RESEARCH INSIGHTS

Do sovereign wealth funds and pension funds sacrifice financial returns to follow environmental, social and governance investment strategies?

- **Using Chile as a case study, this document finds that financial returns would not have been lower if sovereign wealth and pension funds had followed environmental, social and governance (ESG) investment strategies.**
- **In this case study, following ESG investment strategies would have provided better financial returns than conventional investments during the first months of the coronavirus pandemic (January to May 2020).**

CONTEXT

Investors increasingly seek investments that deliver strong financial performance with better environmental, social, and governance performance. ESG investing is especially important for sovereign wealth funds and pension funds for three reasons. First, the costs of unethical and unsustainable practices fall on societies, communities, and employees. Second, sovereign wealth funds and pension funds have a long investment horizon over which these ESG risks could substantially impact financial performance. Third, because sovereign wealth funds and pension funds control a large share of global assets, by following ESG investment strategies they could incentivize firms to improve their ESG performance.

THE PROJECT

Using Chile as a case study, we provide evidence that sovereign wealth funds and pension funds can follow ESG strategies without sacrificing financial returns. Using information from the funds' public reports, we construct ESG counterfactuals for Chile's two sovereign wealth funds (ESSF and PRF) and the averages of Pension Funds A to E. We compare the funds' actual cumulative returns to the cumulative returns of two counterfactuals—a conventional counterfactual constructed from the benchmark indexes and an ESG counterfactual constructed from the ESG counterparts of the benchmark indexes.

Key Concept

ESG INVESTMENT

Refers to investment strategies that consider firms' performance on environmental, social, and governance metrics.

Key Concept

COUNTERFACTUAL

Represents what would have happened under alternative conditions.

RESULTS

Over the full time period for which data are available, the ESG counterfactuals generally provide similar or better cumulative financial returns than the conventional counterfactual and the actual fund while achieving better performance on all ESG metrics that we consider. For example, since February 2012, the cumulative returns of the ESG counterfactual of the PRF fund was 3.48% greater than the conventional counterfactual and 0.99% greater than the actual returns.

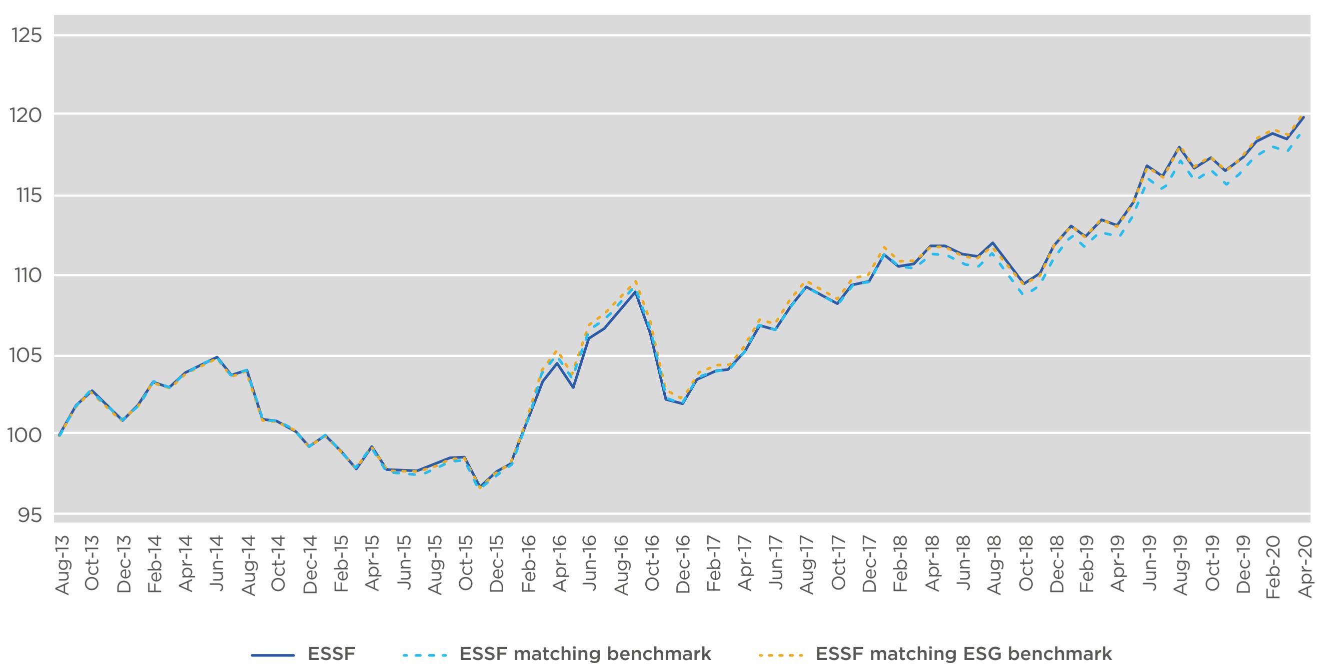
During the coronavirus pandemic, January to May 2020, the ESG counterfactuals' financial returns generally outperformed the financial returns of the actual funds and the conventional counterfactuals. During the time period corresponding to the first months of the coronavirus pandemic, the ESG counterfactual of the PRF have lower cumulative losses by approximately 0.5%. We compare the financial performance of additional conventional indexes and their ESG counterpart indexes to provide broad evidence that ESG investment does not sacrifice financial returns. Our results are not an artefact of the specific indexes or the time period used in our case study, and the broader sample of indexes also indicates that ESG investments do not increase financial risk.

