

Sustainability premium and risk: Betting Against Sustainability?

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23rd November 2023

Abstract

When sustainability of assets is valued, its effect on the discount rates does not only depend on the sustainability of the asset priced, but it is intrinsically mediated by the risk profile of the asset itself. This has implications for the assessment of the sustainability-related spread and for hedging changes in the sustainability concern. Specifically, (1) long-short portfolios of assets sorted on sustainability can even average returns with the opposite sign of the spread and (2) the effectiveness of more sustainable assets in hedging changes to the sustainability premium will depend on their ‘sustainability intensity’ and their risk *jointly*. The main implications are tested on the ESG score dimension for US data and is inconclusive regarding the existence of a ESG-related premium in the first place. Also, the risk profile of the long-short ESG portfolio is not likely to impact the sign of its average returns.

Keywords: Asset Pricing, Portfolio Choice, ESG, Sustainable Investment

JEL Codes: D62, G11, G12, M14, Q5

1 Introduction

To manage climate change, the economy needs to transition into a more sustainable one. This requires a great mobilization of capital, which has in fact started flowing towards investments where Environmental, Social and Governance (ESG) factors are considered in the allocation process. Leaving aside issues concerning other literatures, even critical ones such as what exactly is ‘sustainable’, the key economic concern about this phenomenon is understanding the *value* of economic activities’ ‘sustainability’. The financial literature approaches this by studying the ties between this characteristic and the discount rates that are applied to assess projects’ value, which directly reflects how investors’ welfare is impacted by sustainability. This paper provides further support to the view that investors do value firms’ sustainability and highlights how the pricing of sustainability is not independent from assets’ riskiness, a phenomenon that can affect the measurement of the sustainability ‘premium’ and more

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I thank Giuseppe Cavaliere for his useful comments.

dynamic considerations, which are relevant towards the hedging of climate concerns changes for example.

More specifically, assets' sustainability can affect investors welfare (1) directly, by providing non-pecuniary benefits, as in Pástor et al. (2021); (2) by affecting consumption with inherently different cash flows from the less sustainable counterparts (e.g. being more profitable or hedging better climate and regulations shocks), such as in Yang (2022); or (3) via both, as in Pedersen et al. (2021). While the second channel can have very rich mechanisms and implications, the first one distinctly predicts more sustainable project to have lower expected return than that of an equivalent non-sustainable counterpart. This, in a way, has been challenged by the empirical observation that in recent years more environmentally-sustainable ('green') assets had higher returns, not lower. However, as clearly shown by Pástor et al. (2022), this is likely due to sustained increases in environmental concerns that intensified the demand for greener assets. This, in turn, while lowering expected returns of greener assets, mechanically lead to greater contemporaneous returns. I build on that, showing that increases in the sustainability premium do not impact returns depending on the assets' sustainability measure only, but on their riskiness too. In more practical terms, in a CAPM world, two assets could be identically sustainable, but, if they had different betas, they would react differently to increases in concerns. The reason is that the spread in returns due to sustainability is not only related to sustainability in the first place: it depends on the difference, in the CAPM example, between beta and the sustainability of the asset relatively to the market. This happens because one can always reach the same level of risk of an asset by leveraging the market, obtaining, per dollar spent, the market ESG score. It follows that only assets with ESG scores greater than the ESG provided by the equivalently-levered market should be appreciated for the sustainability contribution to the portfolio.

First, I show this mechanism with a simple model, similar to Pástor et al. (2021) in aim and implications, but more flexible in accommodating multiple risk factors and in allowing more interpretations to the sustainability premium's origin. Specifically, a standard investor who maximises expected utility is faced with an inequality constraint on the average ESG score of its portfolio, which, when binding, places a 'sustainability multiplier' in the optimality conditions very similar to that of an agent with linear preferences for sustainability. While the distinction between linear preferences and a binding constraint appears of second order of relevance, I favour this formulation because once sustainability is modelled as affecting welfare, it is not obvious at all why it should do so in a linear way, while a constraint can well be interpreted as a proper requirement set by households to intermediaries, or even as a physical requirement to achieve aggregate environmental targets, e.g. emit less than a certain amount of CO₂ to avoid catastrophes. The model boils down to a pricing equation that, with standard CAPM assumptions on either returns distribution or wealth utility functional form, closely adheres to the results in Pástor et al. (2021). Nonetheless, following Franceschini (2023), I also show a way to extend the analysis to a more realistic multi-factor setting, while keeping track of all the risks with a synthetic measure. This theoretical formulation enables empirical analysis that are potentially able to distinguish between the static ESG-'preferences'

premium and the premia associated with sustainability-risk motives, via wealth dynamics or sustainability dynamics directly – as displayed in the climate extension of the model of Pástor et al. (2021).

The main result is that, *ceteris paribus*, more sustainable firms are expected to yield lower returns, which is a known result. However, as the premium for sustainability is proportional to the difference between risk and the asset sustainability relative to the market, determining how assets react to sustainability concern shocks is not a straightforward. Indeed, apart from the reaction being greater the more relatively sustainable the asset is, more interestingly, the reaction sign depends on the riskiness too. Specifically, to be positively covarying with concerns overall, the relative sustainability has to be greater than the risk (again, akin to the beta in the CAPM formulation). This is an important fact to establish because it affects the hedging abilities of most standard ‘sustainability’ portfolios, such as a market-neutral portfolio that is long on more sustainable assets and short on the least ones. In facts, this portfolio earns the sustainability-spread proportionally to the difference in sustainability of the two components forming it *minus* the difference in the risk levels of the two. Thus, for certain cross-sectional risk distributions, the spread could perfectly be negative while this portfolio’s average return is consistently positive. It follows that contemporaneous returns of this sustainability portfolio in reaction to changes in the sustainability spread can make it an effective or a terrible hedge. Also, while this consideration might not have had an impact until now, it might in the future. For example, were the greener assets to be given better funding to invest in innovation, they would become riskier in the cross-section and this would harm their ability of hedging later shocks to environmental concerns.¹

