ESG Investing

Climate Risk Pricing

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We develop an environmental macro-finance model to study how markets price transition and physical climate risks. When carbon taxes are below the social cost of carbon, raising them improves long-run welfare even as they reduce current output. Brown firms perform well in the "bad economic states" when low taxes let climate damage worsen. This hedging value gives them lower required returns, reversing standard ESG predictions. The green-minus-brown required return can, however, switch sign depending on how policy and climate shocks interact. Strikingly, climate-concerned investors optimally hedge by holding brown stocks, while skeptics hedge with green. More broadly, private hedging motives can diverge from societal climate objectives.

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