ESG Investing: A Tale of Two Preferences

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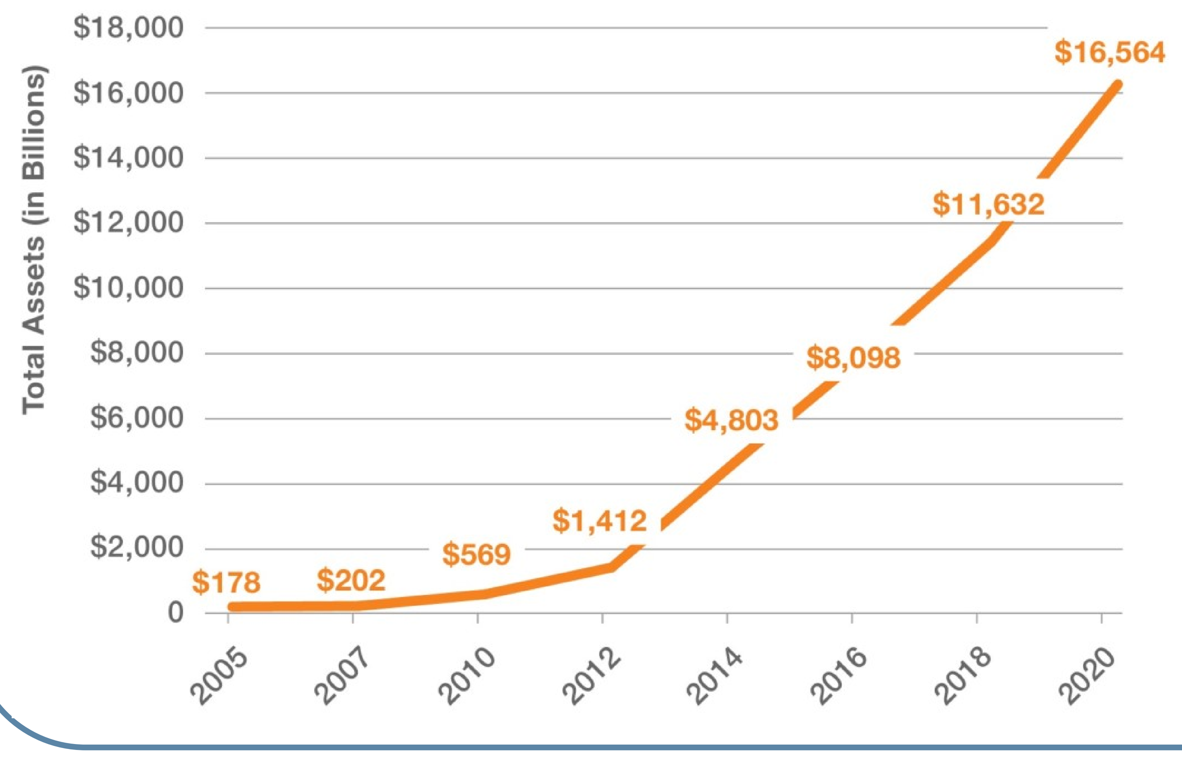
