This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit https://www.djreprints.com.

https://www.wsj.com/articles/esg-investing-can-do-good-or-do-well-but-dont-expect-both-11643033321

ESG Investing Can Do Good or Do Well, but Don't Expect Both

The claim that investors will make more money investing in green bonds is patently absurd. This is the second in a series of Streetwise columns on sustainable investing.

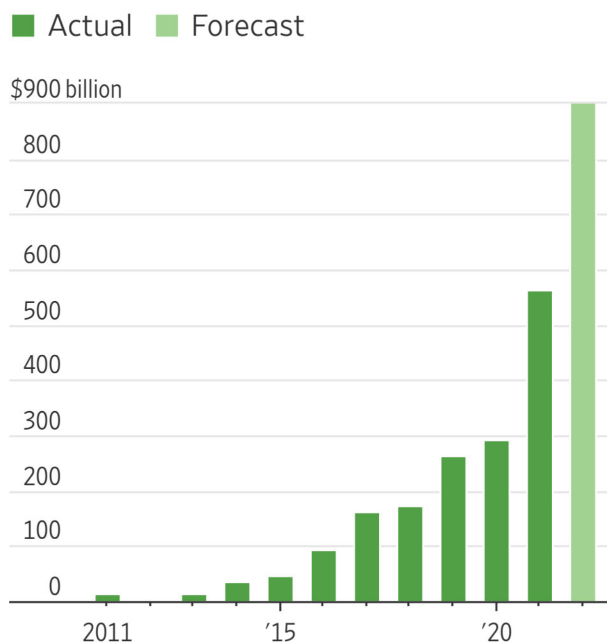
By

James Mackintosh Follow

Updated Jan. 24, 2022 9:08 am ET

The biggest and boldest claim of ESG investors is that investing based on environmental, social and governance conditions will not just improve our world, but make you more money. I have problems with both parts of the claim. The burgeoning market for green bonds shows the difficulties clearly, and stocks with a sustainability label aren't so different.

Green bonds, where governments or companies promise to spend at least some of the proceeds on something environmentally friendly, are having their moment. More were sold last year than ever, and this year global issuance is forecast by BNP Paribas to climb another 60% to $900 billion. The U.K.'s first green government issue, last summer, attracted the highest demand ever for a British bond, and the green tinge is rapidly spreading from Europe to the rest of the world.



The claim that investors will make more money investing in green bonds is patently absurd. Green bonds typically have a slightly lower yield than a standard bond from the same issuer. This locks in guaranteed underperformance for taking identical risks that the government or company will fail to pay the bonds back.

Worse, the rapidly expanding sales of sovereign green bonds of developed countries are doing nothing for the environment, and most corporate green bonds achieve nothing either.

I've discussed many of the problems in past columns, and will come back to more of them in this series, in which I'm taking a critical look at the sustainable investing craze sweeping Wall Street.

The underperformance of green bonds is easy to demonstrate, and shows up in the "greenium"—the higher price, and so lower yield, for a green bond. In the case of the U.K.'s green gilt, as British government bonds are known, this showed up as a yield about 0.02 percentage points lower than would be expected from a normal gilt with a similar maturity. In Germany, where the comparison is simplified by matching green and traditional bonds, the green bond has a yield 0.05 percentage points lower. Holding these green bonds until maturity guarantees worse performance than those who hold ordinary bonds.

Investors who want to stop global warming might be happy to stump up a little extra to achieve their aims. The U.K. government, like all green-bond issuers, promises to spend the money on green projects, which include renewable energy, clean transportation and flood-control measures.

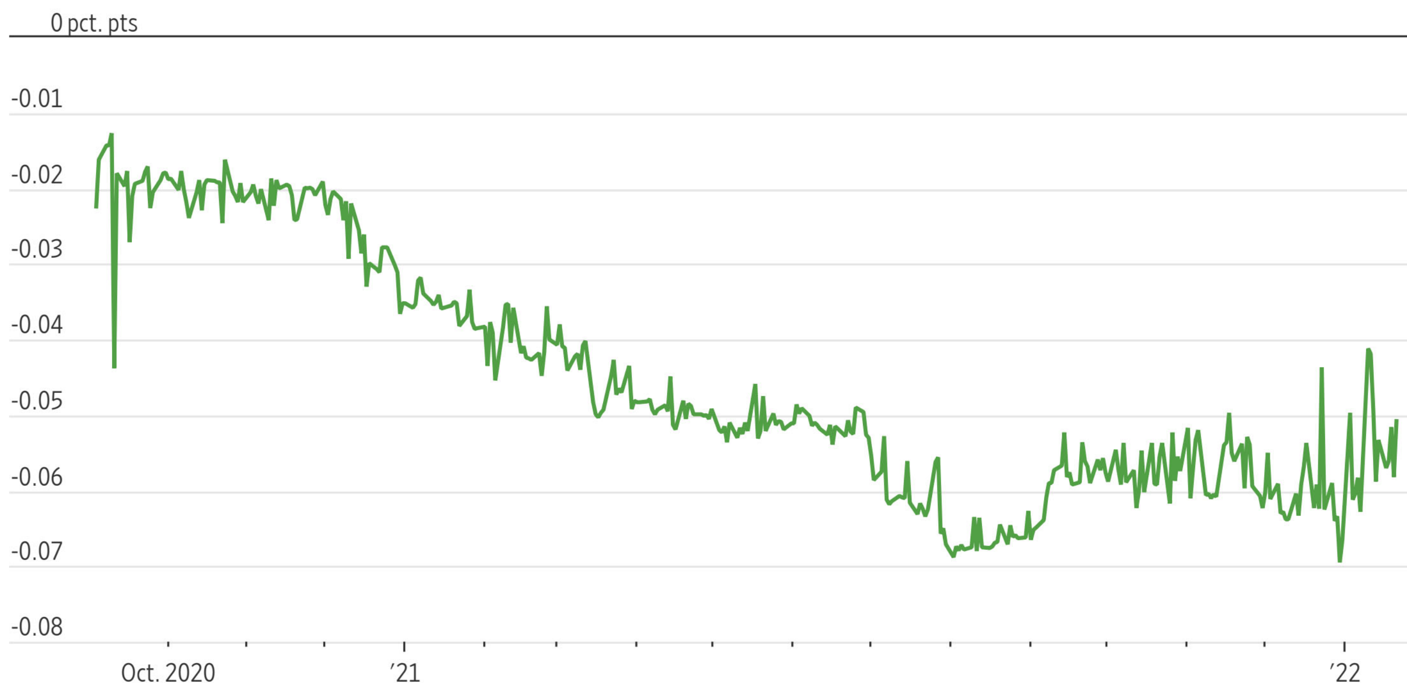
Investors shouldn't bother: The British government, in common with all developed democracies, sets its spending priorities before deciding how to finance them. All these green projects would have happened anyway. In the jargon of green finance, there is no "additionality" from the bonds—and there shouldn't be. In a democracy, it is voters, not global financiers, who decide government spending priorities.

