Sustainable investment - What we know and do not know

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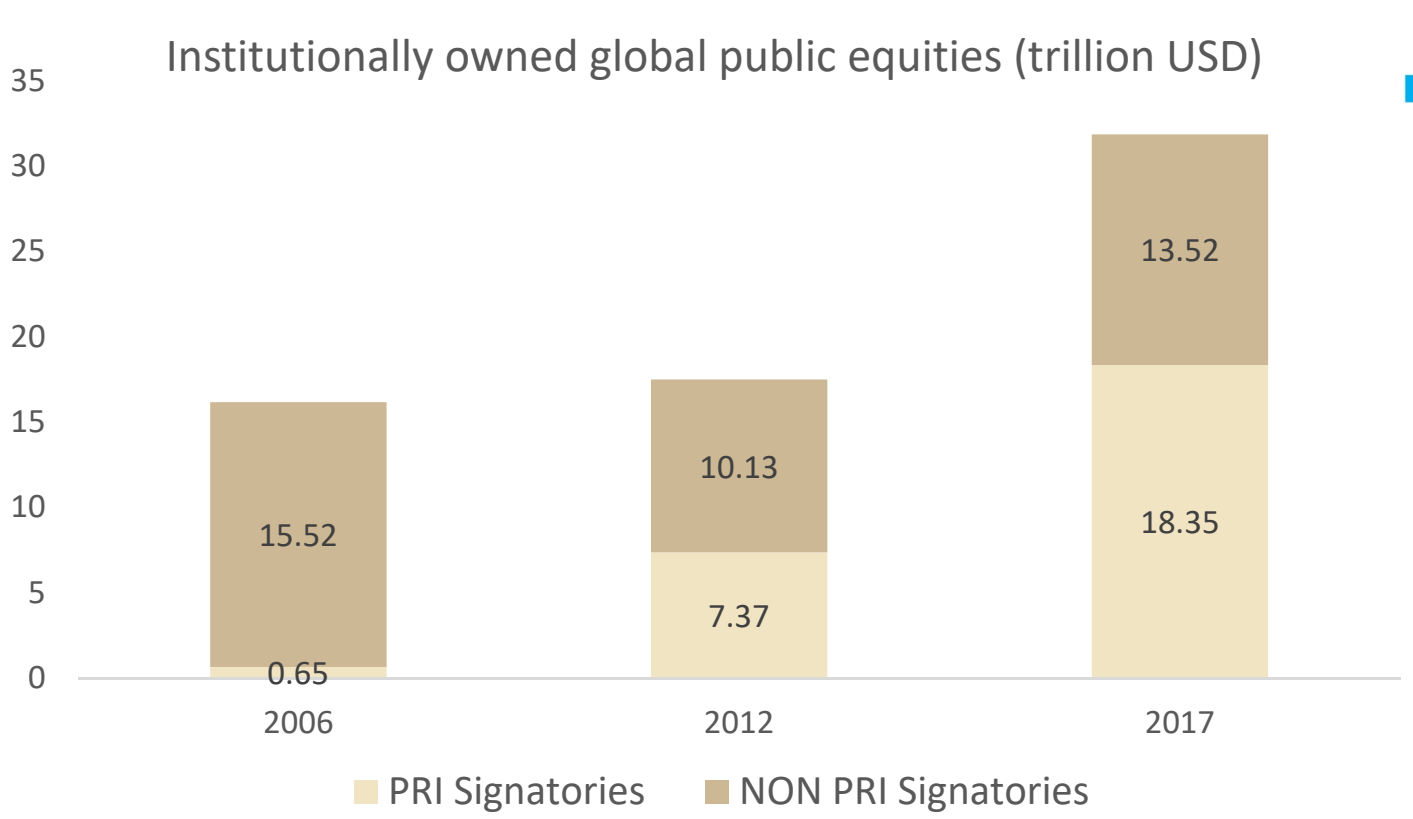
Sustainability in finance and investment

The majority of institutional stock investors are now publicly committed to sustainability



PRI Principles for Responsible Investment

Source: Figure 1b, Gibson, Glossner, Krüger, Matos, and Steffen (2019)

Sustainability in finance and investment

Many current regulatory and policy initiatives

- EU commission released a sustainable finance action plan
- Chinese government is pursuing an ambitious green finance agenda
- Financial Stability Board: Guidelines and framework for climate risk disclosure
  - TCFD: Taskforce for climate related financial disclosures (see https://www.fsb-tcfd.org)
- Central banks: Network for Greening the Financial System
- …. and many more

Outline

1. Some context on sustainable investment

2. What do we know? What do we not know…yet?

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1. Some context on sustainable investment

2. What do we know? What do we not know…yet?

What is sustainable investment about?

- Not one single definition

- Many different forms

- Sustainable investment typically about
  i. long-term
  ii. incorporating sustainability considerations into decision making

How is sustainability typically understood in investment and finance ?

- Two ways of looking at sustainable investment:

1. Conduct (processes, behavior): How sustainable are the operations and processes of an investee firm?
   - e.g., environmental damage, respect of human rights in supply chain, employee satisfaction, health and safety record, etc.

1. The **conduct** dimension (ESG)

vs.

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2. Product: Are the products and services of an investee firm contributing to sustainability?
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2. The **product** dimension (SDGs)

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- Currently much more (and possibly **too much**) focus on the conduct dimension

Outline

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2. What do we know? What do we not know…yet?

