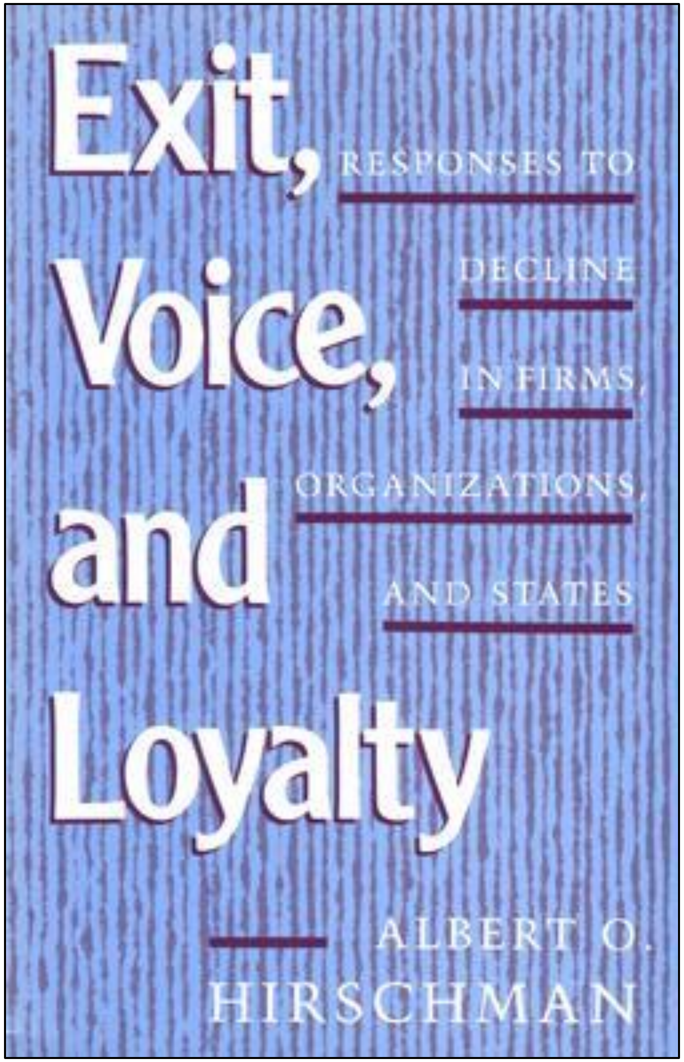
Discussion of Saint-Jean (2024)

"Exit or Voice? Divestment, Activism, and Corporate Social Responsibility"

Discussant: Sangmin Simon Oh (Columbia Business School)

SFS Cavalcade Asia-Pacific 2024

Background: Exit vs. Voice (Hirschman, 1970)



Background: Exit vs. Voice (Broccardo, Hart, and Zingales, 2022)

Exit versus Voice

Eleonora Broccardo

Università di Trento

Oliver Hart

Harvard University

Luigi Zingales

University of Chicago

We study the relative effectiveness of exit (divestment and boycott) and voice (engagement) strategies in a world where companies generate externalities and some agents care about the social impact of their decisions. We show that if the majority of investors are even slightly socially responsible, voice achieves the socially optimal outcome. In contrast, exit does not unless everybody is significantly socially responsible. If the majority of investors are purely selfish, exit is a more effective strategy, but neither strategy generally achieves the first best. We also show that exit can sometimes reduce social welfare.

Recap

Objective

- Evaluate the effectiveness of exit (divestment) and voice (activism) strategies in promoting corporate social responsibility (CSR)

Approach

- Novel classification of mutual funds based on (1) holdings and (2) voting behavior
- Large mutual fund redemptions as shocks to measure the impact on CSR outcomes

Result

- Voice funds are more effective: 1% reduction in equity held by voice funds increases social controversies by 30%
- Exit is less effective overall but works in firms with high CEO wealth-performance sensitivity

Recap

Objective

- Evaluate the effectiveness of exit (divestment) and voice (activism) strategies in promoting corporate social responsibility (CSR)

Approach

- Novel classification of mutual funds based on (1) holdings and (2) voting behavior
- Large mutual fund redemptions as shocks to measure the impact on CSR outcomes

Result

- Voice funds are more effective: 1% reduction in equity held by voice funds increases social controversies by 30%
- Exit is less effective overall but works in firms with high CEO wealth-performance sensitivity

Tackles an important question with cool measurement and methodology!