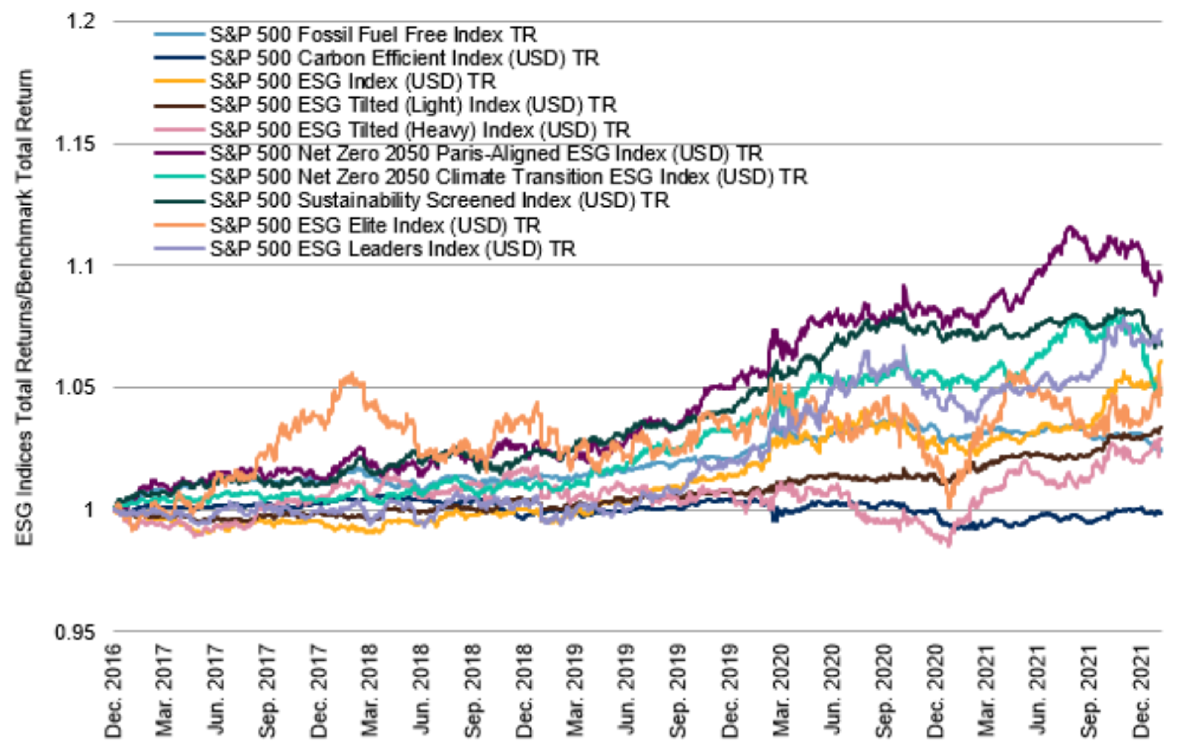
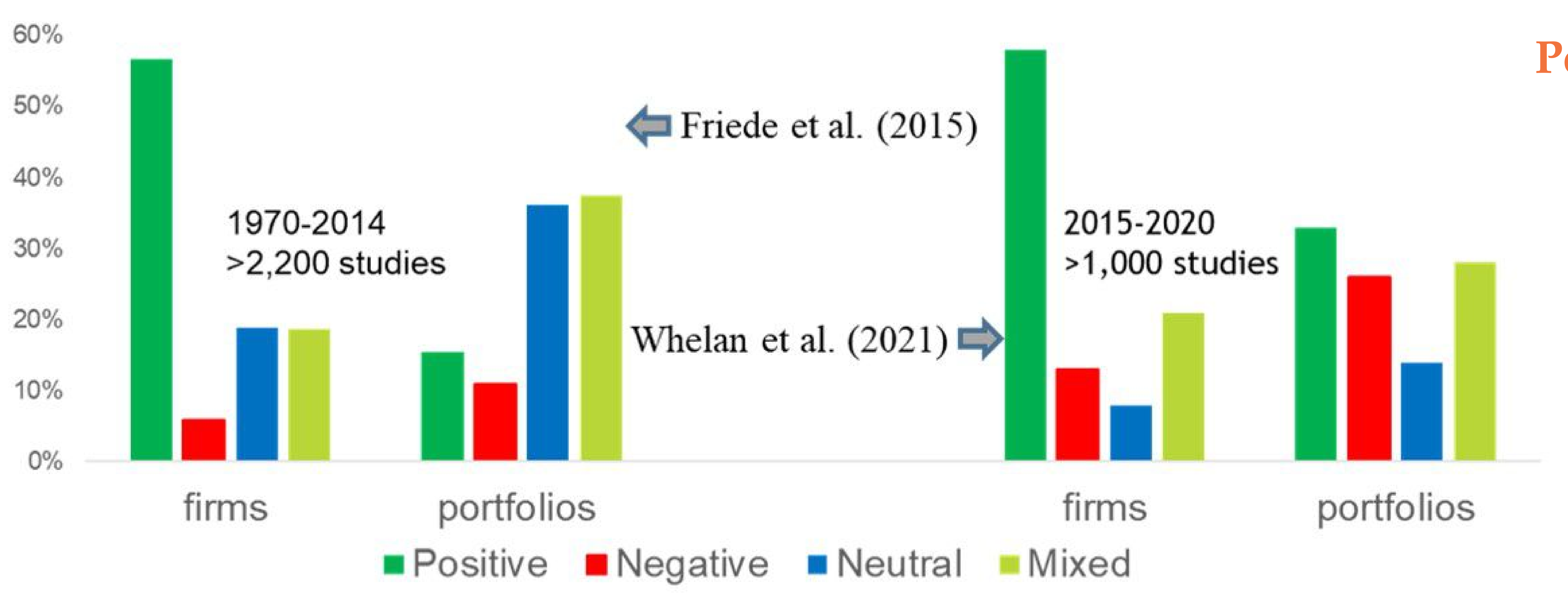
Motivation