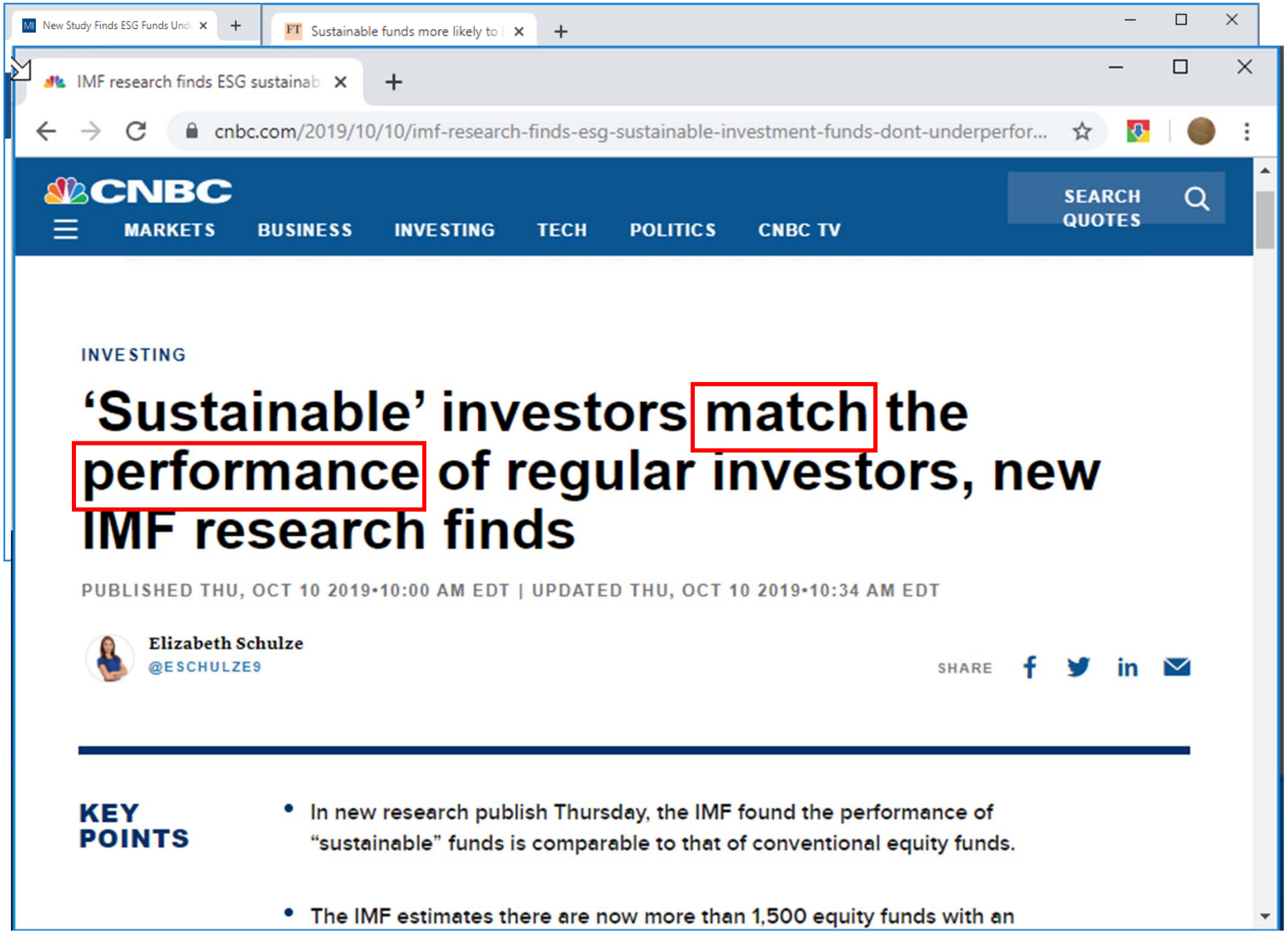
What do we know about sustainable investment?

A. Performance

B. ESG measurement

C. Implementation

D. Impact/"Rainbow" washing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PUBLISHED THU, OCT 10 2019•10:00 AM EDT | UPDATED THU, OCT 10 2019•10:34 AM EDT
Elizabeth Schulze
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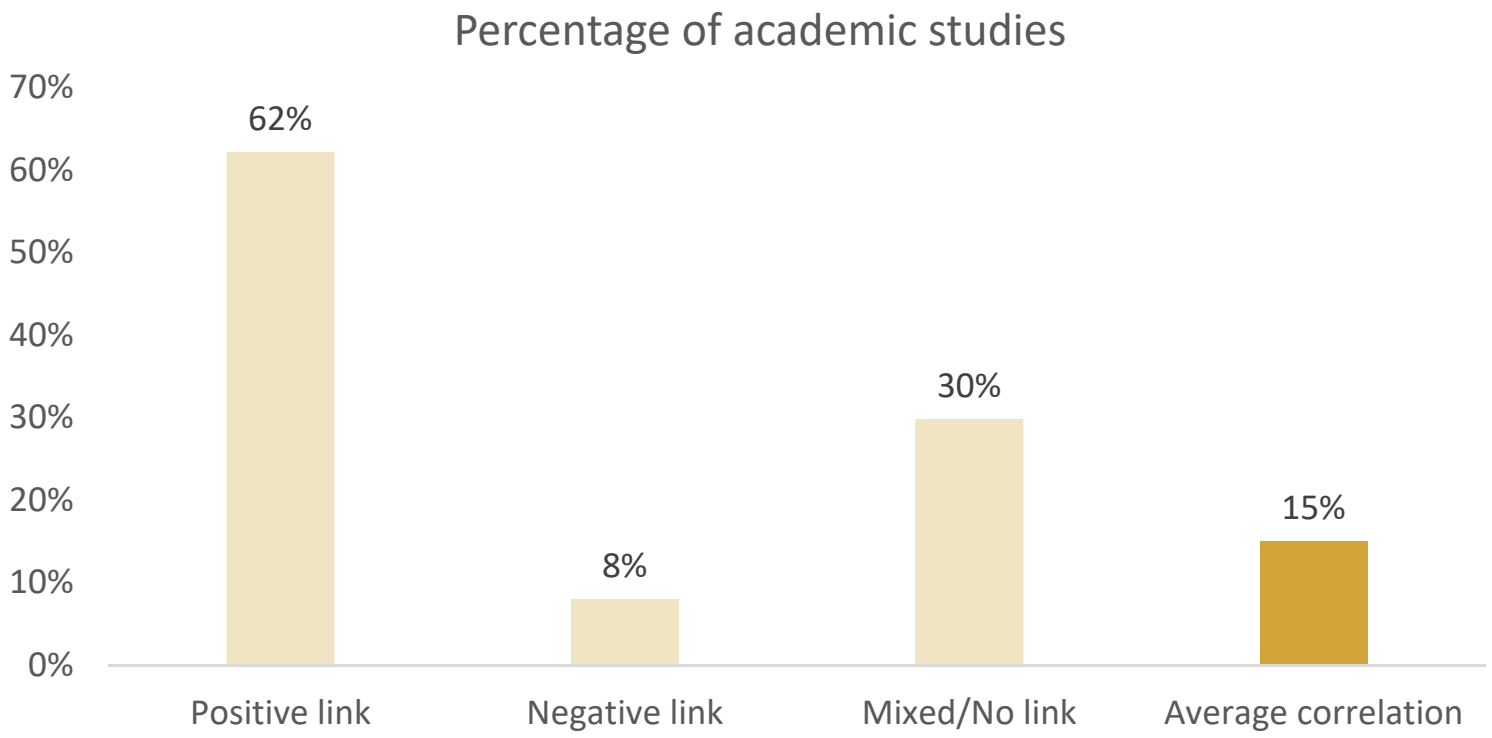
KEY POINTS
• In new research publish Thursday, the IMF found the performance of “sustainable” funds is comparable to that of conventional equity funds.
• The IMF estimates there are now more than 1,500 equity funds with an

