RESPONSIBLE INVESTING

Can Sustainable Investments Maintain Their "Green Premium"?

By: John Streur | March 28, 2022

Washington - At a recent joint symposium held by the University of Virginia and the Investment Company Institute (ICI), panelists debated an important question: Can investors continue to expect above-average returns from sustainable investments — or are they likely to see a mean reversion?

In recent years, the overall performance of mutual funds and ETFs in the environmental, social and governance (ESG) space has largely kept pace with or outshone their non-ESG counterparts, as reported by Morningstar, Barron's and others. Whether this trajectory can continue has been up for debate.

The symposium discussion was sparked by a recent paper from the University of Chicago, "Dissecting Green Returns,"[1] where the authors found a link between the outperformance of "green" securities and the number of "climate shocks" reported in the media.[2] The paper's analysis suggests that press coverage of climate shocks — droughts, heat waves, floods and the like — draws investors to green or ESG-focused investments. In the event climate shocks abate, green investors may see a mean reversion in price performance, according to the paper.

Of course, the potential for mean reversion — the tendency of asset prices to revert to historical norms — is a typical part of market cycles. We believe, however, that ESG considerations are fast becoming integral to corporate, investor and government decision-making — a trend supportive of "green" performance.

Mean reversion or green momentum?

We think the potential for mean reversion is particularly acute where there may be "greenwashing" or an overstatement of a company's sustainability commitment. Moreover, as different industries clearly have different ESG vulnerabilities, mean reversion may be more likely in some sectors than others, depending on environmental or sociopolitical circumstances. For example, while climate risk and its potential impact on security prices is a major concern for oil companies, it is much less of a risk factor for financial services or technology companies.

Taking the long view, we think several trends are likely to support the momentum behind sustainable investments for the foreseeable future:

Climate shocks likely to persist. Inasmuch as the reporting of climate shocks may be contributing to investor interest in ESG, fund flows and "green" performance, we think this trend is likely to continue. Climate change data, including from the recent Intergovernmental Panel on Climate Change (IPCC) report,[3] indicates the frequency and magnitude of climate shocks are likely to increase globally, rather than subside.

Companies' operations are shifting toward sustainability. We see companies reducing their exposures to climate-related risks, and doing so in a way they believe will improve operating cash flows and financial results. We see this occurring with both green and brown companies in the U.S. and overseas. In our view, this indicates a fundamental shift in corporate direction that argues against mean reversion.

Sustainability concerns are far-reaching. Although environmental concerns are high on many investors' priority lists, issues around unequal access to health care, income inequality and lack of diversity, equity and inclusion have come to the fore during the pandemic. Companies bridging these divides may also benefit, over time, from greener returns.

Regulation and better data reporting may increase use of ESG and impact security pricing. As environmental data on carbon and other sustainability factors become more robust and uniform due to regulatory requirements, investor perceptions of a company's "greenness" may change. This may impact a range of securities and their pricing, up or down.

Engagement can be an ESG game changer. Engagement is a powerful tool for heightening public awareness and catalyzing positive corporate change around ESG issues. In some cases, engagement outcomes may materially improve a company's bottom line over the long term — and potentially influence industry direction or policy decisions.

Bottom line: Mean reversion may be a real possibility for some securities, particularly those associated with greenwashing or for companies not addressing their sustainability risks. We believe, however, that ESG has staying power. In our view, sustainability concerns are fundamentally shifting how companies, investors and governments evaluate and conduct business.

1. University of Chicago, "Dissecting Green Returns," Lubos Pastor, Robert F. Stambaugh and Lucian A. Taylor, February 1, 2022.

2. Negative climate news was measured using the **Media Climate Change Concerns Index**, which aggregates data from eight major U.S. newspapers and

was used to measure reported climate shocks.

3. IPCC, "Climate Change 2022: Impacts, Adaptation and Vulnerability," February 27, 2022.

Past performance is no guarantee of future results.

Investing involves risk including the risk of loss. There is no guarantee that any investment strategy, including those with an ESG focus, will work under all market conditions. Investors should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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