E S G   I N V E S T I N G

Assessing Risk through Environmental, Social and Governance Exposures

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Asset owners and allocators are increasingly interested in the Environment, Social, and Governance (ESG) profile of their investments. In this article, we present an empirical investigation of the potential link between ESG exposures of companies and the statistical risk of their equity. We investigate both contemporaneous risk forecasts and what ESG characteristics convey about future risks that are not captured by statistical risk models.

What's Inside?

In this article, we discuss risk and return implications of incorporating ESG considerations in an investment strategy. We focus on the risk side and argue that:

• ESG exposures may be informative about the risks of individual firms. We find clear support for this hypothesis in the data which is robust to a wide variety of controls and various stock universes.

• We also find that ESG scores may help forecast future changes to risk estimates from a traditional risk model. Controlling for the contemporaneous risk model estimates, we show that poor ESG exposures predict increased future statistical risks.

• Our findings are consistent with ESG exposures conveying some information about risk that is not captured by traditional statistical risk models.

Conclusion

Overall, our findings suggest that ESG may have a role in investment portfolios that extends beyond ethical considerations, particularly for investors interested in tilting toward safer stocks. ESG exposures may inform investors about the riskiness of the securities in a way that is complementary to what is captured by traditional statistical risk models.