A. Performance (1)

Is there a consensus about the relation between financial performance and ESG?

- Meta study by Friede, Busch, and Bassen (2015): Aggregate results from hundreds of scientific studies (1970-2015)



Source: Friede, Busch, and Bassen (2015)

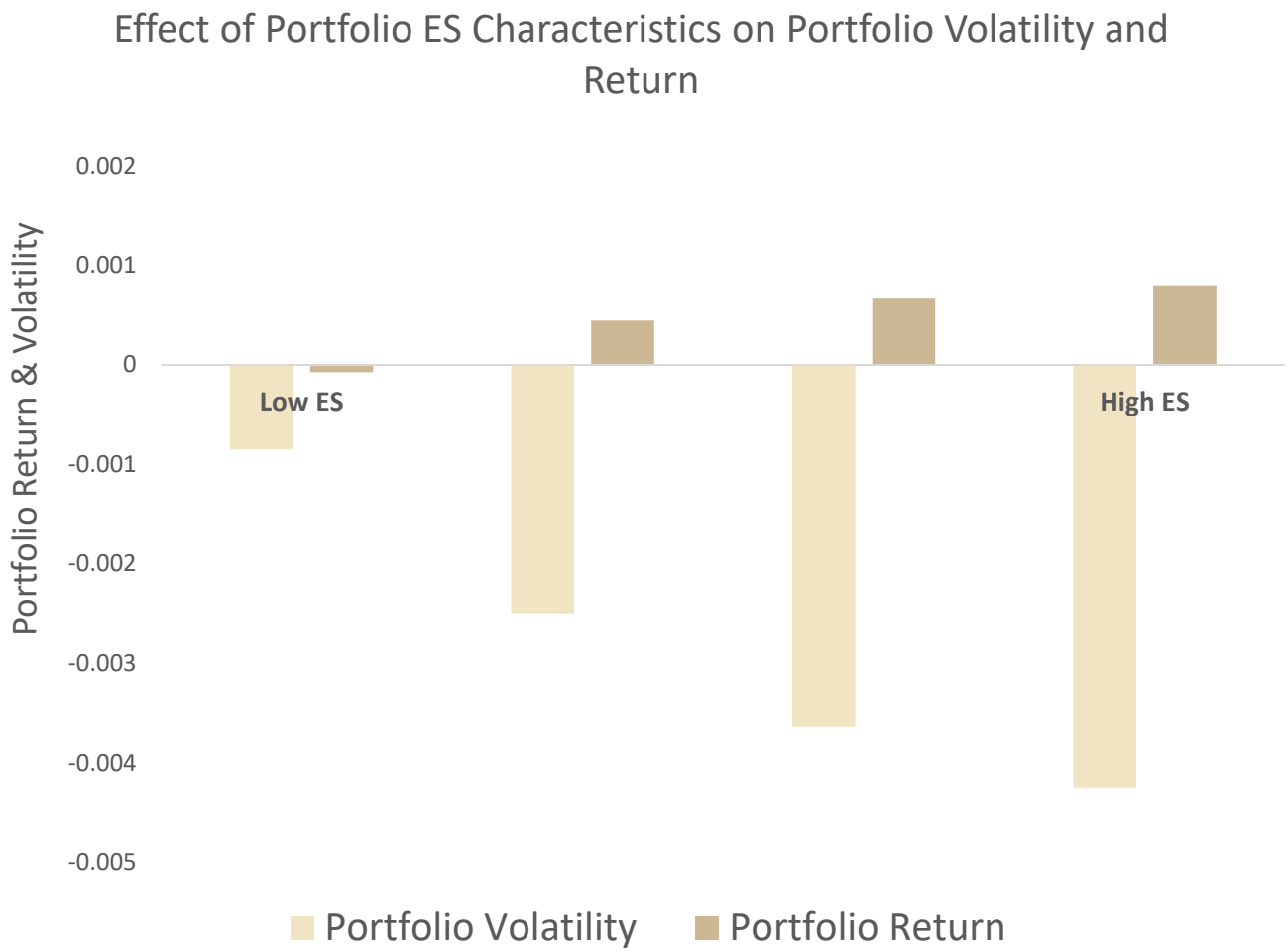
A. Performance (2)

Stock markets punish poor ESG performance

- Krüger (2015): Investors react strongly negatively to negative ESG events in the short run
  - Average 11 day cumulative abnormal return of -0.88%
  - Strongest reaction when negative events concern
    - Environment: -1.54%
    - Communities: -2.14%
  - Consistent with the view that unsustainable corporate behavior is costly for shareholders
  - In contrast, no strong systematic reaction to positive events
- Glossner (2018):
  - Focuses on monthly returns between 2007 and 2016
  - Value weighted portfolio of controversial firms with a known history of poor ESG policies exhibits a four factor alpha of -3.5% per year