This theoretically holds for any characteristic that is associated with a constraint on the portfolio weighted value. Empirically, I test whether Refinitiv ESG data is relevant in this sense in US data and how the risk profile of a high-minus-low portfolio impacts its expected returns, which in turn determine its hedging abilities. Proxying the marginal utilities with the 3 factors from Fama and French (1993) or the market and two factors extracted from the test assets returns, the sustainability-related spread is significantly negative. However, it stops being significant in other specifications – when the market is the only risk factor or when many factors extracted from test assets returns are included, none of which result in a worse pricing performance, undermining the view that this particular score is associated to a binding constraint in the market. Despite the relevance of the exercise, at this stage sustainability-related risk factors are not explicitly included among the risk factors, although they are possibly captured by the factors agnostically obtained from test assets returns. Further, the risk of the high-minus-low portfolio is not significantly different from 0 in all specifications beyond the market-only one, meaning that risk is unlikely to have any impact

¹From an aggregate perspective, green innovation mitigates environmental concerns. So, green firms increasing innovation efforts would work as an hedge to environmental concern, but once the innovation levels are set, and with them the new risk levels, their ability of hedge later shocks to environment concerns would likely worsen. Notice that whether mitigating environmental issues is pro- or counter-cyclical is not obvious, as highlighted by Giglio et al. (2021), so whether greener firms’ returns show a positive or negative sensitivity to environment concerns is not so clear either. Consequently, the effect of more aggregate green innovation is not necessarily counter-acting the argument made in the example.

on how the sustainability is reflected in univariate portfolios. Spread, anyway, that is unlikely to be there in the first place, which is why these implications will have to be tested on more sustainability dimensions,² such as CO2 emissions, and possibly other countries too. This, for some sustainability measures, will also allow to include sustainable bonds, which reduces the number of relevant parameters to be estimated. Lastly, were these hypothesis to find any grip, a further test could rely on a risk- and sustainability-neutral portfolio, whose contemporaneous returns covariance with concerns is directly indicative of risk impact on the sustainability spread.

This study is clearly related to the recent theoretical literature on ESG investment, most importantly with Pástor et al. (2021) and Pedersen et al. (2021), to which this paper adds the study of the peculiar role that risk, in its generality, has in sustainability premium dynamics. This model resembles the model of Pedersen et al. (2021) if it was only populated by investors who have average ESG score in the utility function. They end up characterizing the security market line in terms of Sharpe Ratio and reach the similar conclusions that returns have alphas relative to the CAPM that depend on individual ESG scores relative to the market's score. As they consider a predictive power of ESG scores on profits, however, a higher relative ESG does not guarantee a lower expected return in their model. Just as with Pástor et al. (2021), this paper departs by considering risk beyond mean-variance optimization set-ups and displays in greater detail its impact on predictions that seem to be independent, such as returns on market-neutral sustainable portfolios.

Further, this paper is related to the recent empirical green finance literature, which has been mainly focused on isolating return dynamics due to concern increases and the 'static' sustainability spread, such as Pástor et al. (2022), Hsu et al. (2020) and Ardia et al. (2022). This paper shows another reason why greener assets have not displayed lower returns besides sustained increases in environmental concerns, i.e. baseline assets' risks. Second, the framework used here allows to include environmental sensitivity as a risk and potentially disentangle the risk-led sustainability premium from the 'static preferences' spread. At the current stage, this is not formally studied in this paper, but it will be, by explicitly adding a sustainability-relevant state variable among the risk factors.³ The empirical application also makes this paper take part to the literatures employing General Method of Moments (GMM) to estimate marginal utility loadings, and to those modelling marginal utility in an agnostic way that do not employ pre-determined factors.

In section 2 I outline the theoretical set-up and show the impact of risk on sustainability-related pricing implications, in the simple framework of CAPM; in section 3, I consider the existence of a risk-free asset that also provides a sustainability score and the existence of multiple risks priced in the market; in section 4, I explore the main implications on US data employing the Refinitiv ESG scores; in section 5 I conclude.

²Further motivated by the findings of Berg et al. (2022).

³Several indexes that identify aggregate environmental concerns have been proposed, such as Ardia et al. (2022) and Noailly et al. (2021). However, variables that are univocally related with the other pillars of ESG scores are not obvious at all.

2 Basic theoretical set-up

Consider a standard two-period economy where there are $I + 1$ assets indexed by i , with $i = 0$ being a risk-less asset. Then, assume a single agent living in this economy, who is born at time t and simply chooses assets holdings $\{x_t^i\}_{i=1}^I$ to maximize utility from second-period consumption, which corresponds to the entirety of the accumulated wealth W_{t+1} , i.e.

$$\begin{aligned} & \max_{\{x_t^i\}_{i=0}^I} \mathbb{E}_t [u(W_{t+1})] \\ \text{s.t. } & W_t = x_t^0 + \sum_{i=1}^I x_t^i P_t^i \\ & W_{t+1} = x_t^0 R_t^f + \sum_{i=1}^I x_t^i (P_{t+1}^i + D_{t+1}^i), \end{aligned} \quad (1)$$

where P_t^i and D_{t+1}^i are the price and dividend of asset i at time t , respectively, and R_t^f is the gross risk-free return. Growing concerns about sustainability of investments might enforce an exogenous level of greenness of the portfolio held by this agent, either imposed by a second agent in the form of a ruling government or a household whose savings are managed by the agent just described.

