Executive summary

This thesis investigates whether firms with favorable Environmental, Social, and Governance (ESG) characteristics yield higher average stock returns, examining the potential predictive power of ESG scores on future stock returns. Several theoretical mechanisms, including a free cash flow view, a risk factor view, and a mispricing view, suggest the existence of a predictive relationship between ESG characteristics and stock returns. In particular, the free cash flow view argues that ESG causes “earnings surprises.” If true, this implies that high-ESG-score stocks *outperform* low-ESG-score stocks. The risk factor view argues that poor ESG standards are a source of priced (systematic) risk. If true, this suggests that high-ESG-score stocks *underperform* low-ESG-score stocks. The mispricing view argues that ESG is associated with a non-fundamentally driven demand surplus/deficit. In combination with limits to arbitrage, this view predicts that high-ESG-score stocks *underperform* low-ESG-score stocks.

To examine these three channels and their respective implications, the STOXX 600 constituents was employed as the investment universe. Due to the availability of the Bloomberg ESG score on an annual basis starting in 2015, the analysis was confined to the period between January 2015 and December 2022 (96 months). The resulting dataset comprises 48,296 stock-month observations with complete information on returns and Bloomberg ESG scores. In total, there are 521 unique stocks with at least one monthly observation throughout the sample period.

Three different methodological approaches were utilized for the stock return prediction mechanisms outlined above: portfolio-level analysis, cross-sectional time series (panel) regressions, and a difference-in-differences approach exploiting the COVID-19 crisis during the first quarter of 2020.

In summary, no evidence was found to suggest a positive relationship between ESG scores and future returns. Put differently, no indication was found that high ESG stocks offer a larger long-term average return premium compared to low ESG stocks. In fact, some evidence suggests the opposite, showing that stocks with high ESG scores underperform stocks with low ESG scores in terms of average risk-adjusted returns. However, this evidence is statistically weak and not robust to controlling for a stock’s market capitalization.