A. Performance (3)

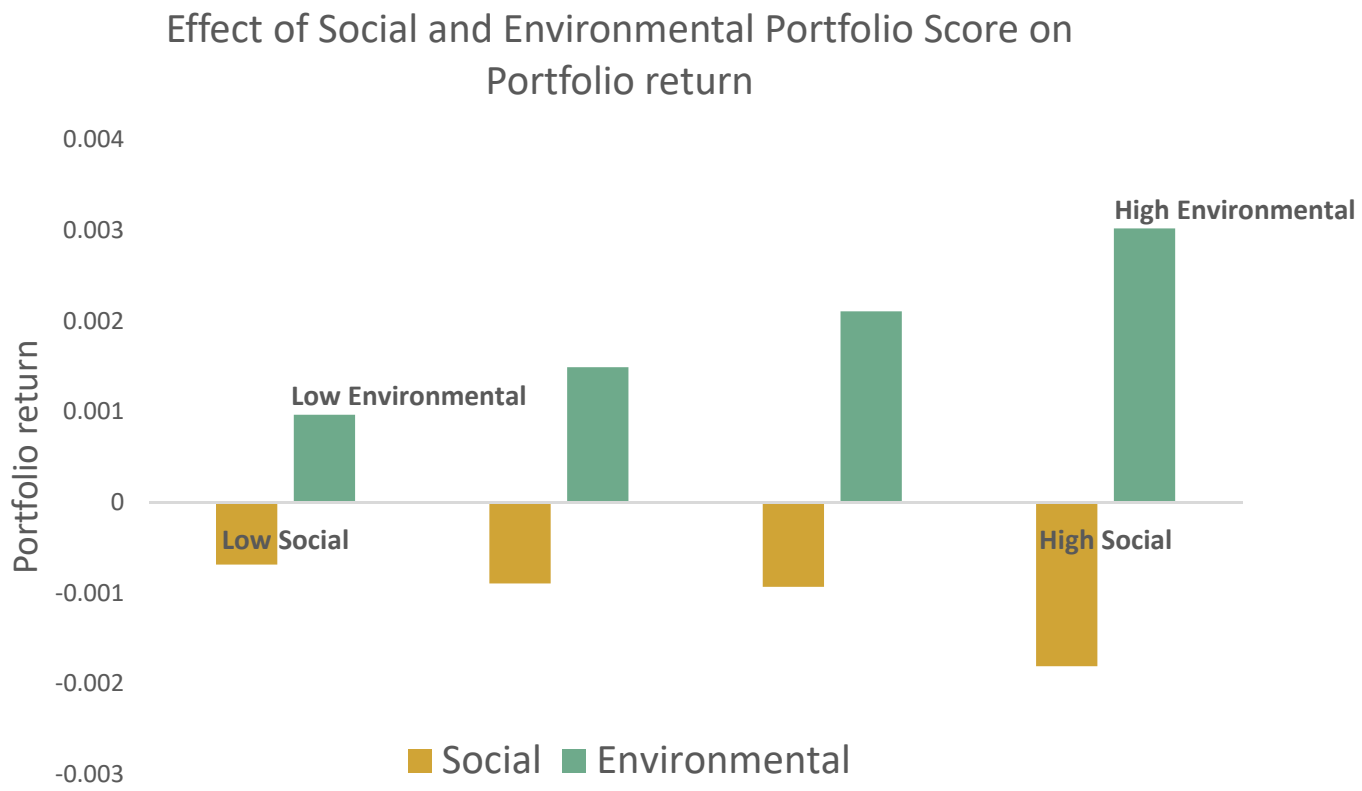
Better ESG policies primarily associated with lower risk



Source: "The Sustainability footprint of Institutional investors" (Gibson and Krüger 2018, SFI WP)

A. Performance (4)

Individual effect of E and S portfolio characteristics on portfolio return can differ



Source: Gibson and Krüger (2018, SFI WP)

A. Performance

What we know

1. Aggregate scientific research points to a slightly positive correlation between financial performance and ESG
   - Positive correlation stronger in Fixed Income, Real Estate, and Emerging markets

2. Stock markets punish poor ESG performance

3. Compared to returns, much stronger statistical relation between risk (e.g., volatility) and ESG in the data:
   - Risk measures generally negatively correlated with measures of ESG

4. ESG often analyzed jointly, but the performance implications of E, S, and G are potentially very different

A. Performance

What we do not know well

- Correlation vs. causation?

- Going forward, if all investors buy the same high-ESG stocks, what does that imply for the performance of ESG strategies in the future?
  - Are they going to underperform?

- What are the risk-return implications of investing in portfolios that are created based on sustainability themes in the product dimension (e.g., solar, water sanitation, e-mobility, etc.)?
  - Are they going to perform like in the past?
  - Are they going to outperform in the future?

What do we know about sustainable investment?

