most common motive for SRI provided by the investors surveyed is to protect reputational risk.
  - *Anderson and Robinson (2021)* surveyed Swedish households and documented that those investors with pronounced ESG-preferences do not reflect those in their investment decisions because these investors are not engaged in financial markets due to lack of knowledge and other reasons (e.g., political views, aversion against markets, etc.).

What do we know about investor preferences?

- It is well-known that fund flows respond strongly to sustainability labels of funds.
- *Hartzmark & Sussman (2019)* use the (unexpected) introduction of sustainability ratings for more than 20000 mutual funds by Morningstar as a natural experiment.
- Of course, preferences could be one reason for that.
  - Alternative explanations: expected performance differences, reputational considerations,…

Figure 1



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What types of investor preferences do we distinguish?

Deontological Preferences

- Deontological investors do not hold certain securities at any price.
- They base their portfolio decisions on whether the action of buying or selling a security itself is right or wrong.
- Heinkel, Kraus, and Zechner (01); Hong and Kacperczyk (09); Berk and Binsbergen (22)

Non-consequentialist Preferences

- Investors receive non-pecuniary “dividends” from holding shares.
- “Warm glow” versus “cold prickle”.
- Utility depends on the investors’ action, not on the consequences of the action.
- Pastor, Stambough and Taylor (21), Pedersen et al (22).

Consequentialist Preferences

- Investors care about the consequences of their portfolio decisions.
- Their utility depends on the aggregate supply of green or brown firms.
- Pastor et al (21), Edmans et al (22).

Experimental evidence on preferences

- No experimental evidence for consequentialist preferences (*Bonnefon, Landier, Sastry & Thesmar, 2022*).
  - Instead, investors seem to invest according to their values (non-consequentialist preferences).
  - Consistent with existing evidence from a literature in economics on donations: *Ottoni-Wilhelm, Vesterlund & Xie (2017)* show that individuals get utility out of the activity of donating and not out of the consequences of their donations.
- *Humphrey, Kogan, Sagi & Starks (2022)* find a strong asymmetry: investors respond more strongly to negative than to positive ESG-aspects.
- Some evidence that social investors are willing to give up financial returns: *Barber, Morse and Yasuda (2021)* find that investors' ex-ante willingness to pay (WTP) for impact investing using VC funds is around 3% p.a..

Social Investor Preferences and Corporate Investment Decisions

Dangl, Halling, Yu & Zechner, 2023, "Social Preferences and Corporate Investment".

- Theoretical framework: To what extent do social investor preferences have an impact on companies through portfolio reallocation decisions?
- Investors' optimal investment decisions reflect the tradeoff between maximizing financial wealth and the utility derived from investing in green and not investing in brown firms.
- Investors affect stock valuations and firms' cost of capital through supply and demand → this provides (potentially) incentives for firms to transition from the brown to the green technology.
- *Main finding:* exclusionary portfolio strategies might have a sizeable impact on the activities of the underlying real-world firms (depending on model parameters).

Social Investor Preferences and Corporate Investment Decisions

Dangl, Halling, Yu & Zechner, 2022, “Stochastic Social Preferences and Corporate Investment Decisions”.

- We analyze a world in which social preferences **evolve over time** (e.g., current pushback in the US and other countries) and evaluate the impact on the transition.
- Similar setup as in the previous paper but when brown firms evaluate the option to become green, they explicitly **take into consideration the uncertainty about social preferences** in the future
- *Main implication of the model:* uncertainty about social preferences of future investor generations **delays the move to a greener economy** (the option to wait becomes more valuable for brown firms).

Conclusion

- Investor preferences for investing in a sustainable way play an important role in Sustainable Finance.
- Two main challenges:
  - Without a substantial and persistent shift in investor preferences towards ESG-considerations the transition will be slowed down.
  - The type (deontological, non-consequentialist or consequentialist) of social preferences has important implications for the development of suitable asset management strategies (e.g., exclusions versus tilts; need for explicit coordination mechanisms among investors).