Columbia Business School

Discussion of:

- "Would ESG Investment Enhance Pension Performance?"
by Chris Geczy and John Guerard

- "ESG Confusion and Stock Returns: Tackling the Problem of Noise
by Florian Berg, Julian Kölbel, Anna Pavlova, and Roberto Rigobon

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Outline

- How costly (if at all) is ESG investing?
- Effects of ESG investing on stock prices and returns
  - 2 pd vs 3 pd models
- Modeling measurement error
- ESG for individuals – role of direct indexing?

Is ESG investing costly?

- Costs of screening
- With no price impact
  - Reduced diversification (lower Sharpe ratio)
  - Potential for screen to pick up companies that will be more successful in the future (win-win)?
- With price impact: Lower expected returns?

Stock prices and returns: 2-period model

- Stock prices depend on
  - Demand for stock by current ESG investors
  - Sensitivity of demand for stock by current non-ESG investors

  → High ESG-rated firms will have higher stock prices

  → Low ESG-rated firms will have lower stock prices

- Future stock returns depend on
  - Current stock price only (1-1 mapping)

  → High ESG-rated firms will have lower expected returns

  → Low ESG rated firms will have lower stock prices

Stock prices and returns: 3-period (or more) model

- Stock prices depend on
  - Demand for stock by current ESG investors
  - Sensitivity of demand for stock by current non-ESG investors
  - Expected future demand by future ESG investors

  → High ESG-rated firms will have higher stock prices

  → Low ESG-rated firms will have lower stock prices

- Future stock returns depend on
  - Current stock price
  - Future ESG ratings
  - Future demand by future ESG investors
  - Future sensitivity of demand by non-ESG investors

→ No clear mapping between today's ESG rating and future returns

ESG and returns

- No clear mapping between today's ESG rating and future returns
- Ways that high ESG-rated firms could have higher expected and actual returns
  - Current high ESG-rated firms could have even higher relative ratings in the future
  - Demand for high ESG-rated stocks could increase in the future
- Important to think more about
  - How responsive will low ESG firms be in the future to today's pressure?
  - How popular will ESG investing be in the future?

Noisy ESG ratings

- Rigobon and co-authors rightly highlight the large differences across ESG ratings

- Sources of differences?

- Implications for measuring impact on returns

Modeling measurement error

- $s_Y = Y + \varepsilon_Y$ (Y= truth, s= signal, ε=noise)

- Rigobon et al assumptions
  1) Classical measurement error: ε_Y uncorrelated with **Y**
  2) Investors know the truth and base investments on it

- Alternative assumptions
  1A) Rational forecast error: ε_Y uncorrelated with **s**
  2A) Investors don't know the truth, base investments on inference from signal(s)

- Implications for results
  - Different biases
  - Different assessments of which signal is better (see, e.g., Miron and Zeldes, Journal of Monetary Economics, 1989)
  - How to modify tests?

ESG for individuals – role of direct indexing

- Direct indexing
  - Customized index tracking through direct ownership of a large number of individual stocks

- Advantages
  - Flexible ESG (and other) screens
  - Tax advantages (for taxable accounts)
  - Voting rights, especially on ESG matters

- Examples
  - Aperio (BlackRock)
  - Parametric (Morgan Stanley)
  - Ethic
  - OpenInvest

Torn from the headlines…

The New York Times By Ron Lieber Dec. 4, 2020

A New Way to Invest for the Vengeful and the High-Minded

Big investment managers are buying up companies that help with so-called direct indexing, which offers clients a way to boot individual companies from their portfolios. It has tax benefits, too.

Imagine a 401(k) where there's no investment menu of stock funds. Instead, you get to make one that aligns with your values.

You could begin by knocking out oil drillers or gun manufacturers, or subtracting companies one by one depending on which ones have crossed you (or the world) lately. And when you're done, you — and not a mutual fund — own individual pieces of every other security that you're not beefing with, whether personally or as a citizen of the world.

Some of the biggest names on Wall Street can conjure up this tantalizing prospect, which is called direct indexing. And they're buying up smaller firms that have already made it a reality for some wealthy investors.