- Exponential growth of ESG integration **in the recent decade**
- **Trending capital inflows** to ESG funds or indices continuously push up their prices
- Realized returns can **stay elevated** for a prolonged time period
- Resulting persistent ESG outperformance can **hinder uncovering actual motivations** for ESG investing



Current State of Literature (ESG Puzzle)



Positive ESG–$\mathbb{E}[R]$ is a **puzzle**

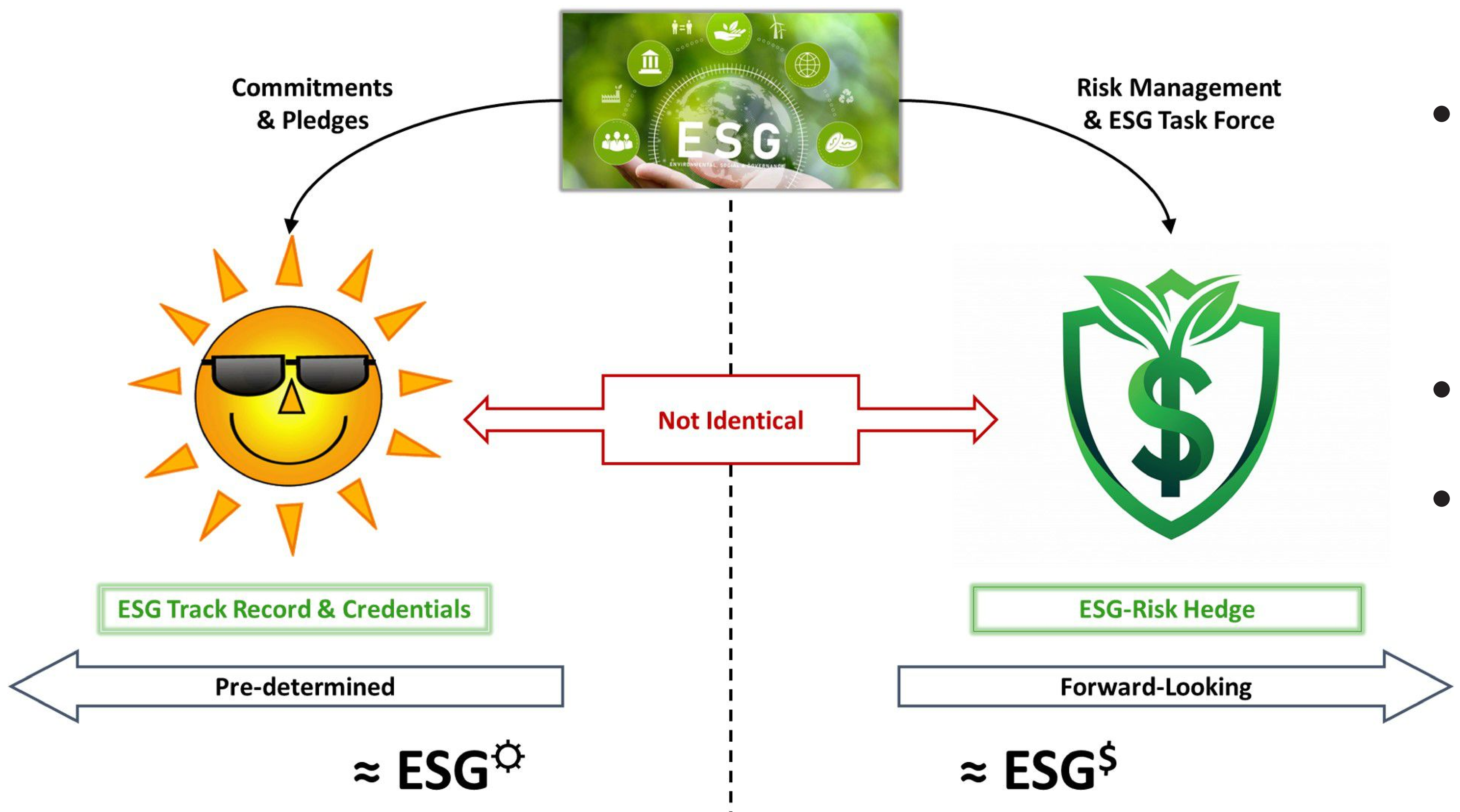
- ESG assets as a **risk-hedge**
  - Albuquerque et al. (2018), Seltzer et al. (2020)
- ESG assets generate **"warm-glow"**
  - Riedl & Smeets (2017), Hartzmark & Sussman (2019), Humphrey et al. (2021), Bonnefon et al. (2022)