A simple way to capture this phenomenon is to require average sustainability of portfolio holdings to be greater than a certain threshold q_t ,⁴ which can be expressed as the inequality

$$\sum_{i=1}^I (x_t^i P_t^i) \cdot \text{ESG}_t^i > q_t \cdot W_t. \quad (2)$$

This is close in spirit to Frazzini and Pedersen (2014), who consider leverage constraints instead of sustainability requirements. Exploiting $W_{t+1} = W_t R_t^f + \sum_{i=1}^I x_t^i (P_{t+1}^i + D_{t+1}^i - P_t^i R_t^f)$, the Lagrangian related to this problem can be expressed as

$$\mathcal{L}_t = \mathbb{E}_t \left[u \left(W_t R_t^f + \sum_{i=1}^I x_t^i (P_{t+1}^i + D_{t+1}^i - P_t^i R_t^f) \right) \right] + \lambda_t \left\{ \sum_{i=1}^I (x_t^i P_t^i) \cdot \text{ESG}_t^i - q_t \cdot W_t \right\} \quad (3)$$

The first-order condition for the optimality of this problem solution when the constraint binds, for each i , is

$$\mathbb{E}_t [u'(W_{t+1})(R_{t+1}^i - R_t^f)] + \lambda_t \text{ESG}_t^i = 0 \quad (4)$$

or

$$\mathbb{E}_t [r_{t+1}^i] = \frac{-\lambda_t}{\mathbb{E}_t [u'(W_{t+1})]} \cdot \text{ESG}_t^i - \text{Cov}_t \left[\frac{u'(W_{t+1})}{\mathbb{E}_t [u'(W_{t+1})]}, r_{t+1}^i \right], \quad (5)$$

⁴A key assumption here is that the risk-free asset does not contribute to the greenness of a portfolio, which might be counterfactual. An extension which allows for this is immediate and will follow in the paper. This also implies more testable conditions.

where r_{t+1}^i is the excess return $R_{t+1}^i - R_t^f$. Then, the market, defined by portfolio weights ω_t^i that ensure $\sum_{i=1}^I \omega_t^i = 1$, has expected excess return

$$\mathbb{E}_t[r_{t+1}^M] = \frac{-\lambda_t}{\mathbb{E}_t[u'(W_{t+1})]} \text{ESG}_t^M - \text{Cov}_t \left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^M \right], \quad (6)$$

where ESG^M is the ESG score per dollar of market holding. The risk-free, not impacting the sustainability constraint is not determined differently from more standard frameworks.

Taking the approximation $u'(W_{t+1}) \approx u'(W_t)R_t^f + u''(W_t)(R_{t+1}^M - R_t^f)$, $\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}$ can be expressed as $a_t - b_t \cdot r_{t+1}^M$, and from (6) the SDF loading b_t can be derived as

$$b_t = \frac{\mathbb{E}_t[r_{t+1}^M] + \frac{\lambda_t}{\mathbb{E}_t[u'(W_{t+1})]} \text{ESG}_t^M}{\text{Var}_t[r_{t+1}^M]}. \quad (7)$$

Then, any asset abides by the following relation

$$\mathbb{E}_t[r_{t+1}^i] = \frac{-\lambda_t}{\mathbb{E}_t[u'(W_{t+1})]} \cdot \text{ESG}_t^i + \left(\mathbb{E}_t[r_{t+1}^M] + \frac{\lambda_t}{\mathbb{E}_t[u'(W_{t+1})]} \text{ESG}_t^M \right) \frac{\text{Cov}_t[r_{t+1}^M, r_{t+1}^i]}{\text{Var}_t[r_{t+1}^M]}, \quad (8)$$

or, more simply,

$$\mathbb{E}_t[r_{t+1}^i] = \tilde{\lambda}_t \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \beta_t^i \right) + \beta_t^i \cdot \mathbb{E}_t[r_{t+1}^M]. \quad (9)$$

$\tilde{\lambda}_t = \frac{-\lambda_t \cdot \text{ESG}_t^M}{\mathbb{E}_t[u'(W_{t+1})]}$ is a negative constant whose magnitude increases the more constrained the agent is and the higher market ESG score is. The key implication is that an expected excess return is proportional to the respective CAPM beta, as in the standard CAPM, and the difference between the ‘ESG-intensity’ $\text{ESG}_t^i / \text{ESG}_t^M$ and the beta. This comes from the fact that riskier assets, having greater discounts, provide less ESG-weighted capital per unit of cash-flows claimed by holding that asset. For example, if two assets have identical expected cash-flows and ESG ratings but different betas, the cash-flows of one with the lower beta will be discounted less and have a higher price, thus helping alleviating the constraint more than the other one.

2.1 Responsible portfolios

Let us consider a portfolio that tries to isolate the spread related to sustainability without having any exposure to market risk: arguably, the most intuitive way would be to hold a portfolio S of more sustainable stocks, financing this by shorting a portfolio NS of less sustainable ones and hedge the resulting sensitivity to the market by holding it in an opposite proportion. The expected excess return of this ‘sustainability’ portfolio, r^{SUS} , would be

$$\mathbb{E}[r^{SUS}] = \mathbb{E}_t[r^S] - \mathbb{E}_t[r^{NS}] - (\beta^S - \beta^{NS})\mathbb{E}_t[r^M] \quad (10)$$

$$= \tilde{\lambda} \left[\left(\frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M} \right) - (\beta^S - \beta^{NS}) \right]. \quad (11)$$

This portfolio effectively has no exposure to the market, the only source of risk here, but its return will reflect the sustainability spread $\tilde{\lambda}$ only if the risk is distributed evenly across assets with different sustainability. This means that testing the existence of any premium associated to characteristics that can be linked to constraints as those defined in this model on a generic ESG score, cannot rely on plain univariate-sort portfolios, even with controls for risk exposure.⁵ If the beta of more sustainable stocks is sufficiently higher than that of less sustainable ones, a portfolio like this would even get to show positive average returns, despite the multiplier on sustainability definitely being negative.

