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Long-run Risks, Returns, and ESG Investing

SUMMARIES



Robert Litterman, Kepos Capital

keynote speaker

Pricing Climate Risk

The appropriate time path for emissions prices, which economists call the “Social Cost of Carbon,” should be thought of as the solution to an optimal control problem. The price of carbon is the brake that society uses to accelerate or decelerate the rate of usage of the atmosphere’s unknown capacity to safely absorb emissions. Right now the incentive to reduce emissions is strongly negative, i.e. governments around the world heavily subsidize the creation of emissions. Potential climate-risk tail events, together with societal risk aversion (which is best observed in the equity risk premium) and expectations of technological change determine the appropriate time path for emissions prices. Societal understanding of this issue is at a tipping point. As expectations of incentives being created sooner and higher increase, the valuations of stranded assets, such

as coal and coal fired power plants will decline. But understanding how forward expectations of carbon emission prices drive current valuations is complex. It is also important to understand that it is not the act of pricing emissions that destroys the value of these assets—it is the economic externality that has already destroyed their value. What the recognition of that externality will do is to reduce their current false valuations. Exxon and Shell have, in their public discussion of stranded assets, shown that they do not understand this issue. Paraphrasing Upton Sinclair, “It is difficult to get a company to understand something, when the valuation of its assets depends on it not understanding it.”

Arik Ben Dor, Barclays

ESG Ratings and Performance of Corporate Bonds

Discussant: Tony Elavia, Mackenzie Financial Corporation

We examine the implications of ESG (Environmental, Social and Governance) focused investing on corporate bond spread and performance. Despite common perceptions, we find that over the last decade credit portfolios with high ESG ratings have modestly outperformed otherwise similar portfolios with lower ratings. The outperformance has not been accompanied by increasing relative valuation as indicated by historical ESG spread premium. This suggests that the performance patterns we documented were not simply a consequence of buying pressure but may have reflected investors' anticipation to the possibility of significant changes in the regulatory business environment.

Kent D. Daniel

Columbia University

Applying Asset Pricing Theory to Calibrate the Price of Climate Risk

Discussant: Jeffrey Bohn, State Street Global Exchange/GX Labs

Kent D. Daniel, Robert B. Litterman, and Gernot Wagne Pricing greenhouse gas emissions is a risk management problem. It involves making trade-offs between consumption today and unknown and potentially catastrophic damages in the (distant) future. The optimal price is necessarily based on society's willingness to substitute consumption across time and across uncertain states of nature. A large body of work in macroeconomics and finance has attempted to infer societal preferences using the observed behavior of asset prices, and has concluded that the standard preference specifications are inconsistent with observed asset valuations. This literature has developed a richer set of preferences that are more consistent with asset price behavior. The climate-economy literature by and large has not adopted this richer set of preferences.

In this paper, we explore the implications of these richer preference specifications for the optimal pricing of carbon emissions. We develop a simple discrete-time model with Epstein-Zin utility in which uncertainty about the effect of carbon emissions on global temperature and on eventual damages is gradually resolved over time. We embed a number of features including tail risk, the potential for technological change and backstop technologies. When coupled with the potential for low-probability, high-impact outcomes, our calibration to historical real interest rates and the equity risk premium suggests a high price for carbon emissions today which is then expected to decline over time. This is in contrast to most modeled carbon price paths, which tend to start low and rise steadily over time.

Ravi Jagannathan

Kellogg School of Management

Environmental, Governance, and Social (ESG) Criteria: Why Should Investors Care?

The responsibility of a firm's management is to maximize the firm's value while abiding by the rules and norms of the society. The value of the firm is determined by the prices that investors are willing to pay for its securities. Those prices depend on how investors perceive the firm's future cash flows and the associated risks, and the return they require for bearing those risks. Increasingly, market participants seem to believe that "doing good for society", in ways that need not necessarily be reflected in near term cash flows, is good for investors as well. Presumably, firms that are doing good by being responsive to a broader set of stakeholders; being accountable for the risks due to environmental factors (from compliance to sourcing to climate change); and have stronger board governance in place; are likely to be in a better position to adapt to future changes in social rules and norms that affect long term

cash flows and associated risks. Environmental, Social, and Governance (ESG) criteria scores are meant to help investors assess a firm's "doing good" performance. One of the objectives of this conference is to promote research that will examine the issues related to measuring such performance and how it affects future cash flows and firm value.