Theories suggest **negative relation**

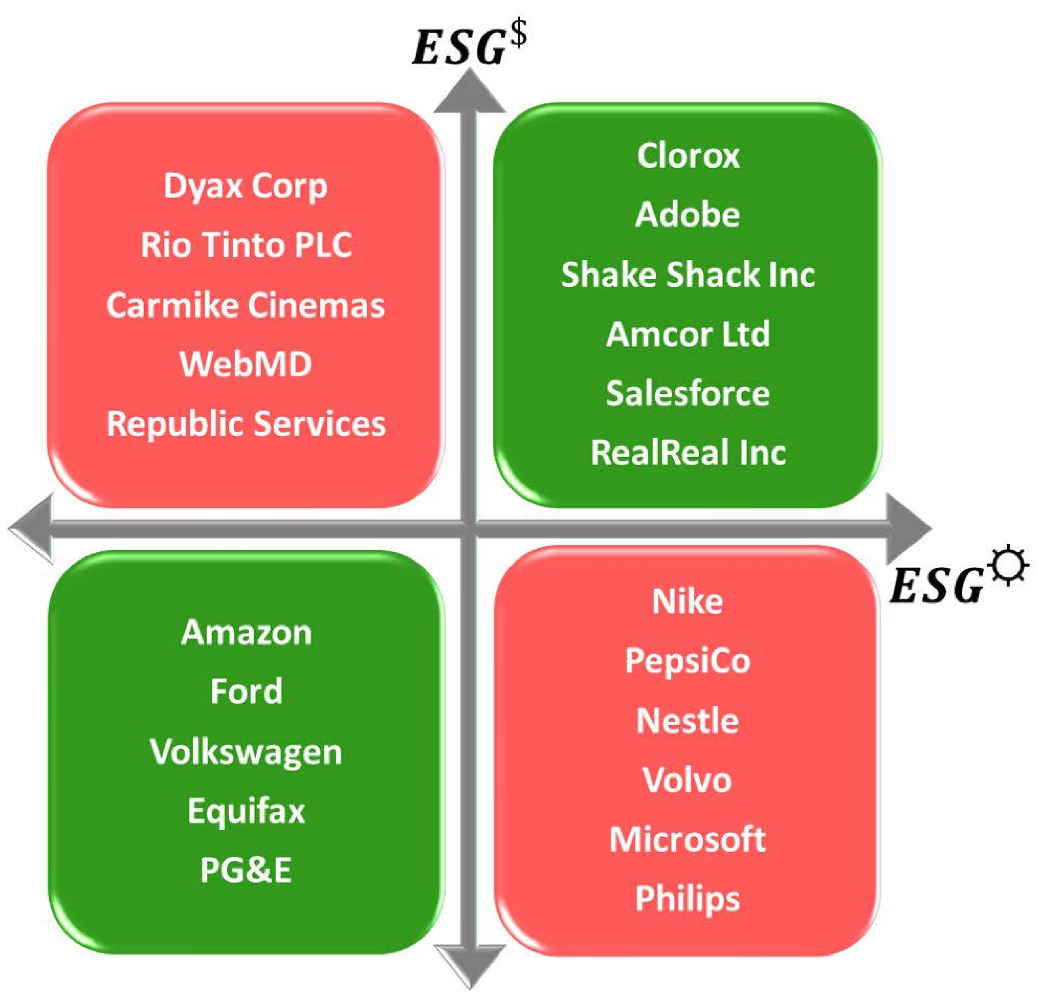
Useful Links

- Paper
- Webpage

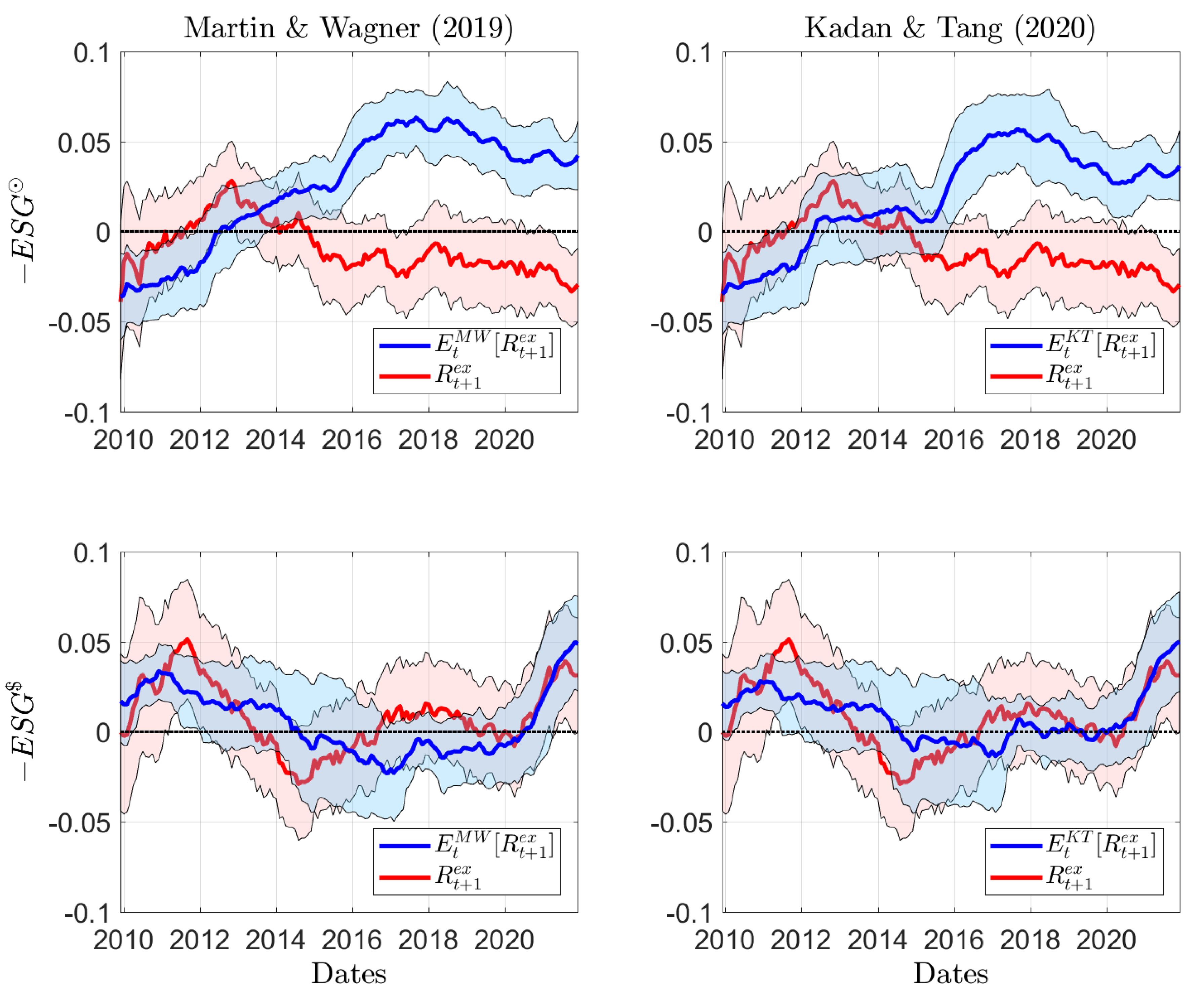
Identification Strategy



- MSCI (IVA) & RepRisk (RRI)
  - $: ESG^{☼} = IVA$
  - $: ESG^{\$} = -RRI$
- $Cor(ESG^{☼}, ESG^{\$}) \approx 0$
- Only $ESG^{\$}$ predicts reg. penalties & litigations
  - Yang (2021) & Glossner (2021)



Results



- Option-implied **ex-ante** expected returns
  - $\mathbb{E}_t^{MW}[R_{t+1}^{ex}]$ & $\mathbb{E}_t^{KT}[R_{t+1}^{ex}]$ (**in blue**)
  - **Negative non-pecuniary & pecuniary ESG premia**
  - **Sizable** up to 1.6% and 3.2% p.a. over 1-month-ahead expected returns, respectively, when comparing lowest vs. highest quintiles within S&P 500 stocks
- Realized returns (**in red**) **mask** $ESG^{☼}$ premium
  - Bias in R_{t+1}^{ex} mainly arises from **trending capital with non-pecuniary motives**
- Cyclicalities
  - Only $ESG^{\$}$ premium evolves **counter-cyclically**
  - $ESG^{☼}$ premium is **pro-cyclical** and **intensifies in mid-2010s**
- External validity of $ESG^{☼}$ & $ESG^{\$}$ as proxies
  - All evidence point to the same direction, **implying their validity**
  - Mutual funds (conventional vs. **ESG** funds)
  - Risk-neutral distribution
- Pecuniary **hedging demand** against non-pecuniary loss