Adair Morse
Presentation for 2019 EFA / European Commission Panel on Sustainability

**Talk Based on (Temporary Title):**

“**Sustainability Disclosures & Stocks: Generating Real Investment for Global Challenges?**”

**By Byung Hyun Ahn, Adair Morse & Panos Patatoukas**
University of California, Berkeley
WHAT WOULD BE REQUIRED TO GENERATE NEW CAPITAL TO SOLVE GLOBAL CHALLENGES?

Need:
• $180 billion in new capital per year to make progress on climate
• Real investment, not sustainability-rated financial holdings

Sustainability Literature:
• Bulk concerns sustainability investing in equities
• Why: Because of investment returns question

Our Agenda:
Nothing wrong with studying sustainability investing in equities for financial returns and risk management purposes, but is sustainability investing in equities useful for solving global challenges?
WHAT WOULD BE REQUIRED TO GENERATE NEW CAPITAL TO SOLVE GLOBAL CHALLENGES?

Framing: Difference between Necessary and Sufficient

**Necessary**
- Sustainability-sensitive flows (=demand, utility,)
  - Requires eco-labeling & research understanding disclosure
  - Non-negative benefit in financial return and/or positive risk management
    - Requires a lot of research on LT investment
    - Plus the regulatory encouragement & freedom

To get to sufficient, need above plus:
- **Real investment**
ILLUSTRATE PROBLEM IN FLOWS

“Do Investors Value Sustainability”
by Sam Hartzmark and Abigail Sussman

“But what about people who invest for non-pecuniary reasons like making the world a better place. Do they matter? Indeed, they do. We find that, after controlling for investor’s expectations of risks and returns, subjects allocated more money to high sustainability funds.” -Oxford Business Law Blog Summary

This is an excellent paper. (Also: Laura Starks’ EFA Presidential Address)

Our point: But does this non-pecuniary utility mean people are “making the world a better place?” Disclosure is necessary but not sufficient.
“The Importance of Climate Risks for Institutional Investors”

According to our survey regarding climate-risk perceptions, institutional investors believe these risks have financial implications for their portfolio firms and that the risks have already begun to materialize, particularly regulatory risks.

Another great paper.

Our take: The first order concern of sustainability investing is financial performance and risk management benefits.

Necessary but not sufficient to say “new capital” and “solve global challenges”

Consistent with Bolton and Kacperczyk: Institutional investors implement exclusionary screening based on scope 1 & 2 but not scope 3 emissions.
Krüger (2015, JFE):

- Event-study of more than 2,000 sustainability related events in firms
- Find: Strong negative short term returns when negative events. No reaction to positive events.

Implications: Market penalizes – consistent with view of financial interest in sustainability as risk management-oriented.

- See also paper on downside risk / engagement – Hoepner et al, 2019
- And a host of work on whether ESG loadings are factor exposures (I saw a wonderful keynote by Philipp Krüger on this)
FIRST PASS

Preliminary:

- **Outcome**: real activities in accounting data
- **Related to**: Changes in KLD
  - Note: Most movement in KLD is mechanical/methodological
  - Thus, not endogenous to firm decisions
KLD CHANGES

<table>
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<tr>
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<th>ΔES (Total)</th>
<th>ΔES(Material)</th>
<th>ΔES(Immaterial /Methodology)</th>
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Point 1: Changes in KLD are rare and mostly mechanical changes when MSCI took over and tweaked scoring
KLD changes & institutional investor concurrent allocation changes:

13-F Net Flows (In vs Out) & Returns

<table>
<thead>
<tr>
<th>Panel A:</th>
<th>KLD Δ&lt;0</th>
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<tr>
<td>Passive Index-like ETFs/Funds</td>
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<td>Active</td>
<td>In</td>
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<tr>
<th>Panel B:</th>
<th>KLD Δ&gt;0</th>
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<td>Passive Index-like ETFs/Funds</td>
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Green: Positive Returns
Red: Negative returns

Significant 1year forward returns circled

Point 2: Flows that are sustainability-triggered may have demand-induced price distortion that is captured by trading against sustainability (reminiscent of Hong & Kacperczyk)
RETURN IS DRIVEN BY NON-MATERIALITY CHANGES

Growth of $1 in 3 portfolios, rebalanced once per year when KLD comes out

$\Delta <0$ $\Delta = 0$ $\Delta >0$

<table>
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<tr>
<th>$\Delta\text{ES(Material)}$</th>
<th>$6.19$</th>
<th>$11.52$</th>
<th>$7.26$</th>
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<tbody>
<tr>
<td>$\Delta\text{ES(Immaterial)}$</td>
<td>$14.21$</td>
<td>$10.27$</td>
<td>$7.52$</td>
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One can quibble (correctly) with risk adjustment, factor loadings, etc., but these deficiencies are not going to erode the magnitude difference between 14.21 and 7.52
**REAL INVESTMENT (FIRST LOOK)**

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A first look paints a pretty abysmal picture.
(UNRELATED) POINTS ON POLICY & RESEARCH

1. It is a disservice to retail and other unsophisticated investors to have funds/ETFs labeled as an SRI index without some disclosure as to the process
   • If you tell me you are excluding weapons it is magnitude less increase in tracking error than if you are excluding defense industries
   • If you tell me you are picking the 20 hot SRI stocks it’s a very different portfolio than one with an ESG slightly tilted weighting scheme
2. Someone needs to pay attention to the sham SRI fintechs (sham= not greenwashing but double fees)
3. Research need: to figure out why constrained portfolios are performing at market
   • One time information vs climate risk vs climate policy risk
4. Policy need: desperate to get labeling to reveal truth in all assets classes in order to enable more capital to flow, fiduciary and fiduciary-philanthropic packages