Discussion of “The Cost of ESG Investing”

by Lindsey, Pruitt, and Schiller

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This paper

- What is the consequence if investors implementing ESG strategies?
  - Little changes to beta (systematic risk exposure) or alpha
  - It implies near-zero cost of implementing ESG-investing
  - It also means that the commonly used 4 ESG ratings provides negligible new information on either risk or mispricing

- Method: IPCA can rule out the concern of misspecification of known pricing factors
  - Traditionally, the standard is FF5, FF5+Mom, or HXZ5

- Important, yet obviously surprising results!
  - How to reconcile with existing studies that do find some sorts of ESG premium
    - e.g., Pastor et al. (2021a), Edmans (2011)
    - Due to different exposure to systematic factors
  - How to reconcile with the fast-growing and enormous size of ESG investment
    - This paper's explanation: disagreement/uncertainty of the ESG ratings, or certain type of ”green washing”

Comment #1: ESG measurements

- This paper's main conclusion builds on the premise that the 4 ESG ratings contain all ESG-related information

- But this is not clear:
  - Their formula are subjective and in "black-box" (Berg et al. 2020)
  - Industry-adjusted
  - Self-selected coverage (more on large and clean firms)

- Suggestions: use more transparent data (easy w/ IPCA), for example,
  - RepRisk provides the raw data of the company news
  - CO2 emission data from TruCost (e.g., Bolton & Kacperczyk 2020)
  - Pollution data (e.g., Hsu, Li, & Tsou 2022)
  - Industry dummies
    - "Sin" stocks (e.g., Hong and Kacperczyk 2009)
    - Emission vs clean based on IPCC categorizations (e.g., Choi, Gao, & Jiang 2020)
    - Available for all firms all the years

Comment #2: Disagreement of ESG ratings

- This paper provides a convincing conceptual framework that shows how the difference in using ESG ratings or implementing ESG-investing can lead to the non-result
  - Based on Pastor et al. (2021a)
  - A nice figure shows that the ranking correlations of the ratings are close to zero!

- In meanwhile, Avramove et al. (2021) and Gibson, Krueger, and Schmidt (2021) show that ESG rating disagreement/uncertainty is priced
  - Then, how to reconcile?

- I hope the authors can push further in this direction, for example
  - Subsample of firms with low ESG rating divergence
  - Input the ranking correlations of ESG ratings into the model

- More direct evidence of this explanation will further enhance the pervasiveness

Comment #3: A risk-based explanation

- It is possible that stock price or valuation ratio has already taken into account the firm's risk associated with ESG issues
  - For example, for "E" or climate change, there can be physical risk, regulatory risk, transitional risk, etc.

- Then, including the ESG ratings would be redundant
  - Then, price foresees these risks, leading to no return predictability (distinct from a preference-based story)
  - And they will also be picked up by IPAC as a coherent component in the systematic factors, results in little change to beta

- Given there is a strong trend of devaluation on carbon-intensive stocks globally
  - e.g., Choi, Gao, Jiang, and Zhang (2022); figure

- A quick test would check the robustness when removing all valuation ratios from the input characteristics
  - Slow characteristics still include div3m_me, div6m_me, and div12m_me

Comment #4: A preference-based explanation

- ESG preference will lead to low price valuation but high expected returns of low ESG stocks
  - Similar to the price of "sin" effect (Hong and Kacperczyk 2009)

- Increasing concern of the ESG issues and the rise of ESG investing
  - Reflects a preference shift of investors
  - The preference shift induces divestments of low ESG-rated stocks
  - Leading low returns of low ESG stocks due to selling pressure

- Such shift and divestment trend can be a long-lasting and gradual process
  - Due to large existing holding (e.g., Norwegian wealth fund's plan on divesting coal and fossil fuel firms)
  - Or lack of consensus among investors and policy makers