Recap

Objective

- Evaluate the effectiveness of exit (divestment) and voice (activism) strategies in promoting corporate social responsibility (CSR)

Approach

- Novel classification of mutual funds based on (1) holdings and (2) voting behavior
- Large mutual fund redemptions as shocks to measure the impact on CSR outcomes

Result

- Voice funds are more effective: 1% reduction in equity held by voice funds increases social controversies by 30%
- Exit is less effective overall but works in firms with high CEO wealth-performance sensitivity

Tackles an important question with cool measurement and methodology!

Plan for Discussion

1. Are we underestimating the effect of divestment?
2. Cost of capital and threat of exit
3. Extension to other investors and other firm dimensions

Point 1. Are we underestimating the effect of divestment?

Recap: Empirical Specification

Controversies depend on past quarter exit pressure and voice:

$$\text{Controversy}_{n,t} = \text{Exit}_{n,t-1} + \text{Voice}_{n,t-1} + \tilde{\delta}_t + \alpha_n + \tilde{u}_{n,t}.$$

Taking two-period differences and using instruments:

$$\begin{aligned}\text{Controversy}_{n,t+2} - \text{Controversy}_{n,t} = {} & \beta_{\text{Exit}} \overbrace{(\text{Exit}_{n,t+1} - \text{Exit}_{n,t-1})}^{\text{Instrumented by } Z_{n,t}^{\text{Exit}}} \\ & + \beta_{\text{Voice}} \underbrace{(\text{Voice}_{n,t+1} - \text{Voice}_{n,t-1})}_{\text{Instrumented by } Z_{n,t}^{\text{Voice}}} + \delta_{t+2} + u_{n,t+2},\end{aligned} \tag{2}$$

Recap: Empirical Specification

Controversies depend on past quarter exit pressure and voice:

$$\text{Controversy}_{n,t} = \text{Exit}_{n,t-1} + \text{Voice}_{n,t-1} + \tilde{\delta}_t + \alpha_n + \tilde{u}_{n,t}.$$

Taking two-period differences and using instruments:

$$\begin{aligned}\text{Controversy}_{n,t+2} - \text{Controversy}_{n,t} = {} & \beta_{\text{Exit}} \overbrace{\left(\text{Exit}_{n,t+1} - \text{Exit}_{n,t-1}\right)}^{\text{Instrumented by } Z^{\text{Exit}}_{n,t}} \\ & + \beta_{\text{Voice}} \underbrace{\left(\text{Voice}_{n,t+1} - \text{Voice}_{n,t-1}\right)}_{\text{Instrumented by } Z^{\text{Voice}}_{n,t}} + \delta_{t+2} + u_{n,t+2},\end{aligned} \tag{2}$$

Instrument: Changes in exposure to exit and voice funds due to large redemptions:

$$\begin{cases} Z^{\text{Exit}}_{n,t} = \sum_i MFHS_{n,i,t} \times \mathbf{1} \cdot (\text{Exit Fund}_{i,t}) \\ Z^{\text{Voice}}_{n,t} = \sum_i MFHS_{n,i,t} \times \mathbf{1} \cdot (\text{Voice Fund}_{i,t}) \end{cases}$$

where:

$$\text{Flows}_{i,t} = \frac{\text{TNA}_{i,t} - \text{TNA}_{i,t-1} \times (1 + \text{Return}_{i,t})}{\text{TNA}_{i,t-1}} \qquad MFHS_{n,i,t} = \text{Flows}_{i,t} \times \text{Ownership}_{n,i,t-1}.$$

Measuring Threat of Exit

Measure of threat of exit faced by firm n from its mutual fund shareholders:

$$\text{Exit}_{n,t} = \sum_i \text{Ownership}_{i,t,n} \times \mathbf{1} \cdot (\underbrace{\text{Exit Fund}_{i,t}}_{\beta_{S,i,t}>0 \text{ \& No index}})$$

ii. Firm-level statistics					
Quarter with at least one controversy (0/1,×100)	2.37	0	0	0	15.21
Overall fund ownership (%)	19.84	18.81	14.14	24.06	8.32
Exit fund ownership (%)	3.04	2.28	1.11	4.15	2.77
Voice fund ownership (%)	5.93	5.45	1.87	8.85	4.91