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B. ESG measurement

ESG scores of firms can disagree substantially

B. ESG measurement (1)

Several recent papers study ESG rating divergence

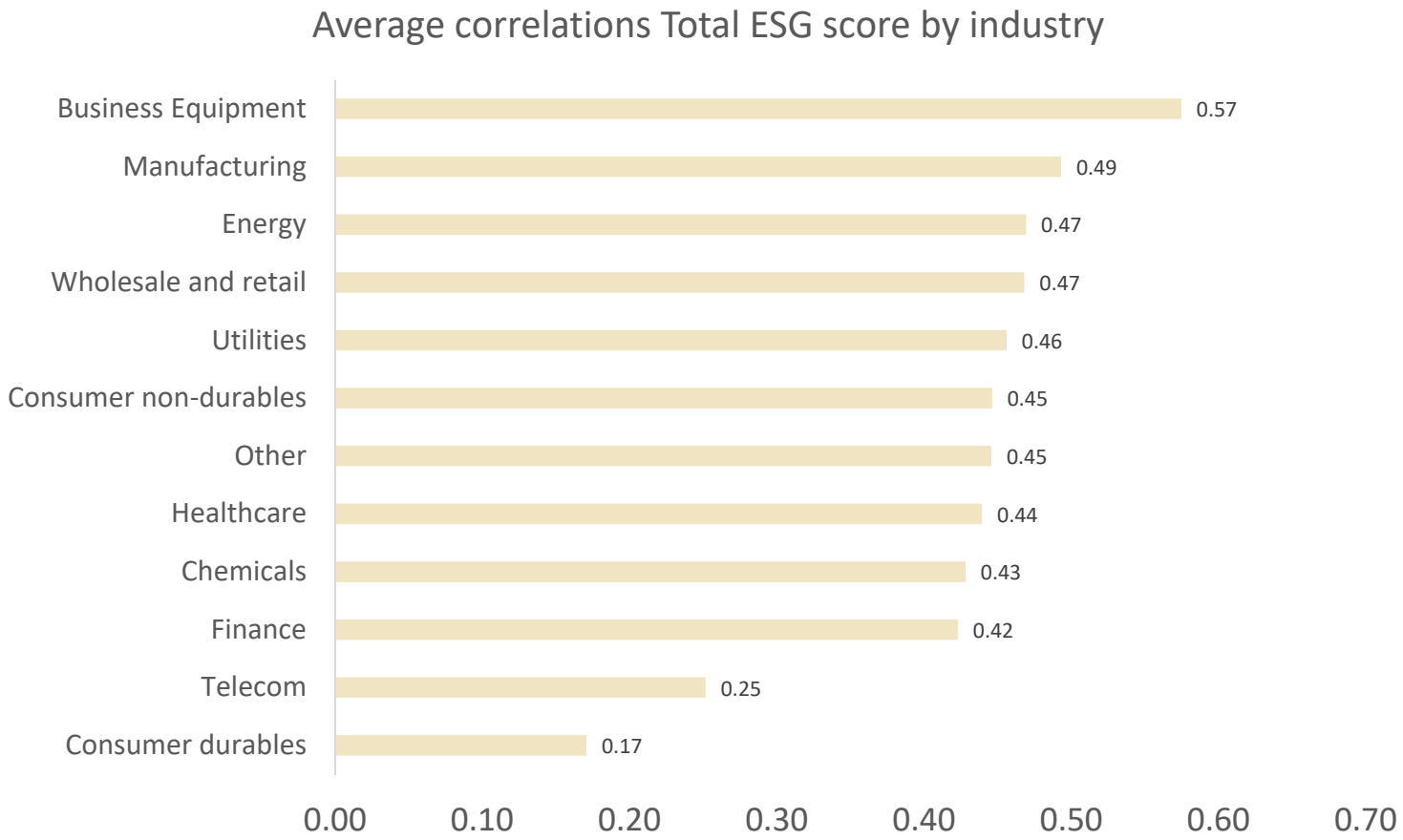
- Gibson, Krüger, Riand, and Schmidt (2019, WP)
  - Sample: S&P 500 firms, 2013-2017
  - ESG scores from six providers:
    - Thomson Reuters, KLD, MSCI, Sustainalytics, Bloomberg, and Inrate

- Average correlation across data providers for Total ESG score: **0.47**

- Surprisingly, correlation lowest for governance, highest for environment
  - E: 0.43
  - S: 0.32
  - G: 0.19

B. ESG measurement (2)

ESG disagreement varies across industries (but not a lot)



Source: Gibson, Krüger, Riand, and Schmidt (2019, WP)

B. ESG measurement (3)

Which kind of firms have higher ESG disagreement?

i. Higher asset tangibility: less disagreement on environmental dimension

ii. More profitable firms: less disagreement (overall; environmental)

iii. Firms without credit rating: more disagreement (overall; social)

iv. Larger firms: more disagreement

B. ESG measurement (4)

What we do not know that well: Why do ESG scores diverge?

- Conceptualization of sustainability: Lack of a shared view of what it means for a firm to be sustainable
  - Legal origins of data providers

- Technical reasons
  - raters use different categories
  - raters measure the same categories differently
  - raters give different weights to categories in the aggregation process

- Disclosure
  - Inconsistencies in terms of how issuer companies report and disclose data

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C. How do institutions implement sustainable investment in public equities?

- No official classification/taxonomy of SRI implementation strategies
- CFA classification (Amel-Zadeh & Serafeim, 2018; CFAI, 2015; GSIA, 2018; see also AQR, 2019)

Asset allocation

- [Neg] Negative screening
- [Pos] Positive screening
- [N-b] Norms-based
- [The] Thematic