In the case of the green gilt, the terms allow half the funds raised to go toward spending the year before it was issued. Even if an investor could convince herself that new green-bond-financed projects were somehow additional, and otherwise might not happen, money that was spent a year ago definitely happened anyway.

Cost of Going Green

Germany's green bonds offer a lower yield than standard bonds, a difference misleadingly called the "greenium"

German 2030 government bond "greenium"



Note: German government bonds used because ordinary and green have same maturity and coupon.
Source: Refinitiv

Green bonds do lock in spending, as the money can't—at least in theory—be diverted into a shiny new aircraft carrier or, in the case of the U.K., a royal yacht. The trouble is that green bonds finance only a small part of spending, and there's a lot of government spending that qualifies. As a result, developed-country green government bonds don't really lock in spending, because there is plenty of other "green" spending that can be substituted if the government decides to cancel a project.

Not all green bonds suffer these problems. A newer model of so-called sustainable company bonds ties payments to targets for corporate carbon reduction or less water use. If the issuer fails to meet the self-imposed goals, the coupon payments typically rise by 0.25 to 0.5 percentage points. These bonds create a small but obvious financial incentive for the issuer to meet green targets. But this lower yield ensures that what's better for the environment is worse for the investor.

SHARE YOUR THOUGHTS

What do you think of the idea that you can improve the world and make money at the same time?

This trade-off between trying to do the right thing and making more money is obvious in bonds. But it is fiercely disputed by ESG investors in stocks, even though the same issues apply.

Take one of the most important rules of investing: The starting price matters. This is clear in bonds, as the price you pay going in determines the yield.

In stocks, it should be obvious, but is often ignored. The stock of a hopeless business with only a few years of life left in it could be a great investment, so long as it is even cheaper than the fundamentals justify. Equally, a wonderful, rapidly growing company with a rock-solid business model will be a terrible investment at the wrong price.

A company doing everything right on ESG might still be wildly overpriced; an all-male, all-white coal-mining-to-tobacco conglomerate run by Dr. Evil could be so cheap as to be a great—if unpleasant—investment. Even if ESG issues matter as their proponents say, the price is a vital determinant of future returns even over long periods. Simply buying "good" companies isn't a route to outperformance.

Danish clean-energy company Orsted shows the problem: From its extremely high valuation at the start of last year, stock in the poster-child for the zero-carbon transition has plunged 41%, while coal stocks have soared.

Clean Energy, Dirty Performance

Denmark's Orsted is the poster child for the clean energy transition. Coal stocks aren't.

Source: Refinitiv

If ranking companies by ESG scores really could help identify companies that will produce higher or more stable earnings, those companies should have a higher price, as everyone wants higher and more stable earnings. But once the better profit outlook is priced in, there's no further outperformance.

The case for doing well by doing good can at best only be temporary; in spite of the thousands of asset managers running trillions of dollars who have signed ESG pledges, advocates have to believe both that ESG helps earnings, and that it still isn't priced in.

I'm sympathetic to the idea that ESG disclosures contain information useful to investors, but that's just investing. Use that information to find stocks that are cheaper or more expensive than they should be, and you can profit. But trawling through the ESG reports isn't work for do-gooders, it's for capitalists. "Clean" stocks will sometimes be overpriced and "dirty" stocks sometimes cheap, even after including ESG information, and to profit

you have to be willing to sell the clean stocks and buy the dirty ones—the exact opposite of what ESG investors do.

If ESG truly offers rewards to investors, it brings no virtue. If it is virtuous, expect a lower reward.

Write to James Mackintosh at james.mackintosh@wsj.com

Appeared in the January 25, 2022, print edition as 'ESG Investing Can Either Do Good or Do Well, but Not Both.'

Copyright © 2022 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers visit https://www.djreprints.com.