The *SUS* portfolio effectively has 0 beta, so it might not be obvious from (9) why betas' differential appears in (11). The reason is that the ESG intensity of this portfolio $\frac{\text{ESG}_t^{SUS}}{\text{ESG}_t^M}$ is not simply $\frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M}$, but is augmented by the ESG intensity of the market portfolio, which is 1, times the position in it, which depends on the *S* and *NS* betas' differential.

2.2 Hedging sustainability concerns risk

It follows that risk also impacts how more sustainable assets hedge sustainability concerns shocks too. This can be seen decomposing unexpected returns into changes to expected discount rates and to expected cash-flows growth rates, as in Campbell (1996). Making the simplifying assumption of independence of aggregate sustainability concern shocks with market returns expectations and firm *i* fundamentals, the contemporaneous relation between an assets return and sustainability concerns is characterized by

$$\frac{\partial(r_t^i - \mathbb{E}_{t-1}[r_t^i])}{\partial(\lambda_t - \mathbb{E}_{t-1}[\lambda_t])} \propto \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \beta_t^i \right). \quad (12)$$

Specifically, for the *SUS* portfolio, this is

$$\frac{\partial(r_t^{SUS} - \mathbb{E}_{t-1}[r_t^{SUS}])}{\partial(\lambda_t - \mathbb{E}_{t-1}[\lambda_t])} \propto \left(\frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M} \right) - (\beta^S - \beta^{NS}), \quad (13)$$

meaning that hedging the risk of a high-minus-low sustainable portfolio can be considered an hedge only as long as more sustainable assets are not significantly riskier than lowly or non-sustainable. This is a fact that has relevance for the future as the risk pattern can change over time. For example, being R&D generally considered a risky activity, as more sustainable firm were to become the ones closer to the technology frontier and in need of innovation, as it is happening with the automotive sector, then, the sustainable portfolio can potentially become a terrible hedge for sustainability concerns.⁶

A portfolio that is market- and sustainability-neutral allows to study this effect explicitly.

⁵This has been done for example in Hsu et al. (2020) and Yang (2022).

⁶See footnote 1.

Consider a portfolio investing \$ 1 in the S portfolio, shorting $\text{ESG}^S/\text{ESG}^{NS}$ of the NS portfolio, funding this position shorting $1 - \text{ESG}^S/\text{ESG}^{NS}$ of a risk-free asset and hedging it shorting \$ $\beta^S - \text{ESG}^S/\text{ESG}^{NS}\beta^{NS}$ of the market. The expected returns of this ‘Betting Against Sustainability’ (BAS) portfolio is

$$\mathbb{E}_t [r_{t+1}^{BAS}] = \mathbb{E}_t [r^S] - \frac{\text{ESG}^S}{\text{ESG}^{NS}} \mathbb{E}_t [r^{NS}] - (\beta^S - \frac{\text{ESG}^S}{\text{ESG}^{NS}} \beta^{NS}) \mathbb{E}_t [r^M] \quad (14)$$

$$= \tilde{\lambda}_t (\beta_t^{NS} - \beta_t^S) \quad (15)$$

The, the contemporaneous relation between BAS’ returns and sustainability concerns shocks is naturally

$$\frac{\partial(r_t^{BAS} - \mathbb{E}_{t-1} [r_t^{BAS}])}{\partial(\tilde{\lambda}_t - \mathbb{E}_{t-1} [\tilde{\lambda}_t])} \propto (\beta^S - \beta^{NS}). \quad (16)$$

This is helpful in identifying the impact that risk has on sustainability spreads.

3 A more realistic model

3.1 With sustainable bonds

Consider the presence of a bond that contributes to the required sustainability of the portfolio, such as green bonds contribute to environmental sustainability, which is indexed as $i = GB$. Then,

$$W_t = \sum_{i=1}^I x_t P_t^i + x_t^0 + x_t^{GB} \quad (17)$$

$$W_{t+1} = \sum_{i=1}^I x_t (P_{t+1}^i + D_{t+1}^i) + x_t^0 R_t^f + x_t^{GB} R_t^{f,GB}, \quad (18)$$

while the sustainability requirement becomes

$$\sum_{i=1}^I (x_t^i P_t^i) \cdot \text{ESG}_t^i + x_t^{GB} \cdot \text{ESG}_t^{GB} > q_t \cdot W_t. \quad (19)$$

The first-order condition related to the holdings of the sustainable risk-free asset, which can be obtained from a Lagrangian formed in a similar way to the previous section, implies the spread on the sustainable bond being determined as

$$R_t^{f,GB} - R_t^f = - \frac{\lambda_t \text{ESG}_t^{GB}}{\mathbb{E}_t [u'(W_{t+1})]}, \quad (20)$$

which is non-positive. The optimality condition for the risky asset i , combined with the

previous condition, results in a more explicit pricing condition:

$$\mathbb{E}_t[r_{t+1}^i] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} - \text{Cov}_t \left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^i \right], \quad (21)$$

where r_{t+1}^i is the excess return $R_{t+1}^i - R_t^f$. This essentially deviates from a standard formulation for the term multiplying the sustainable bond rate.