Measuring Threat of Exit

Measure of threat of exit faced by firm n from its mutual fund shareholders:

$$\text{Exit}_{n,t} = \sum_i \text{Ownership}_{i,t,n} \times \mathbf{1} \cdot (\underbrace{\text{Exit Fund}_{i,t}}_{\beta_{S,i,t}>0 \text{ \& No index}})$$

ii. Firm-level statistics					
Quarter with at least one controversy (0/1,×100)	2.37	0	0	0	15.21
Overall fund ownership (%)	19.84	18.81	14.14	24.06	8.32
Exit fund ownership (%)	3.04	2.28	1.11	4.15	2.77
Voice fund ownership (%)	5.93	5.45	1.87	8.85	4.91

Two potential sources of mismeasurement:

1. ESG preferences of non-mutual fund shareholders are not accounted for explicitly

Measuring Threat of Exit

Measure of threat of exit faced by firm n from its mutual fund shareholders:

$$\text{Exit}_{n,t} = \sum_i \text{Ownership}_{i,t,n} \times \mathbf{1} \cdot (\underbrace{\text{Exit Fund}_{i,t}}_{\beta_{S,i,t}>0 \text{ \& No index}})$$

ii. Firm-level statistics					
Quarter with at least one controversy (0/1,×100)	2.37	0	0	0	15.21
Overall fund ownership (%)	19.84	18.81	14.14	24.06	8.32
Exit fund ownership (%)	3.04	2.28	1.11	4.15	2.77
Voice fund ownership (%)	5.93	5.45	1.87	8.85	4.91

Two potential sources of mismeasurement:

1. ESG preferences of non-mutual fund shareholders are not accounted for explicitly
2. Measure weights all “exit” funds equally, w/o heterogeneity in the price impact
    - Actual price pressure a fund can exert may vary across investors

Measuring Threat of Exit

Measure of threat of exit faced by firm n from its mutual fund shareholders:

$$\text{Exit}_{n,t} = \sum_i \text{Ownership}_{i,t,n} \times \mathbf{1} \cdot (\underbrace{\text{Exit Fund}_{i,t}}_{\beta_{S,i,t}>0 \text{ \& No index}})$$

ii. Firm-level statistics					
Quarter with at least one controversy (0/1,×100)	2.37	0	0	0	15.21
Overall fund ownership (%)	19.84	18.81	14.14	24.06	8.32
Exit fund ownership (%)	3.04	2.28	1.11	4.15	2.77
Voice fund ownership (%)	5.93	5.45	1.87	8.85	4.91

Two potential sources of mismeasurement:

1. ESG preferences of non-mutual fund shareholders are not accounted for explicitly
2. Measure weights all "exit" funds equally, w/o heterogeneity in the price impact

Suggestion 1a

Split the sample into high and low mutual fund ownership and estimate the exit effect separately (is exit more powerful when "exit funds" threats carry more weight?)

Suggestion 1b

Weigh each "exit" fund's ownership by its likely price impact in constructing $Exit_{n,t}$

Point 2. Cost of Capital and Threat of Exit

How does cost of capital mediate the response to threat of exit?

Author: “Firms with higher cost of capital may be more responsive to funds’ threat of exit to keep their cost of equity as low as possible”

How does cost of capital mediate the response to threat of exit?

Author: "Firms with higher cost of capital may be more responsive to funds' threat of exit to keep their cost of equity as low as possible"

Stylized Model

- Consider a firm with value $V = CF / r$ where CF is the cash flow and r is the cost of capital

How does cost of capital mediate the response to threat of exit?

Author: "Firms with <u>higher cost of capital</u> may be <u>more responsive to funds' threat of exit</u> to keep their cost of equity as low as possible"

Stylized Model

- Consider a firm with value $V = CF / r$ where CF is the cash flow and r is the cost of capital
- When ESG-motivated funds exit, the stock price declines by ΔP, which results in a proportional increase in the firms' cost of capital: $\Delta r = (k \cdot \Delta P) / P_0$
  - $k > 0$ captures the sensitivity of the cost of capital to changes in stock price.

How does cost of capital mediate the response to threat of exit?

Author: "Firms with <u>higher cost of capital</u> may be <u>more responsive to funds' threat of exit</u> to keep their cost of equity as low as possible"

Stylized Model

- Consider a firm with value $V = CF / r$ where CF is the cash flow and r is the cost of capital

- When ESG-motivated funds exit, the stock price declines by ΔP, which results in a proportional increase in the firms' cost of capital: $\Delta r = (k \cdot \Delta P) / P_0$
  - $k > 0$ captures the sensitivity of the cost of capital to changes in stock price.

