Skills and Sentiment in Sustainable Investing

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Motivation

- **Sustainable investments** have **surged** over the past decade
- Many investors claim that they are able to achieve **high returns** while **investing sustainably**
- Some investors have **strict** and some have **flexible** investment mandates

Abstract

We document a significant difference in the returns of sustainable investing across investor types. Investors with strict ESG mandates earn 3.1% less than flexible investors. The mechanism is that flexible investors are able to react on expected ESG improvements. They buy stocks that subsequently experience ESG score increases. After ESG improvements have realized, demand from strict mandate investors pushes up stock prices, resulting in positive returns for flexible investors. These returns are higher when accompanied by rising climate sentiment, as seen during the 2010s. Our channel accounts for 51% of the return difference between strict and flexible ESG investment mandates.

Theoretical Framework

Continuum of agents maximise

$$U[W_{1i}, X_i] = -e^{-aW_{1i} - b_i' X_i}, \tag{1}$$

where $b_i = s_i g$.

In equilibrium

$$r^e = \beta_M r_M^e + g\mu_g + \tilde{g}\frac{\bar{s}}{\gamma} + \tilde{s}g + \epsilon, \tag{2}$$

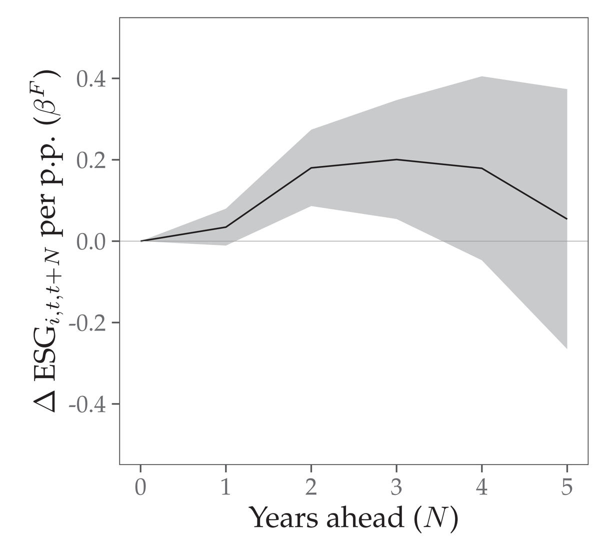
where $\mu_g \propto -\bar{s}$, and $\tilde{g}$ and $\tilde{s}$ are innovations in g and s

Results

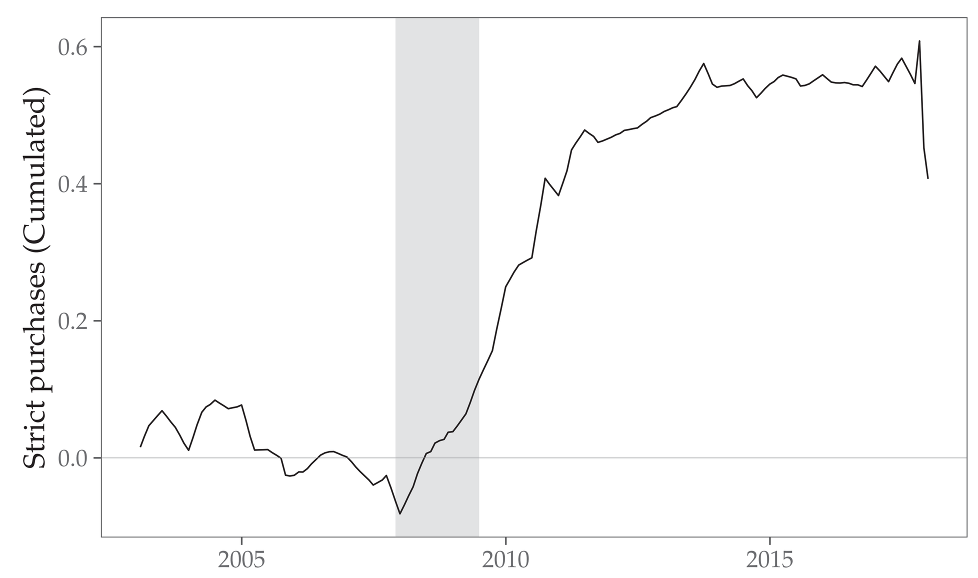
- **Flexible investors earn high returns** when investing sustainability
- In comparison to strict investors, the returns earned by flexible investors are **3.1% higher**