In a CAPM world, this translates to

$$\mathbb{E}_t[r_{t+1}^i] = r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \beta^i \right) + \beta^i \mathbb{E}_t[r_{t+1}^M], \quad (22)$$

where $r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}}$ essentially provides a proxy of $\tilde{\lambda}_t$. ‘Sustainable’ bonds are essentially available for environmental sustainability, but it still useful as it allows an easier empirical test. It follows that the expected returns of a plain high-minus-low sustainability portfolio, previously addressed as ‘SUS’ and determined by (11), is now

$$\mathbb{E}[r^{SUS}] = r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \left[\left(\frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M} \right) - (\beta^S - \beta^{NS}) \right] \quad (23)$$

and the returns of the sustainability- and market-neutral BAS portfolio, previously defined by (14), amounts now to

$$\mathbb{E}[r^{BAS}] = r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} (\beta^{NS} - \beta^S). \quad (24)$$

3.2 Factor-zoo world

Given the remarkable amount of evidence in favour of multi-factor models, it is useful to consider the case in which the marginal utility is affected by risks other than undiversifiable variance. Rearranging (5) and (6), one can obtain a broader formulation of the pricing condition that any asset has to abide by:

$$\mathbb{E}_t[r_{t+1}^i] = \tilde{\lambda}_t \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \frac{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^i]}{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^M]} \right) + \frac{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^i]}{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^M]} \mathbb{E}_t[r_{t+1}^M], \quad (25)$$

or, more simply,

$$\mathbb{E}_t[r_{t+1}^i] = \tilde{\lambda}_t \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \gamma_t^i \right) + \gamma_t^i \cdot \mathbb{E}_t[r_{t+1}^M]. \quad (26)$$

This follows closely what was previously derived, just with a broader measure of risk, $\gamma_t^i = \frac{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^i]}{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^M]}$. While $u'(W_{t+1})$ is empirically not easy to identify, all of the asset pricing literature provides alternatives, one of which is its projection on the returns, as in the similar application in Franceschini (2023).

This implies

$$\mathbb{E} [r^{SUS}] = \tilde{\lambda} \left[\left(\frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M} \right) - (\gamma^S - \gamma^{NS}) \right] \quad (27)$$

and

$$\mathbb{E} [r^{BAS}] = \tilde{\lambda}(\gamma^{NS} - \gamma^S). \quad (28)$$

It also naturally extends to the case where sustainable bonds are available, simply plugging $r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}}$ for $\tilde{\lambda}_t$.

4 A look at ESG constraints

4.1 Test assets

The analysis focuses on the US stock market; monthly data on stocks is provided by CRSP. The time span of the analysis is ultimately determined by the yearly ESG data, which is from Refinitiv. The series starts in 2002, but it had a remarkable increase in coverage in 2003, which is when the analysis starts from, ending in 2021. Table 3 displays the fraction of the US stock market coverage by the ESG measure. By no means the analysis has to be confined to this measure, indeed it will not be, moving on, as many more sustainability measures can be associated to constraints in portfolio formation.

The test assets pool is formed by portfolios of stocks sorted by characteristics that are known to generate dispersion in average returns and are widely used in the literature. Three of these are based on market capitalization (size), three on book-to-market (B/M) equity ratio, three on the cumulated return over the 11 months ending a month before (mom), and three portfolios based on the ESG score. Finally, the SUS portfolio and the market are added, for a total of 14 test assets. The number of portfolios per characteristic is chosen to ensure a minimum of approximately 60 firms per portfolio, given the limited number of firms covered by the ESG measure. Size and B/M portfolios are formed based on NYSE capitalization quantiles. All of the portfolios are value-weighted to obtain the portfolios' returns and portfolios' ESG score at every date. Statistics of the portfolios are in table 1.

A clear pattern, obviously, emerges in the esg-sorted portfolio as well as in the size portfolios as well as in the B/M, where ESG scores increase with size and decrease with B/M. Momentum portfolios instead appears to have no meaningful relation to esg scores. Returns mostly conform with the literature, with returns being lower for greater size portfolios and lower B/M ratios. Momentum portfolios show a more bizarre behaviour, with worse performing assets having higher returns, although the unexplained returns by CAPM increase with momentum as expected. More sustainable assets, as expected from theory have lower returns, reflected in the negative average return of the SUS portfolio. To have a first sight of the relation between sustainability and risk, figure 1 charts the relative ESG scores and

4-year rolling window of the high- and low-sustainability portfolios. Most of the variation comes from the beta of the least portfolio, ‘non-sus’, but the difference in risk reached at most half the difference in relative ESG scores, up to 2022.

Table 1: Test assets statistics. In parenthesis the HAC standard errors, computed following Lazarus et al. (2018). Monthly returns annualized, sample from Jul 2004 to Dec 2021.

Stat	size.1	size.2	size.3	BM.1	BM.2	BM.3	mom.1	mom.2	mom.3	sus.1	sus.2	sus.3	sus.html	AVG
r. ESG (%)	43.030 (7.204)	56.621 (1.460)	102.267 (0.827)	103.449 (1.785)	100.233 (1.814)	88.766 (3.451)	99.209 (1.422)	100.736 (0.567)	96.885 (1.440)	36.046 (1.881)	67.859 (6.531)	121.551 (4.708)	85.505 (1.693)	84.781
Avg. ret (%)	40.100	17.176	10.366	11.245	8.495	13.126	10.045	10.525	9.745	12.809	11.033	9.952	-4.003	12.355
SD (%)	282.196	89.919	55.454	50.995	55.476	87.238	77.914	50.700	52.918	67.499	62.668	56.340	37.412	78.979
CAPM α (%)	17.820 (17.497)	2.937 (4.096)	0.305 (1.073)	2.151 (1.510)	-1.438 (0.989)	0.521 (3.010)	-2.824 (2.034)	1.438 (1.401)	0.582 (1.091)	1.280 (1.860)	-0.068 (1.459)	0.070 (1.105)	-2.385 (1.463)	1.568
CAPM β	2.275 (0.536)	1.454 (0.103)	1.027 (0.038)	0.928 (0.018)	1.014 (0.020)	1.287 (0.132)	1.314 (0.100)	0.928 (0.027)	0.936 (0.042)	1.177 (0.063)	1.134 (0.038)	1.009 (0.037)	-0.165 (0.050)	1.101

