Doing Well by Doing Good? Risk, Return, and Environmental and Social Ratings

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Summary

Assets managed under investment approaches that consider environmental and social (ES) factors in portfolio selection and management around the world have grown from US$22.8 trillion in 2016 to US$30.7 trillion in 2018. During the current COVID-19 pandemic, ES funds have attracted record inflows during the crisis. The key question we aim at addressing in this study is why do investors care about ES?

Perhaps, investors rationally view high ES scores as a signal of high future returns. But then the performance of ES funds is mixed. If anything, investing in ES funds is typically associated with larger costs to investors. These findings have led many researchers to interpret investors' interest in ES as either irrational or due to the intangible benefit derived from "doing good." If the demand for ES assets is only due to irrational beliefs or intangible benefits, reasons to invest using ES criteria would be shaky under the standard assumptions that markets are competitive and investors are rational. However, firms might "do well by doing good" in the sense that high ES stocks may be likely to deliver less disappointing outcomes in periods when the stock market disappoints: put differently investments in high ES might have low downside risk. In this paper, we investigate this proposition and find strong

empirical evidence in support of it. To the extent that investors care more about downside losses than upside gains, they can rationally view high ES stocks as attractive assets to hold.

The main results of the paper suggest that stocks sorted on ES scores do not differ significantly in their subsequent (risk-adjusted) returns. In addition, while we find that high ES stocks have lower unconditional market risk than low ES stocks in the same industry, firm characteristics are mostly responsible for the difference in market risk. However, and more importantly, we find that high ES stocks do have statistically significantly lower downside risk than low ES stocks with similar firm characteristics. We find that this is true across various measures of downside risk.

The results of this study are important to financial regulators and investors alike. Among all implications the results suggest that by means of an appropriate emphasis on ES investing, the overall investment risk in the market can be reduced because of a lower downside risk. This is true regardless of theintangible benefits potentially accruing to ES assets.

Nonetheless, the research findings mentioned above imply a cautionary tale: although investing in ES stocks have the statistically significant benefit of a lower downside risk for long-term investors, the economic magnitudes of the estimated effects are humbling. In other words, while high ES stocks do have lower downside risk than low ES stocks, the magnitude is found to be quite small. As a consequence, ES scores should be incorporated into the investment objectives, but in a way that can provide a synergetic supporting role in achieving investment objectives. However, it is worthwhile mentioning that the smaller recorded effects may very well stem from a measurement problem. Indeed, it is a stylised fact that ESG ratings from leading agencies disagree substantially. So, it is important for financial regulators, as well as institutional investors in Hong Kong and internationally, to rely on multiple ratings for better results of lowering downside risk via ES criteria.