	ESG low	ESG high	LS
Flexible investors	0.088	**0.392**	**0.304**
t-statistic	0.773	3.784	2.027
Strict investors	-0.049	0.130	0.179
t-statistic	-0.374	1.108	1.089
Monthly difference	0.137	**0.262**	0.125
Yearly difference	1.644	**3.144**	1.500
t-statistic	0.965	2.353	0.750

- Flexible investors **predict** ESG scores



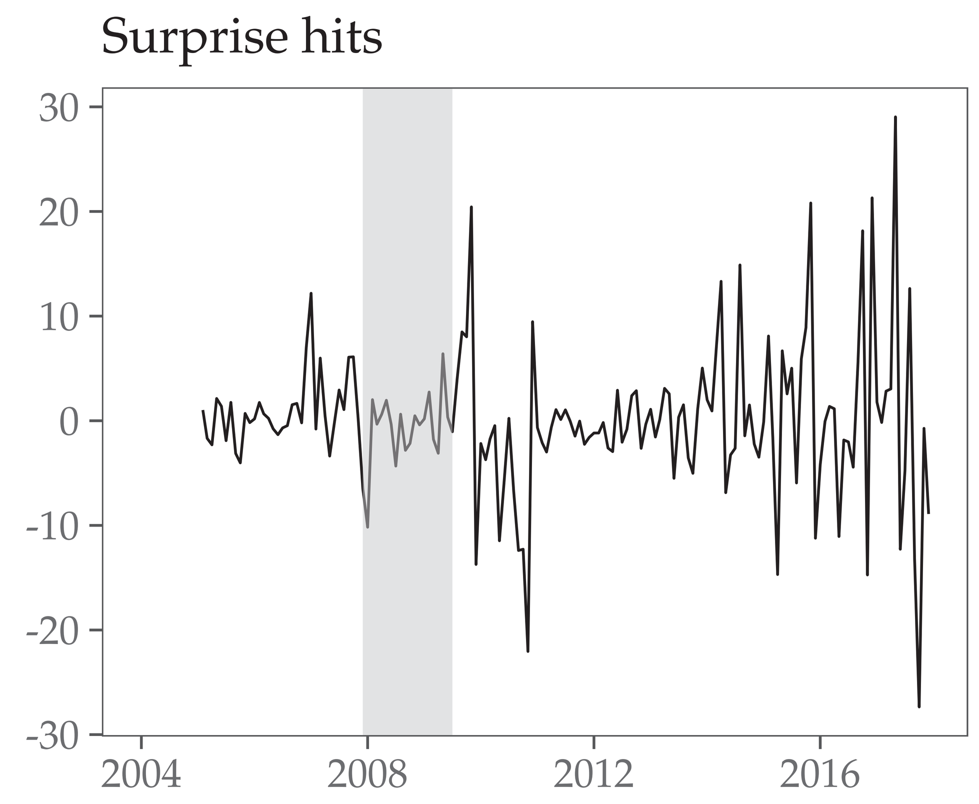
- Strict investors **demand** high ESG stocks from flexible investors



- The additional demand pushed up prices by **0.8 bp per ESG** score increase

Climate Sentiment

- We create our own sentiment measure through Google Search volumes on the term **Climate Change**
- We adjust for seasonality and autocorrelation to filter out **shocks** to climate change



- We find that our climate sentiment measure **positively correlates** to the returns earned by flexible investors as well as a general sustainable investing strategy
- We conclude that climate sentiment is a **key driver** in the returns to sustainable investing

Conclusion

1. Cost to strict investment mandate within **sustainable investing** of 3.1%
2. Socially unconstrained premium arises from **skill** in predicting ESG scores
3. Socially unconstrained premium increases with **climate sentiment**

→ Results suggest more green projects to be financed, and ultimately a more sustainable future

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