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Stocks in environmentally-minded firms fare better than their polluting peers

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The stocks of environmentally-minded companies are a better bet for investors than shares in their polluting rivals, reveals a new study by the University of Sussex Business School and Birkbeck, University of London.

Companies with better-than-average environment performance gave investors better returns and lower risk than their competitors, the study by Dr. Panagiotis Tzouvanas and Professor Emmanouil Mamatzakis found.

The study found on average a portfolio with the best-performing environmental stocks could have up to 7% superior annual returns than a portfolio with highly polluting stocks, while the risk of environmental stocks is around 30% less.

An investor who put $100 in 2005 into a green minded company whose environmental performance was 10% above their industry standard every year would get around $45 more back on their investment in 2018 than if they backed a polluting company whose environmental performance was 10% below the sector average, the study authors explained.

The authors of the study say their findings suggest investment in environmental stocks would improve the efficiency of financial markets and provide strong justification for investors to select environmental stocks in a typical min-variance portfolio analysis.

They also note that the research adds further justification for policies that seek to lower greenhouse gas (GHG) emissions by not just halting environmental degradation but improving the performance of markets around the globe.

Dr. Panagiotis Tzouvanas, Lecturer in Finance at the University of Sussex Business School, said: "Our study shows that it pays to invest in environmental stock and that it is justified from a portfolio selection point of view. The research also indicates, to a certain extent, that it is profitable for a firm to invest in clean technologies.

"Our findings show that stocks with superior environmental performance have higher equity valuation and benefit from lower associated risks and particularly lower idiosyncratic risk. We have found strong evidence that portfolio selection of firms with strong environmental performance is justified both in terms of market returns and risks.

"There is one note of caution for investors from our findings on the relationship between the stocks of environmentally and systematic risk but there are good reasons for this link in terms of the challenges of adapting to cleantech."

The study is the first of its kind to examine the association between companies' environmental performance and their risk-adjusted returns.

The authors compared market-based returns and risks of stocks for environmental and non-environmental companies using data on the performance of firms in the S&P 500 between 2005 to 2018. Companies were considered environmental firms if their GHG emissions were lower than the average of their competitors.

The research, to be published in the October edition of the International Review of Financial Analysis, shows that stocks in environmental companies offer higher returns and have lower idiosyncratic and total risk.

The study did find that environmental companies carried a higher systemic risk but the authors believe this is explained by the impact of macroeconomic, regulatory and social factors on environmental performance. They add that adapting to the cleantech revolution can mean companies face higher compliance costs, raising capital and increasing competition.

The research found that environmental companies were the best performer in all industry-specific portfolios they examined with the largest gains to be found for green-minded companies in Consumer Discretionary, Energy, Financial and Health Care portfolios.

Businesses in environmentally sensitive industries such as the energy sector were the biggest beneficiaries of reducing their GHG emissions, the study found.

An energy firm that decreased their pollution output by 10% would benefit from a 3% boost to their share price. On the other hand, firms operating in real estate or consumer staples received no share price increase from decreasing their emissions.

Emmanouil Mamatzakis, Professor of Finance at Birkbeck, University of London, said: "Our findings reveal that the stocks of companies with strong environmental performance are value for money in the portfolio, while also contributing to the sustainability of the economy.

"Our findings justify the use of policy and regulation interventions that encourage and incentivise environmentally-responsible 'green' investment."

"Our study also found that environmental performance has a very strong negative association with total and idiosyncratic risk. From an investor's perspective this very important because it implies that higher diversification can be achieved by including environmental stocks in an investment portfolio."

More information: Panagiotis Tzouvanas et al, Does it pay to invest in environmental stocks?, *International Review of Financial Analysis*

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