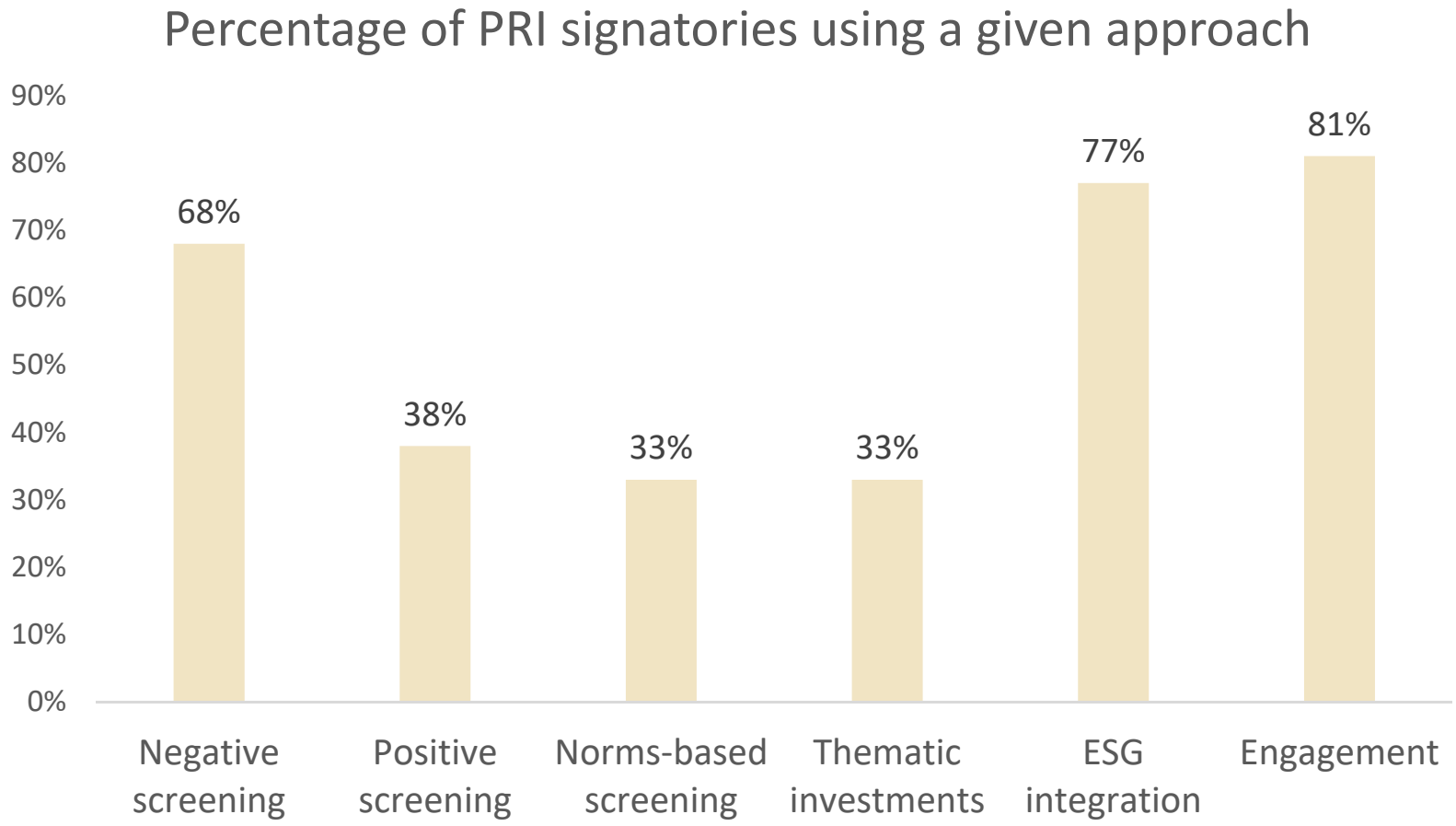
[Int] ESG Integration

Engagement

- [Indiv eng] Individual engagement
- [Colla eng] Collaborative engagement
- [Int vot] Internal voting

C. How do institutions implement sustainable investment in public equities?

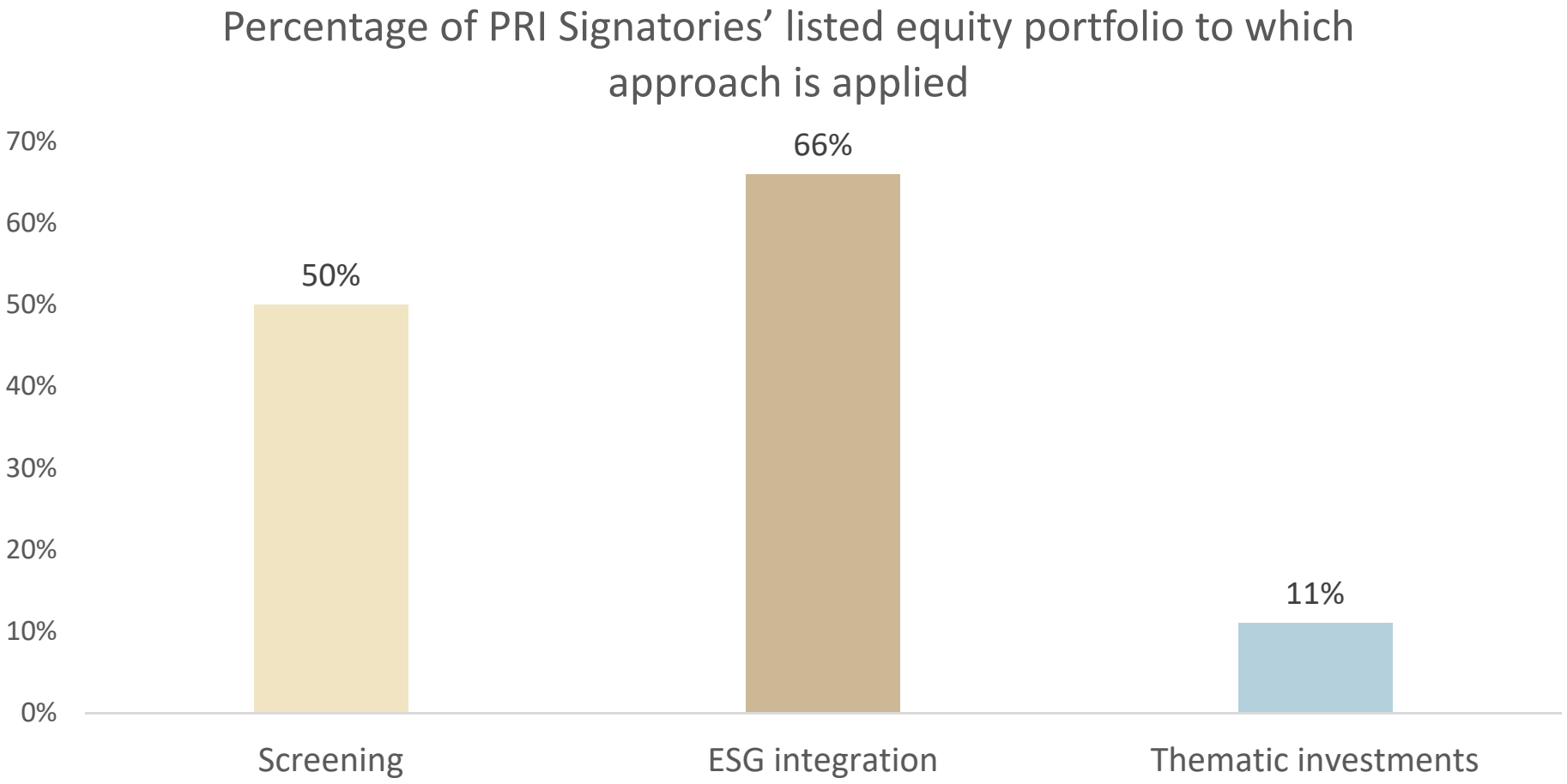
Predominantly through Engagement, ESG integration, and Negative screening