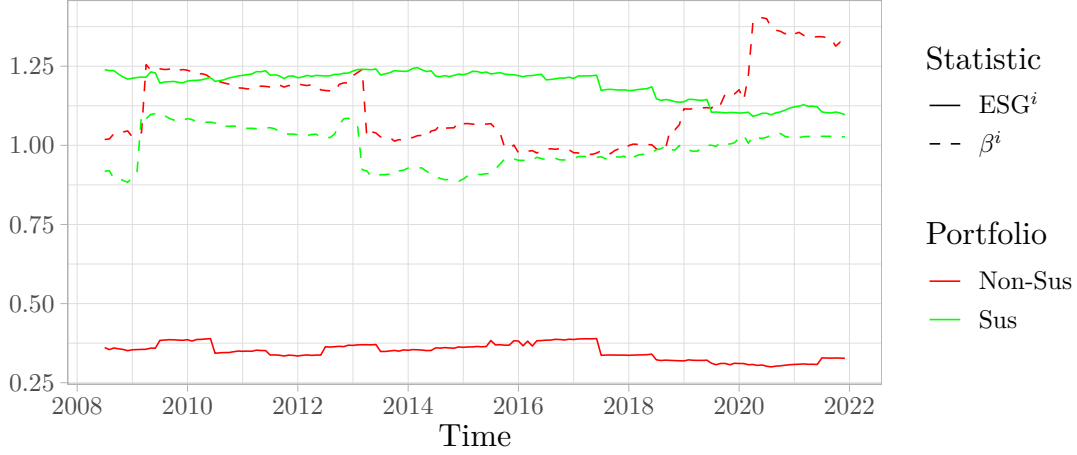


Figure 1: ESG intensity and 4-year rolling window of high- and low-sustainability portfolios, both reported on the vertical axis.

4.2 Risk factors

The scaled marginal utility is assumed to be linear in a set of risk factors \mathbf{f} , i.e. $\frac{u'(W_{t+1})}{\mathbb{E}[u'(W_{t+1})]} = 1 - \mathbf{f}'_t \mathbf{b}$. Four sets of factors are used: (1) market factor only; (2) the three factors of Fama and French (1993), which include the market, named ‘FF3’; (3) the market and the first two principal components of the test assets, orthogonalized with respect to the market to avoid redundant information, named ‘F(3)’; (4) the market and six principal components, named ‘F(7)’. The number of factors are chosen with two criteria: match the size of FF3 for comparison and not including components that explain less than 5% of returns variance given the cumulative variance explained being around 90% already. The scree plot of the Principal component analysis is in figure 2. More sets can be tested, with a special interest in including state variables that capture sustainability-relevant concerns.

4.3 Pricing results

The main condition of interest is (5), which translates into the moment condition

$$\mathbb{E}[r_t^i] - a \cdot \text{ESG}_{t-1}^i - \mathbb{E}[(\mathbf{f}'_t \mathbf{b})(r_t^i - \mathbb{E}[r_t^i])] = 0, \quad (29)$$

where a return the unconditional expectations of $\tilde{\lambda}$ and \mathbf{f} are the factors spanning the scaled marginal utility with loadings \mathbf{b} , which are to be estimated together with a . The covariances are then estimated contemporaneously exploiting the moment

$$s_i + \mathbb{E}[(\mathbf{f}'_t \mathbf{b})(r_t^i - \mathbb{E}[r_t^i])] = 0, \quad (30)$$

where s_i is the empirical counterpart of $\text{Cov}\left[\frac{u'(W_{t+1})}{\mathbb{E}[u'(W_{t+1})]}, r_{t+1}^i\right]$, employed to obtain estimates of the γ s. The estimation results are in table 2.

The unconditional sustainability spread $\mathbb{E}[\tilde{\lambda}] = a \cdot \mathbb{E}[\text{ESG}_t^M]$ is negative and slightly

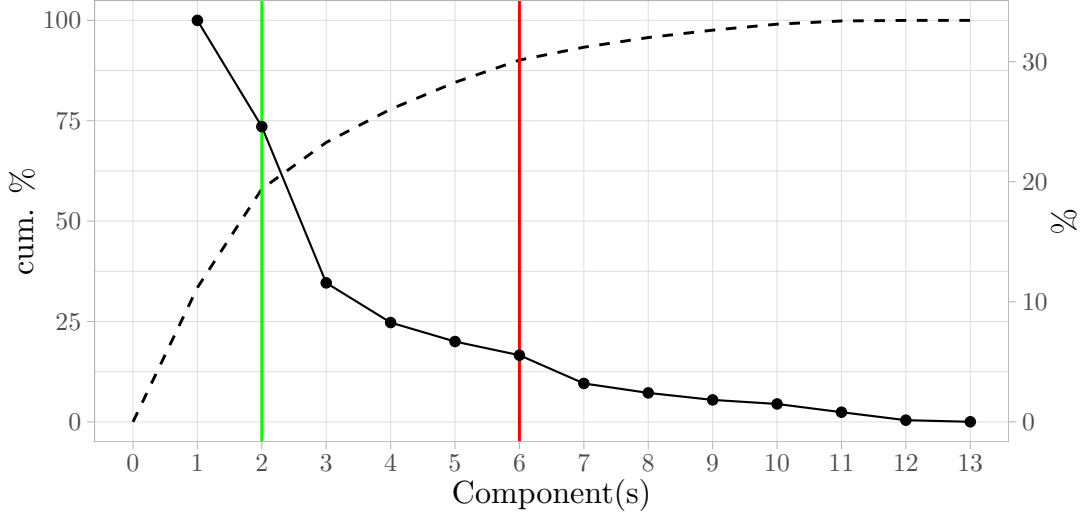


Figure 2: Scree plot of principal component analysis. On the horizontal axis the number of component considered, on the vertical axis the share of variance explained by the relative component (solid line) and the cumulative share of variance explained (dotted line). The green vertical line marks the 2nd component while the red one the 6th.