POLICY IMPLICATIONS

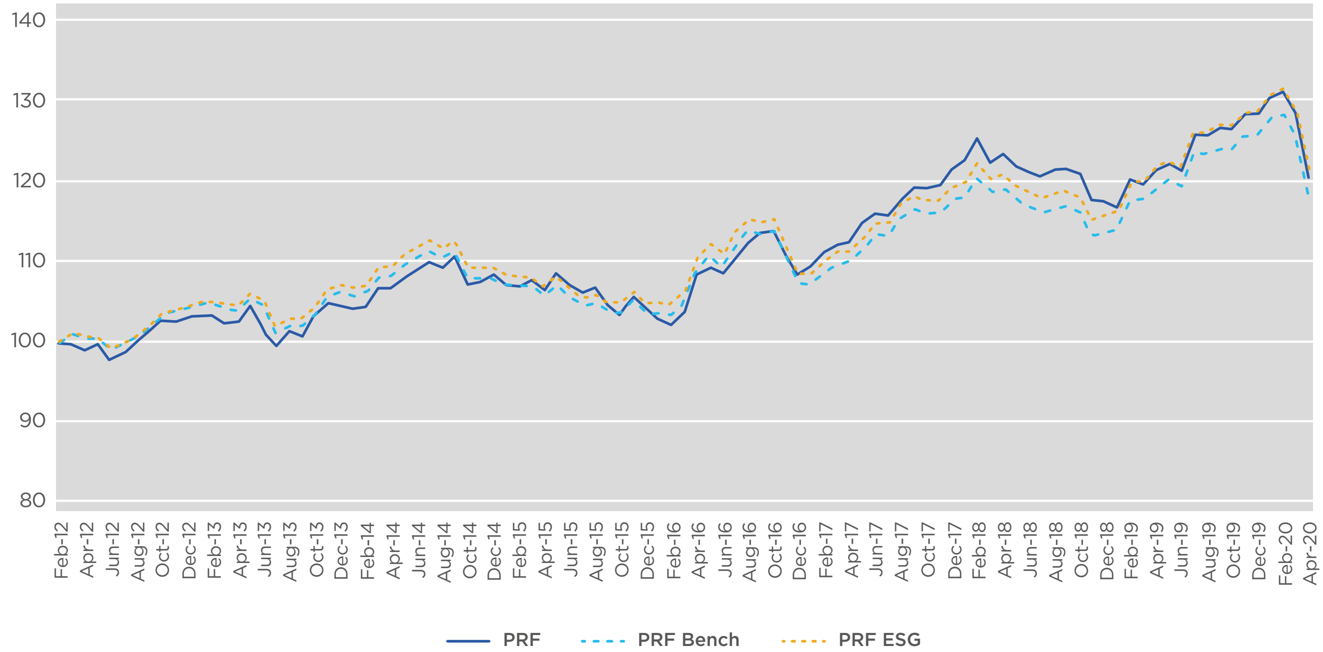
The increased interest in ESG investment is part of a larger trend toward a redefinition of the role of business in society. Firms are embracing the broader objective of maximizing stakeholder value instead of a narrow focus on maximizing shareholder value. To optimally incorporate ESG factors into investment decisions and to allow prices to fully reflect ESG performance and risks, investors need greater transparency of ESG performance and widespread standardized reporting of ESG metrics.

Over the past few months, governments have expanded their roles, and public support for climate change and green recovery policies has remained high. This is the time to implement low or no cost climate change mitigation and adaption policies, such as policies that increase ESG investment.

Cumulative Returns of Economic and Social Stabilization Fund



Cumulative Returns of the Pension Reserve Fund



FULL STUDY

[Hoffmann, B., T. Armange i Jubert, and E. Parrado. 2020. The Business Case for ESG Investing for Pension and Sovereign Wealth Funds.]

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

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