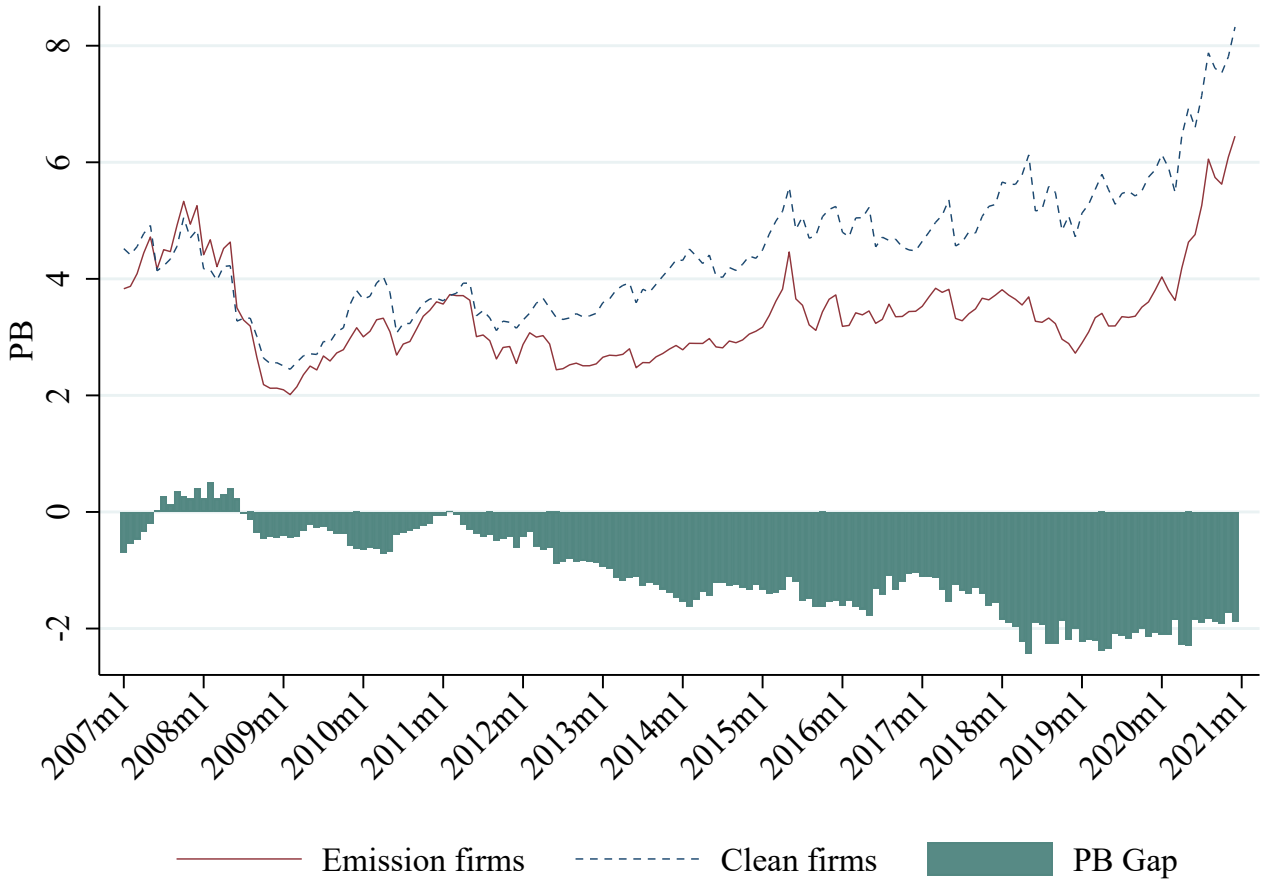
- So, in this sample period, the competing effects may cancel out, resulting in no ESG alpha
  - Hard to discern using current data
  - Revisit this test after 10 years

Conclusion

- Overall, it is an interesting and thought-provoking paper
  - It helps us to understand ESG investment and its impact in a more systematic way
  - It has important welfare implications

- I enjoyed reading it and learned a lot

Price Gap between Emission and Clean



- Industry-based categorization: emission versus clean firms
- 26 international equity markets

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