Table 2: cross-sectional pricing estimation, HAC standard errors in parenthesis. Coverage 2004-2021.

	Mkt only	FF3	F(3)	F(7)
$E[\tilde{\lambda}]$	-5.753 (4.023)	-8.844* (4.810)	-5.146* (3.053)	1.717 (3.768)
Market factors	0.302** (0.131)	0.514** (0.224)	0.274** (0.118)	0.142 (0.114)
J-test	94.3***	105.5***	100.2***	97.9***
MAPE	2.431	2.309	2.446	0.831
HML a.p.e.	3.479** (1.575)	1.864 (1.701)	2.187 (1.494)	-1.392 (2.217)

*** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$

significant only for ‘intermediately’ complex models, but not in all of them. The market factor is always positive, and positive in all estimations apart from the biggest model, F(7). Anyway, all the models’ validity is rejected by the J-test. Adding factors beyond the market appears to have an effect only for the most complex model of all, F(7), which has remarkably lower Mean Absolute Pricing Errors (MAPE) than the other models. The intermediate models show no material improvement on the single factor model overall, although the SUS portfolio gets priced better, in terms of MAPE. This results overall suggest that this model does not describe reality very accurately; it is likely that the measure of ESG employed here is not one that is related to strongly binding constraints. Nonetheless, estimates provide weak support towards the existence of a negative spread related to sustainability.

To observe the impact of risk on univariate sustainability portfolios such as SUS, the γ s implied by the previous estimation are computed and reported in table 3. Specifically, the

Table 3: ΔESG and $\Delta\gamma$. In parenthesis HAS standard errors. Standard errors of $\Delta\gamma$ are obtained via Delta method from the covariances estimates from the GMM step.

ΔESG	$\Delta\gamma$			
	Market	FF3	F(3)	F(4)
0.855*** (0.017)	-0.165** (0.067)	0.094 (0.135)	-0.127 (0.165)	-0.637 (0.791)

*** $p < 0.01$; ** $p < 0.05$; * $p < 0.1$

differential in ESG intensity is

$$\Delta\text{ESG}_t = \frac{\text{ESG}_t^S}{\text{ESG}_t^M} - \frac{\text{ESG}_t^{NS}}{\text{ESG}_t^M} \quad (31)$$

and the differential in risks is

$$\Delta\gamma = \gamma^S - \gamma^{NS}. \quad (32)$$

It can be seen that the estimates, read with (27), do not suggest risk affecting significantly how the spread $\tilde{\lambda}$ gets reflected into $\mathbb{E}[r^{SUS}]$: it is unlikely that $\Delta\gamma > \Delta\text{ESG}$, even though it can be seen that considering more risks results in higher $\Delta\gamma$. More accurate analysis regarding the impact of risk through the sustainability channel would stem from exploiting (28), but the previous results suggest that other constrained-characteristics, such as carbon emissions, might be better case studies for the mechanisms highlighted in this paper.

5 Conclusion

Assessing how sustainability affects asset prices, and thus investors' welfare, is key to better address current generational challenges. It is shown that a constraint on the average score of the portfolio held by an agent that binds induces a negative spread on the risk premium of an asset that is proportional to its sustainability score. In other words, the sustainability provided by the asset is appreciated by the agent. The spread, however, is not only function of how constrained the agent is or how sustainable the asset is, but also of how risky the asset is. This happens because it is always possible to reach the same risk of an asset by leveraging risk factors portfolios, which provide their own sustainability scores; then, an asset's sustainability should be remunerated only if higher than this equivalently-levered sustainability score. This in turn affects the returns of naive portfolios based on univariate sorting on sustainability, which can be used to capitalize the spread or to hedge shocks to the constraint, i.e. sustainability concerns. Empirical analysis conducted on an ESG measure covering US data is not conclusive regarding the existence of such a sustainability premium in the first place and that risk actually plays a relevant role either. I intend to conduct the analysis on other sustainability-related measures and possibly on other countries.

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6 Derivations

The Lagrangian related to the problem with sustainable bonds is

$$\begin{aligned} \mathcal{L}_t = \mathbb{E}_t \left[u \left(W_t R_t^f + \sum_{i=1}^I x_t (P_{t+1}^i + D_{t+1}^i - P_t^i R_t^f) + x_t^{GB} (R_t^{f,GB} - R_t^f) \right) \right] \\ + \lambda_t \left\{ \sum_{i=1}^I (x_t^i P_t^i) \cdot \text{ESG}_t^i + x_t^{GB} \cdot \text{ESG}_t^{GB} - q_t \cdot W_t \right\} \end{aligned} \quad (33)$$

The resulting first order conditions are

$$\mathbb{E}_t [u'(W_{t+1})] (R_t^{f,GB} - R_t^f) + \lambda_t \text{ESG}_t^{GB} = 0 \quad (34)$$

for the sustainable bond, and

$$\mathbb{E}_t [u'(W_{t+1})(R_{t+1}^i - R_t^f)] + \lambda_t \text{ESG}_t^i = 0 \quad (35)$$

for the risky asset i .

