Journal of Asset Management (2021) 22:77–78
https://doi.org/10.1057/s41260-021-00214-4

EDITORIAL

Introductory editorial

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Published online: 18 March 2021

As soon as he took office, on the 20th of January 2021, Joseph Robinette Biden made the choice to re-join the Paris Climate Agreement. This choice sent the issue of climate change straight back up onto the top of the world agenda. Initiated in 2016 at the COP 21 summit in Paris and since ratified by more than 190 countries, the commitment was made to curb the rise in temperature between 1.5 and 2 degrees Celsius. Or else, survival may be at stake. The commitment calls, as challenging as indeed it sounds, for the building of an economy that the planet can sustain.

It is important to underline that the investment community has a crucial role to play in this endeavour. Since it is up to investors in the end to decide which enterprise to finance and which one not—within the limits of market laws that is—they are *de facto* at the frontline of building the new economy. Market mechanisms have over time, in coherence with Friedman's (1962) doctrine of liberal capitalism, led to investment selection processes that favour economically viable enterprise. The key question today is whether the same market mechanisms can lead to a selection of enterprise that is sustainable as well. Would that be conceivable? Would investors eventually not prefer sustainable over unsustainable, all else equal?

Finance theory tells us that all depends on whether investors judge the gains to weigh up against the risks. That being so, making such judgements is by no means trivial. As a starting point, investors will need access to adequate information, extra-financial information, to be in the capacity to assess the sustainability costs and risks. Yet beyond the new information, it requires new expertise as well. Investors need to work out how to blend the extra-financial data into the regular information flows onto which the existing investment processes rely. The blending must be such as to be able to assess the economic viability and the sustainability of business enterprise in the same time.

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Adding the extra risk dimension calls for a complete overhaul of the portfolio management process. While new regulation is burgeoning, meaning to streamline the extra-financial information and make it easier to use, the proliferation of this information, extracted from many sources all bundled together into ESG scores, has made the integration of these factors more and more complex. The portfolio manager encounters great difficulties, right from the construction of the portfolio, in quantifying and comparing the extra-financial data. For the information to translate into investment risk, it must be brought back to the investment horizon. Sea levels rise over decades … an Eco tax meant to fight this may come tomorrow. Indeed, a short-term investor will not have the same tack on climate change, for example, as a long-term investor. Integrating all these considerations into the portfolio management methodologies, is what makes sustainable investing challenging, and fascinating.

It is, despite all, arguably a positive point that the risks related to climate change, and more generally to the societal challenges we are facing today, are becoming more perceptible. The more these risks are seen to latently inflict material damage to invested capital, the more they will become part of the investment selection processes. The earlier such transformation takes place, the earlier may asset prices react. Logically, divestments from assets that are seen to finance unsustainable enterprise will push their prices down. This pricing pressure sends out clear signals to firms to clean up their production lines, and with a bit of luck this may happen before the latent risks become real.

It is a time race. The transformation of the investment industry towards one that finances a sustainable economy seems underway. The question is what will go faster: global warming or the corrective action driven, in large part, by the capital markets. Crucial in this race is that investors gain experience in what-is-called sustainable investing. It is work in progress. It is encouraging to see that serious efforts are going into ESG research, and we are thrilled to contribute to these efforts via this special issue.

In the lead article, Frank Fabozzi, Peck Wah Ng and Diana Tunaru study the impact of Corporate Social

Responsibility (CSR) on Corporate Financial Performance (CFP) and credit ratings in Japan. Their findings are mixed. On an aggregated data level, the impact of ESG scores, used as proxies for CSR, on CFP appears negative, whereas on a more granular data level, test results diverge depending on how CSR and CFP are measured. The impact is negative for the accounting values of firms yet turns positive for market values. Moreover, much depends on the individual E, S and G pillars of the ESG scores that are used and on the test method counting in nonlinear effects or not. The authors believe that two opposing effects are at play, stemming from the agency problem, which pushes toward lower CFP, and from the value-enhancing view leaning toward higher CFP. The impact on credit ratings is more convincingly positive. Overall, it is fair to say that Japanese firms are relatively new to corporate social responsibility; according to the Milken Institute, the portion of investors' reports using ESG scores is 18% in Japan in 2018, compared to 39% in the USA and 46% in the EU.

In their article named "Green Bonds: Shades of Green and Brown" Moritz Immel, Britta Hachenberg, Florian Kiesel and Dirk Schiereck make an account of how the green bond market fares today, thirteen years into its existence. Much has happened since the World Bank issued the first Green Bond in 2008. The authors give evidence that green bonds are trading at a (small) premium compared to non-green (brown) bonds. Interestingly, among the green bonds those scoring high on ESG criteria, in terms of Environmental-, Social- and Governance issues, are more expensive than those that do not.

In his article named "Air Pollution, Investor Sentiment, and Excessive Returns" Matthew Muntifering gives evidence of a remarkable market phenomenon. In the same way that stock markets tend to be upbeat on sunny days, he finds an opposed effect coming from air pollution: polluted air in New York City makes the stock markets downbeat. Matthew, who is doing his PhD in the Department of Agricultural Economics and Rural Sociology, Auburn, conducted his study using the air quality index provided by the Environmental Protection Agency.

In their article named "Sustainability Efforts, Index Recognition, and Stock Performance" Moonsoo Kang, K.G. Viswanathan, Nancy A. White and Edward J. Zychowicz study the price behaviour of stocks entering the North America Dow Jones Sustainability Index, a flagship stock index based on ESG criteria that was launched in 1999. The authors find that stock prices go up on the news of entrance, indicating that the selected stocks are in effect in demand. The authors have verified that the positive reaction is not a result of selection bias other than the ESG criteria.

In his article named "Expected and Realized Returns on Stocks with High and Low ESG Exposure" Olaf Stotz shows that there is a discrepancy between the expected return on stocks with high ESG scores and the eventual outcome. Interestingly, the *ex post* realised returns on high-scoring ESG investments largely outdo the *ex ante* expectations based on the financial fundamentals of the underlying firms, that is, over the period from 2008 to 2018 in the US. Olaf attributes this finding to the news on discount rates, which in effect indicates that high ESG assets are in demand.