- Suppose $\Delta P = -\theta P_0$ where θ is the fraction of equity held by ESG investors.
  - Then $\Delta r = -k \cdot \theta$ and $(\Delta r / r) = -k \cdot \theta \cdot (1/r)$.
  - Firms with low *r* experience a larger proportional increase in cost of capital.

How does cost of capital mediate the response to threat of exit?

Author: "Firms with higher cost of capital may be more responsive to funds' threat of exit to keep their cost of equity as low as possible"

Stylized Model

- Consider a firm with value $V = CF / r$ where CF is the cash flow and r is the cost of capital
- When ESG-motivated funds exit, the stock price declines by ΔP, which results in a proportional increase in the firms' cost of capital: $\Delta r = (k \cdot \Delta P) / P_0$
  - $k > 0$ captures the sensitivity of the cost of capital to changes in stock price.
- Suppose $\Delta P = -\theta P_0$ where θ is the fraction of equity held by ESG investors.
  - Then $\Delta r = -k \cdot \theta$ and $(\Delta r / r) = -k \cdot \theta \cdot (1/r)$.
  - Firms with low r experience a larger proportional increase in cost of capital.
- Intuition: Low r firms have a higher valuation sensitivity to changes in stock price.

How does cost of capital mediate the response to threat of exit?

Author: "Firms with higher cost of capital may be more responsive to funds' threat of exit to keep their cost of equity as low as possible"

Stylized Model

- Consider a firm with value $V = CF / r$ where CF is the cash flow and r is the cost of capital
- When ESG-motivated funds exit, the stock price declines by ΔP, which results in a proportional increase in the firms' cost of capital: $\Delta r = (k \cdot \Delta P) / P_0$
  - $k > 0$ captures the sensitivity of the cost of capital to changes in stock price.
- Suppose $\Delta P = -\theta P_0$ where θ is the fraction of equity held by ESG investors.
  - Then $\Delta r = -k \cdot \theta$ and $(\Delta r / r) = -k \cdot \theta \cdot (1/r)$.
  - Firms with low r experience a larger proportional increase in cost of capital.
- Intuition: Low r firms have a higher valuation sensitivity to changes in stock price.

Suggestion 2

Clarify why firms with high cost of capital would be expected to respond more strongly

Point 3. Extension to Other Investors and Other Firm Dimensions

Extension #1: Beyond Mutual Funds

Q. How may results in this paper on mutual funds extend to other ESG Investors?

Extension #1: Beyond Mutual Funds

Q. How may results in this paper on mutual funds extend to other ESG Investors?

1. **Short-Term Performance Focus**
   - Mutual Funds: Prioritize short-term performance due to performance-sensitive flows
   - Other 13F Investors: Hedge funds or pension funds may better support long-term ESG strategies ⇒ Voice

Extension #1: Beyond Mutual Funds

Q. How may results in this paper on mutual funds extend to other ESG Investors?

1. **Short-Term Performance Focus**
   - Mutual Funds: Prioritize short-term performance due to performance-sensitive flows
   - Other 13F Investors: Hedge funds or pension funds may better support long-term ESG strategies ⇒ Voice

2. **Use of Proxy Advisors**
   - Mutual Funds: Heavy reliance on proxy advisors
   - Other 13F Investors: May engage with management more often ⇒ Voice

Extension #1: Beyond Mutual Funds

Q. How may results in this paper on mutual funds extend to other ESG Investors?

1. **Short-Term Performance Focus**
   - Mutual Funds: Prioritize short-term performance due to performance-sensitive flows
   - Other 13F Investors: Hedge funds or pension funds may better support long-term ESG strategies ⇒ <u>Voice</u>

2. **Use of Proxy Advisors**
   - Mutual Funds: Heavy reliance on proxy advisors
   - Other 13F Investors: May engage with management more often ⇒ <u>Voice</u>

3. **Regulatory Constraints**
   - Mutual Funds: Face strict diversification requirements and position limits
   - Other 13F Investors: More flexibility in concentration ⇒ <u>Both</u>

Extension #1: Beyond Mutual Funds

Q. How may results in this paper on mutual funds extend to other ESG Investors?

1. **Short-Term Performance Focus**
   - Mutual Funds: Prioritize short-term performance due to performance-sensitive flows
   - Other 13F Investors: Hedge funds or pension funds may better support long-term ESG strategies ⇒ <u>Voice</u>