Combining sustainable bond and common asset conditions:

$$\frac{\mathbb{E}_t [u'(W_{t+1})(R_{t+1}^i - R_t^f)]}{\text{ESG}_t^i} = \frac{\mathbb{E}_t [u'(W_{t+1})] (R_t^{f,GB} - R_t^f)}{\text{ESG}_t^{GB}} \quad (36)$$

$$\mathbb{E}_t [u'(W_{t+1})(R_{t+1}^i - R_t^f)] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \mathbb{E}_t [u'(W_{t+1})] (R_t^{f,GB} - R_t^f). \quad (37)$$

So,

$$\mathbb{E}_t [r_{t+1}^i] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} - \text{Cov}_t \left[\frac{u'(W_{t+1})}{\mathbb{E}_t [u'(W_{t+1})]}, r_{t+1}^i \right]. \quad (38)$$

Then, the market has expected excess return

$$\mathbb{E}_t [r_{t+1}^M] = \sum_{i=1}^I \omega_t^i \cdot \mathbb{E}_t [r_{t+1}^i] \quad (39)$$

$$= \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} - \text{Cov}_t \left[\frac{u'(W_{t+1})}{\mathbb{E}_t [u'(W_{t+1})]}, r_{t+1}^M \right]. \quad (40)$$

Assuming $\frac{u'(W_{t+1})}{\mathbb{E}_t [u'(W_{t+1})]} = a_t - b_t \cdot r_{t+1}^M$,

$$\mathbb{E}_t [r_{t+1}^i] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} + b_t \text{Cov}_t [r_{t+1}^M, r_{t+1}^i] \quad (41)$$

$$\mathbb{E}_t [r_{t+1}^M] = \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} + b_t \text{Var}_t [r_{t+1}^M]. \quad (42)$$

Then, $b_t = \frac{\mathbb{E}_t [r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB}}{\text{Var}_t [r_{t+1}^M]}$ and

$$\mathbb{E}_t [r_{t+1}^i] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} + \left(\frac{\mathbb{E}_t [r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB}}{\text{Var}_t [r_{t+1}^M]} \right) \text{Cov}_t [r_{t+1}^M, r_{t+1}^i] \quad (43)$$

$$= \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} + \left(\mathbb{E}_t [r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \cdot r_t^{f,GB} \right) \beta^i \quad (44)$$

$$= \frac{r_t^{f,GB}}{\text{ESG}_t^{GB}} (\text{ESG}_t^i - \text{ESG}_t^M \beta^i) + \beta^i \mathbb{E}_t [r_{t+1}^M] \quad (45)$$

$$= r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \beta^i \right) + \beta^i \mathbb{E}_t [r_{t+1}^M] \quad (46)$$

For a factor-zoo with a sustainable bond:

$$\frac{\mathbb{E}_t[r_{t+1}^i] - \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} r_t^{f,GB}}{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^i\right]} = -1 = \frac{\mathbb{E}_t[r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} r_t^{f,GB}}{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^M\right]}, \quad (47)$$

so

$$\frac{\mathbb{E}_t[r_{t+1}^i] - \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} r_t^{f,GB}}{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^i\right]} = \frac{\mathbb{E}_t[r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} r_t^{f,GB}}{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^M\right]} \quad (48)$$

$$\mathbb{E}_t[r_{t+1}^i] - \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} r_t^{f,GB} = \frac{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^i\right]}{\text{Cov}_t\left[\frac{u'(W_{t+1})}{\mathbb{E}_t[u'(W_{t+1})]}, r_{t+1}^M\right]} \left(\mathbb{E}_t[r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} r_t^{f,GB} \right) \quad (49)$$

$$\mathbb{E}_t[r_{t+1}^i] = \frac{\text{ESG}_t^i}{\text{ESG}_t^{GB}} r_t^{f,GB} + \frac{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^i]}{\text{Cov}_t[u'(W_{t+1}), r_{t+1}^M]} \left(\mathbb{E}_t[r_{t+1}^M] - \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} r_t^{f,GB} \right) \quad (50)$$

$$\mathbb{E}_t[r_{t+1}^i] = \frac{r_t^{f,GB}}{\text{ESG}_t^{GB}} (\text{ESG}_t^i - \text{ESG}_t^M \gamma_t^i) + \gamma_t^i \mathbb{E}_t[r_{t+1}^M] \quad (51)$$

$$\mathbb{E}_t[r_{t+1}^i] = r_t^{f,GB} \frac{\text{ESG}_t^M}{\text{ESG}_t^{GB}} \left(\frac{\text{ESG}_t^i}{\text{ESG}_t^M} - \gamma_t^i \right) + \gamma_t^i \cdot \mathbb{E}_t[r_{t+1}^M]. \quad (52)$$

7 Additional tables and figures

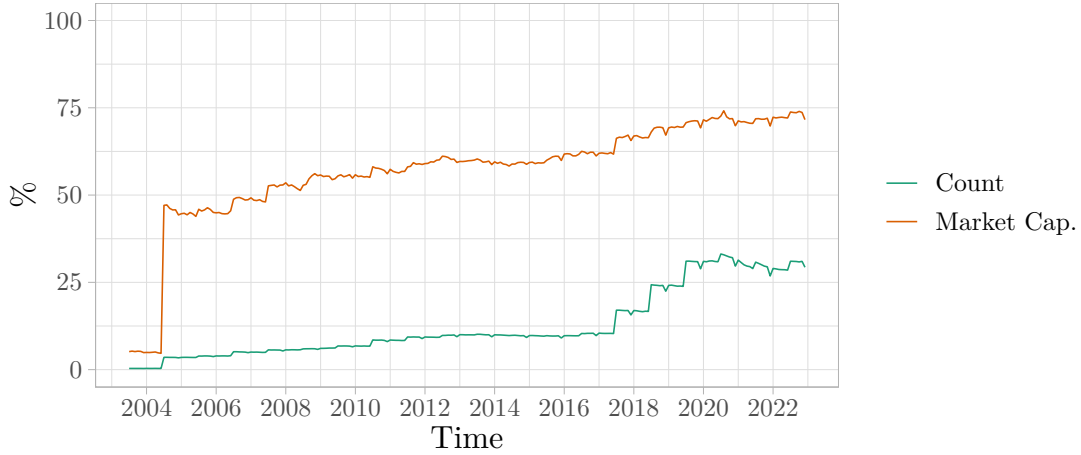


Figure 3: Refinitiv ESG scores coverage of the US market stocks in CRSP monthly file.