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The unintended consequences of divestment[☆]

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ABSTRACT

A divestment campaign aims to depress share prices to induce managers to change firm behavior. Assuming that managers make profit-maximizing decisions in the absence of a campaign, firms that accede to divestors' demands raise short-run share prices but depress long-run profits. Managers who are more interested in short-run prices are therefore more motivated by divestment than managers who care about long-run profits. We show that, as most managerial compensation contracts reward long-run profitability and stock returns, divestment can be ineffective at best, and perhaps counterproductive, rewarding managers who attract divestment campaigns. In a quantification exercise, we show that the wealth of most executives running likely divestment targets in 2015 would be unaffected by even large movements in share prices. Of those affected, a substantial majority would benefit from divestment.

1. Introduction

On May 6, 2014, Stanford University announced that it would no longer invest funds in coal mining firms and would divest its existing holdings. According to university president John Hennessy:

> Stanford has a responsibility as a global citizen to promote sustainability for our planet. The university's review has concluded that coal is one of the most carbon-intensive methods of energy generation and that other sources can be readily substituted for it. Moving away from coal in the investment context is a small, but constructive, step while work continues, at Stanford and elsewhere, to develop broadly viable sustainable energy solutions for the future.[1]

In part, divestment campaigns such as Stanford's allow groups to credibly signal their displeasure with a company, industry, or country's actions, but larger divestment campaigns also aspire to affect the prices and profitability of offending firms. Most campaigns are too small to have much effect. In this paper, we ask what would happen if a divestment campaign were large enough to have a meaningful effect on share prices. Would this yield the benefits that divestment proponents seek?

To answer this question, we focus on whether managers have incentives, via their compensation schemes, to respond to divestors' demands. In our model, divestment depresses near-term share prices of target firms at the expense of long-term profits. This means that managers who are rewarded more for high near-term prices are more amenable to divestors' demands than managers who are rewarded more for long-run success. Managers who are re-

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[1] See Stanford News Service (2014).

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warded for high stock returns, perversely, have incentives that are precisely backward, i.e., shares in firms subject to a divestment campaign earn higher returns, so managers of those firms are rewarded for what campaigners see as bad behavior.

We establish the preceding point theoretically and derive the optimal managerial response to divestment for any arbitrary compensation scheme. For completeness, we also derive the optimal compensation scheme that induces executives to respond to divestment by mitigating the harm that campaigners perceive. As is standard, in our model, long-term compensation is optimal for cheaply inducing effort. The best way to induce good behavior, however, is to make the executive short-termist. Because a divestment campaign affects prices now more than later, incentives based on short-term price changes are necessary. Therefore, a tension exists between the contract that would allow divestment to work and real-world contracts that are generally designed to motivate long-term performance. If divestment campaigns are large enough, designing contracts for managers that motivate both effort and mitigation of the harm is at least theoretically possible. The larger the divestment campaign, however, the fewer remaining activists who can pressure the board or compensation committee to adopt an effective contract.

After establishing the theoretical points, we perform a quantification exercise estimating the change in manager wealth for potential United States divestment targets, as of 2015. We compile a list of all US firms in a variety of industries that are often targeted by divestment campaigns (e.g., tobacco, oil and gas, and metals) for which we have data on the compensation of their executives. We calculate the effect on each firm's stock price from a divestment campaign of either a fixed percentage of the firm's shares or a fixed dollar value, assuming a short-run elasticity of demand for the firm's shares of either -1 or -5. We assume an infinite long-run elasticity.

Once we have calculated the stock price reduction from a divestment campaign, we estimate the change in chief executive officer (CEO) wealth due to this price reduction. She is less wealthy if she is periodically selling her shares during the divestment campaign, because her average selling price is lower. She is more wealthy if she is receiving stock grants during the divestment campaign if those grants are fixed value, meaning that the grant is for a specified dollar value of stock. For any given grant amount, she receives more shares if the share price is lower, and the long-term value of those shares is not affected by divestment. For a similar reason, she is also wealthier if she receives options during the divestment campaign. We exclude all discretionary transactions and focus on recurring stock sales and stock and option grants.

This analysis yields a number of noteworthy results. First, very few executives would be hurt by a divestment campaign of any size. A large majority would not be meaningfully affected even under the most favorable conditions for campaigners: a relatively inelastic demand for shares and a large campaign. Second, some managers would benefit substantially from a divestment campaign. One manager would have been nearly $1 million better off had his firm been subject to a $10 million divestment campaign in 2015. Third, some managers would have been worse off if faced with a divestment campaign, though this group is smaller. The cofounder and then-CEO of Cheniere Energy, Charif Souki, would have been just over $1 million worse off if faced with a divestment campaign of 1% of Cheniere's shares during 2015.

Finally, substantial observable variation exists in the likely effect of a campaign on manager wealth. Campaigners must seek out firms whose executives are selling their positions. Souki sold shares every month in 2015, making him an appealing target for campaigners. Perhaps not coincidentally, on August 4, 2015, the investor Carl Icahn announced an activist position in the firm. Icahn clearly did not push for divestment (by definition, as his firm is the largest shareholder in Chiniere), but our argument for activists focusing on firms whose executives are selling shares holds regardless. To the extent that responding to activists' demands increases the near-term share price, executives at target firms ought to be more responsive if they are actively selling shares.

We conclude by discussing optimal strategies for activists. The first step is to evaluate the compensation plans of executives at a target firm. If those executives are heavy net sellers of shares in their own firms, then they are potential divestment targets. If not, then divestment is unlikely to be effective, and activist investment is probably a better route. The second step is for investors to determine their current holdings in target firms. The magnitude of the effect of a divestment campaign is limited by campaigners' holdings prior to campaign onset. Unless they already own large stakes, they are unlikely to succeed in their efforts. The magnitude of the effect of an investment campaign is not limited by existing holdings. Instead, investment is limited only by the wealth of the campaigners. Especially if investors are willing to invest heavily in a small number of firms, this magnitude can be substantially larger than anything divestment can achieve.

The paper proceeds as follows. In Section 2, we briefly review the literature on divestment. In Section 3, we construct a simple model in which managers can exert short- and long-run effort and can choose whether to respond to a potential divestment campaign by mitigating an externality that some investors loathe. We derive optimal contracts that satisfy various objectives that investors may have. In Section 4, we compare the compensation policies that we see in practice, like fixed number stock option grants, fixed value stock grants, etc., to the contracts analyzed in Section 3. In Section 5, we take the model to the data, and quantify how much wealthier or poorer executives at a variety of potential divestment targets would have been in 2015. We allow various assumptions concerning the size of a divestment campaign and the elasticity of demand for shares. Section 6 concludes.

2. Literature

Any existing or previous divestment campaigns are unlikely to have produced any substantial effect on stock prices. In a setting with relatively clean identification, Teoh et al. (1999) provide empirical evidence that the South African boycott to end apartheid, the most prominent di-