Paul D. Kaplan and Paul Justice, Morningstar

ESG and Mutual Funds

Margaret Stumpp, Quantitative Management Associates LLC

Paul Kaplan and Paul Justice Morningstar has developed a Sustainability Score for mutual funds and ETFs that rolls up the ESG scores on individual companies issued by Sustainalytics. In this paper, we first review Morningstar's methodology and summarize the resulting scores. We then see if there are any statistical relationships between the Sustainability Score are (1) historical risk-adjusted performance as measured by the Morningstar "star" rating, (2) the forward-looking Morningstar Analysts Rating, and (3) fund expenses. In way we see how the Sustainability Score fits within the framework of analytics that investors can use when selecting funds.

John Kohler

Santa Clara University

Impact Investing: Portfolio Assembly and Risk Management

Discussant: Vitali Kalesnik, Research Affiliates

This session will explore impact investing beyond the boundaries of ESG. The themes presented will include 100% impact across broad asset classes, assembly of a portfolio with intentional and measurable impact, and observations from those asset managers who are building an impact portfolio. The session will also present risk mitigation strategies, including diversification,

investment weighting, and the use of novel investment vehicles. This session will be informed by recent publications from the sector in impact portfolio assembly, financial models, and definition of impact.

Lukasz Pomorski

AQR Capital Management

Quality, Risk, and ESG Investing

Discussant: Rick Nelson, Syzygy Advisors

We discuss both risk and return implications of incorporating ESG considerations in an investment strategy. We focus on the risk side in particular and argue that ESG exposures may be informative about the risks of individual firms. We find clear support for this hypothesis in the data, showing a strong negative correlation between how attractive a stock is from the ESG perspective and how risky it is from the point of view of a forward-looking risk model. This finding is strong overall, robust to a wide variety of controls, and clear globally as well as in individual regions (US, World ex US, or in emerging markets). Importantly, we also find that ESG scores convey information about risks that may not be captured by a more traditional risk model. Controlling for the contemporaneous risk model estimates, we show that poor ESG exposures predict increased statistical risks in the future. Our findings suggest a clear role for ESG in investment portfolios, although that role may have more to do with risk than with the potential to earn higher average returns.

Laura T. Starks

University of Texas at Austin

Green Wash or Green Walk: The Environmental Responsiveness of Institutional Investors

Discussant: Alison Li, CalPERS

Previous research has debated whether firms face reputational losses from environmental violations or whether the significant losses to market value are due to legal and regulatory penalties. We take a different approach by examining the reactions of institutional investors to exogenous shocks to a firm's environmental responsibility. Using a differences-in-differences framework, we find that the institutional investors expected to be most sensitive to EPA violations do indeed reduce ownership in the firms, suggesting that the firms face reputational losses along with the penalties imposed by the government.

Andrew Wu

University of Michigan

Is Socially Responsible Investing a Luxury Good?

Discussant: Sharon Hill, Delaware Investments

We investigate the risks and returns of socially responsible investing (SRI) utilizing firm-level data on corporate social responsibility ratings.

While firms with high ratings do have higher average alphas than those with low ratings, these alphas are time varying, with high-ranked stocks significantly outperforming low-ranked ones during good economic times, but significantly underperforming them during bad economic times. In addition, reductions in firms' social responsibility ratings lead to temporarily lower abnormal returns, and this fact is more pronounced during good economic times. Furthermore, the abnormal returns after CSR-related press announcements by individual firms are significantly positive during good times and mildly negative during bad times. These evidences are consistent with time-varying, wealth-dependent preferences toward SRI, which result in more responsible stocks behaving in a fashion akin to luxury goods: the alpha difference is significantly correlated with both luxury consumption from NIPA and the sales growth of luxury-good retailers.