2. **Use of Proxy Advisors**
   - Mutual Funds: Heavy reliance on proxy advisors
   - Other 13F Investors: May engage with management more often ⇒ <u>Voice</u>

3. **Regulatory Constraints**
   - Mutual Funds: Face strict diversification requirements and position limits
   - Other 13F Investors: More flexibility in concentration ⇒ <u>Both</u>

4. **Room for Coordination**
   - Mutual Funds: Limited ability to coordinate
   - Other 13F Investors: More room for coordinated engagement ⇒ <u>Voice</u>

Extension #2: Beyond Social Dimension

Q. How may results in this paper on social controversies extend to climate concerns?

Extension #2: Beyond Social Dimension

Q. How may results in this paper on social controversies extend to climate concerns?

1. **Measurement and Attribution**
   - Social controversies: Clear firm-specific events, easily attributable
   - Climate concerns: Harder to attribute responsibility ⇒ <u>Voice</u>

Extension #2: Beyond Social Dimension

Q. How may results in this paper on social controversies extend to climate concerns?

1. **Measurement and Attribution**
   - Social controversies: Clear firm-specific events, easily attributable
   - Climate concerns: Harder to attribute responsibility ⇒ Voice

2. **Time Horizon of Impact**
   - Social controversies: Immediate reputational damage, clear short-term effects
   - Climate concerns: Long-term risks with gradual materialization of costs ⇒ Voice

Extension #2: Beyond Social Dimension

Q. How may results in this paper on social controversies extend to climate concerns?

1. **Measurement and Attribution**
    - Social controversies: Clear firm-specific events, easily attributable
    - Climate concerns: Harder to attribute responsibility ⇒ <u>Voice</u>

2. **Time Horizon of Impact**
    - Social controversies: Immediate reputational damage, clear short-term effects
    - Climate concerns: Long-term risks with gradual materialization of costs ⇒ <u>Voice</u>

3. **Industry Structure**
    - Social controversies: Firm-specific solutions are often possible
    - Climate concerns: Industry-wide transitions needed with collective action ⇒ <u>Voice</u>

Extension #2: Beyond Social Dimension

Q. How may results in this paper on social controversies extend to climate concerns?

1. **Measurement and Attribution**
   - Social controversies: Clear firm-specific events, easily attributable
   - Climate concerns: Harder to attribute responsibility ⇒ <u>Voice</u>

2. **Time Horizon of Impact**
   - Social controversies: Immediate reputational damage, clear short-term effects
   - Climate concerns: Long-term risks with gradual materialization of costs ⇒ <u>Voice</u>

3. **Industry Structure**
   - Social controversies: Firm-specific solutions are often possible
   - Climate concerns: Industry-wide transitions needed with collective action ⇒ <u>Voice</u>

4. **Stakeholder Pressure**
   - Social controversies: Often driven by employees, customers, media
   - Climate concerns: Broader stakeholders (regulators, future generation) ⇒ <u>Both</u>

Final Thoughts

- Author studies when ESG-motivated investors should use divestment (“exit”) or activism (“voice”) in promoting corporate social responsibility.

- **Punchline:** Voice is generally more effective than exit, and exit only works when CEOs have high wealth-performance sensitivity

Final Thoughts

- Author studies when ESG-motivated investors should use divestment (“exit”) or activism (“voice”) in promoting corporate social responsibility.

- **Punchline:** Voice is generally more effective than exit, and exit only works when CEOs have high wealth-performance sensitivity

- **There’s a lot to like about this paper!**
    - Attacks one of the key questions in sustainable finance
    - Great data exercise that integrates multiple strands in the literature
    - Clear identification strategy that leverages institutional features

Final Thoughts

- Author studies when ESG-motivated investors should use divestment (“exit”) or activism (“voice”) in promoting corporate social responsibility.

- **Punchline:** Voice is generally more effective than exit, and exit only works when CEOs have high wealth-performance sensitivity

- **There’s a lot to like about this paper!**
  - Attacks one of the key questions in sustainable finance
  - Great data exercise that integrates multiple strands in the literature
  - Clear identification strategy that leverages institutional features

- **Some questions prompted by the paper for the future:**
  - What are the relative <u>costs</u> of exit vs. voice strategies for investors, and how do these costs affect their choice of engagement strategy?
  - How can policy and market structure be designed to optimize the mix of exit and voice in ESG investing? (e.g., proxy voting rules, disclosure requirements)