ESG Confusion and Stock Returns Tackling the Problem of Noise

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How does ESG (environmental, social, and governance) performance affect stock returns? Answering this question is difficult because existing measures of ESG perfor- mance — ESG ratings — are noisy and, therefore, standard regression estimates suffer from attenuation bias. To address the bias, we propose two noise-correction procedures, in which we instrument ESG ratings with ratings of other ESG rating agencies, as in the classical errors-in-variables problem. The corrected estimates demonstrate that the effect of ESG performance on stock returns is stronger than previously estimated: after correcting for attenuation bias, the coefficients increase on average by a factor of 2.6, implying an average noise-to-signal ratio of 61.7%. The attenuation bias is stable across horizons at which stock returns are measured. In simulations, our noise-correction pro- cedures outperform the standard approaches followed by practitioners such as averages or principal component analysis.

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