Source: Gibson, Glossner, Krüger, Matos and Steffen (2019, WP)

C. How do institutions implement sustainable investment public equities?

Thematic investments are still niche



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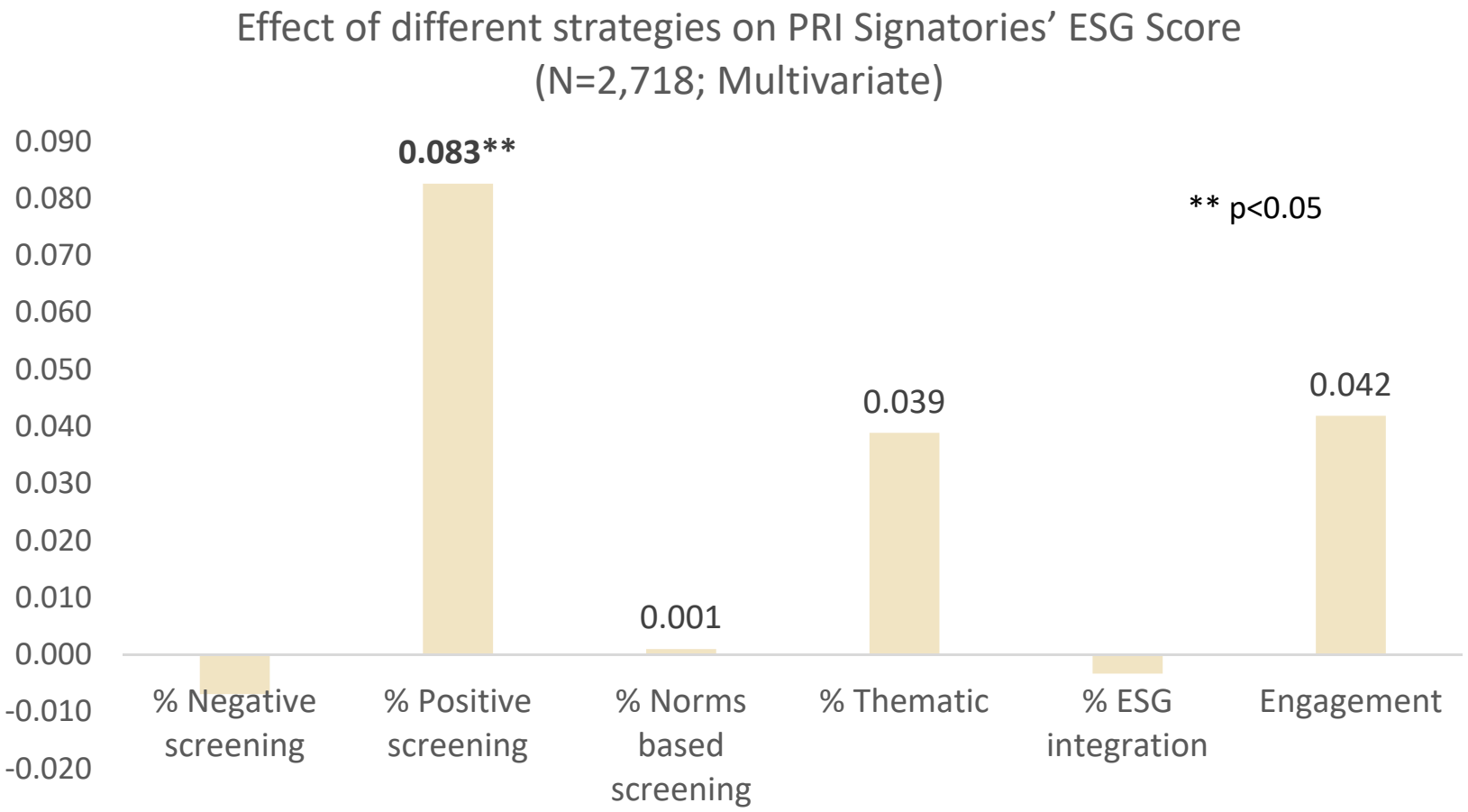
C. Does implementation strategy matter?

Only the intensity of Positive screening significantly related to portfolio-level ESG score



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D. Impact washing: What we know?

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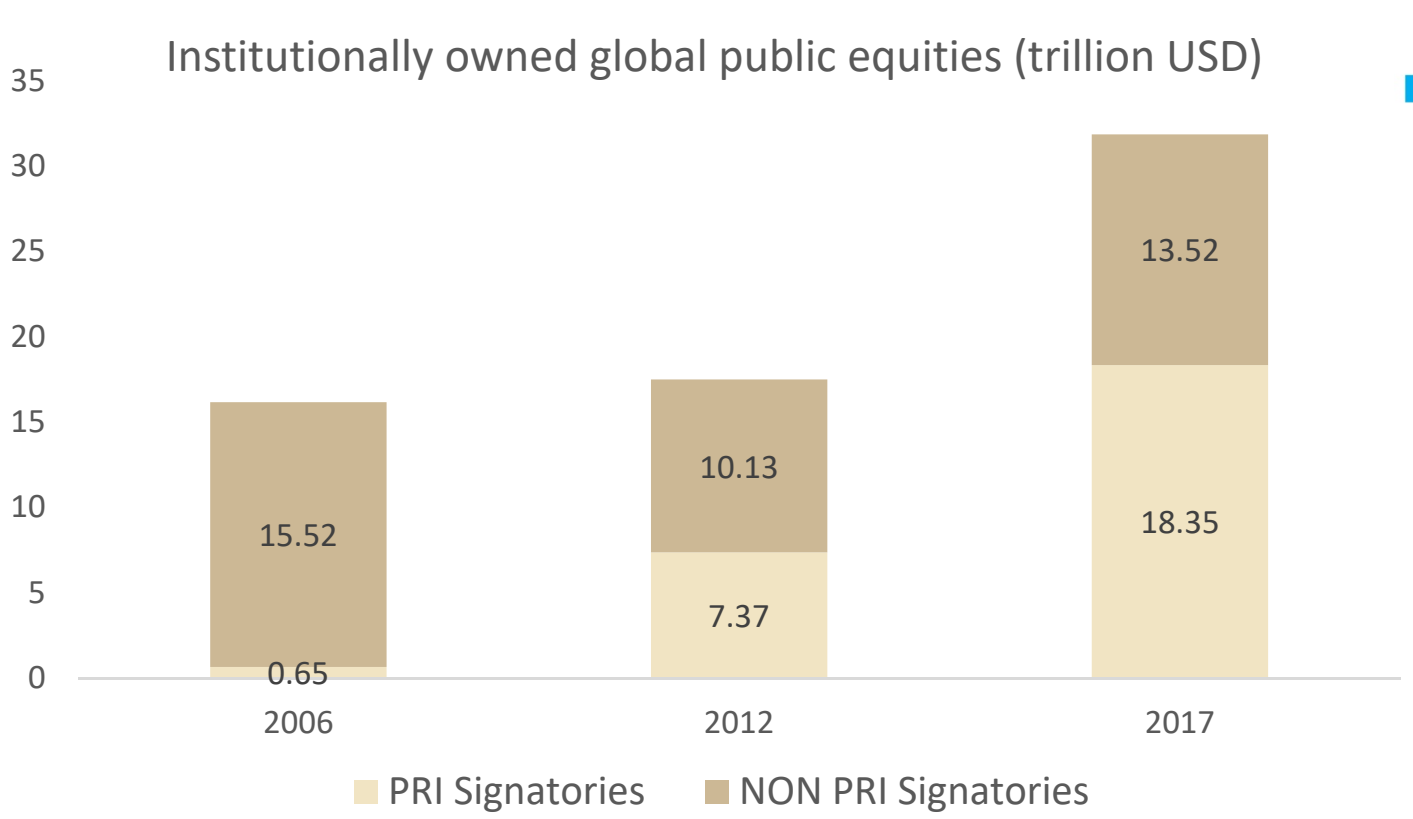

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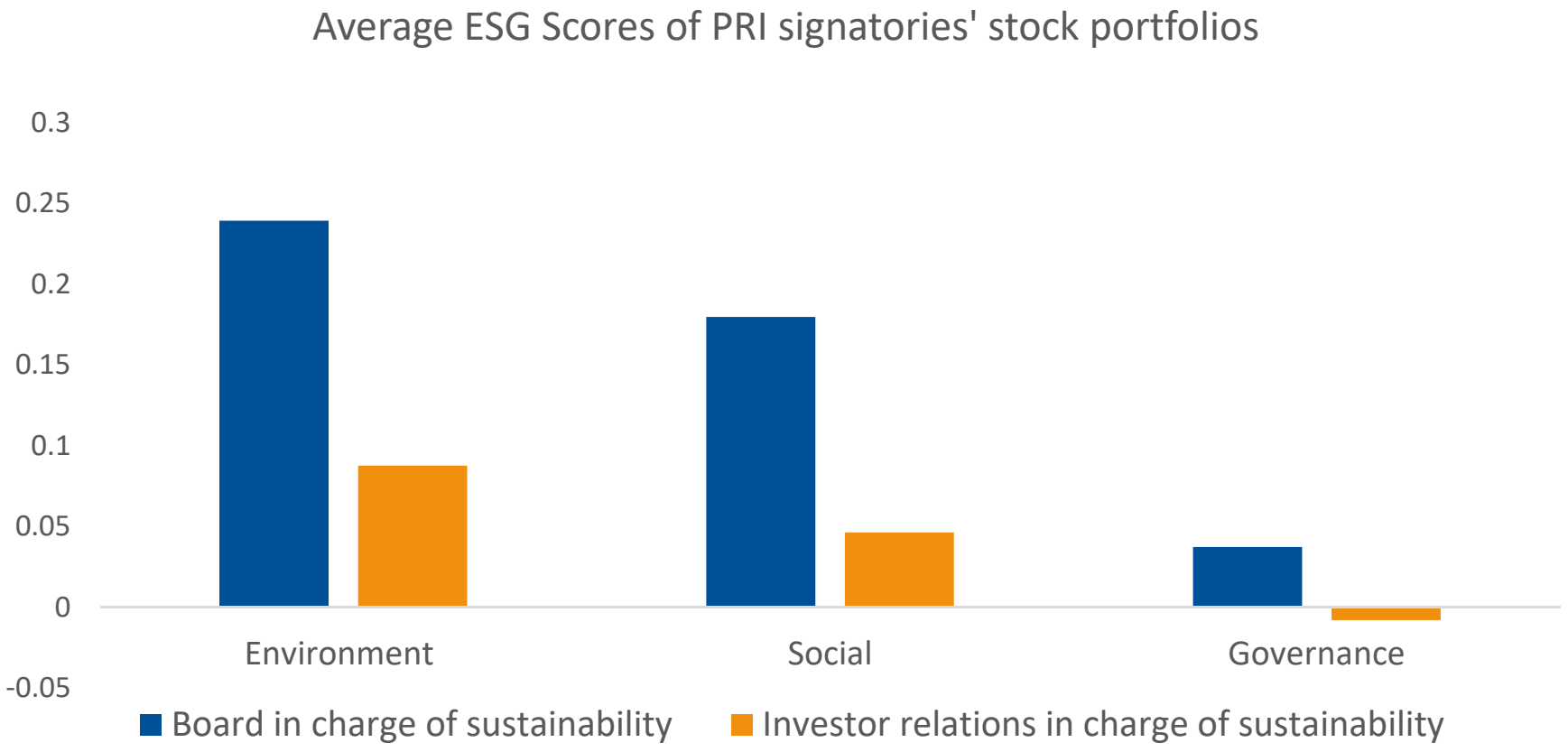
D. Impact washing: What we do not know

Who is sincere and who is simply riding the wave and “rainbow” or “impact washing”?



Source: Gibson, Glossner, Krüger, Matos, and Steffen (2019)

Thank you for your attention.

Questions?

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