Does it pay to be green?
Environmental performance and global financial returns

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Extended Abstract

There is considerable research on the connection between socially responsible investment and financial performance. One strand of this literature considers the effects of corporate environmental performance (CEP) on corporate financial performance (CFP) but this is done mostly on the micro (firm) level. In this paper we try to make a new connection of CEP with financial performance but at the macro level. We are using, for the first time to the best of our knowledge, the panel data set of the Environmental Performance Index (EPI) and relate it to global financial performance (GFP) for a large number of developed and developing economies. Maybe not surprisingly, we find that, on average, "it does pay to be green" and that investing on the financial markets of countries that are improve their position (i.e. their ranking) in the EPI index might be a new sensible way of global fund allocation. To examine the nexus, if any, between financial performance and environmental rankings we utilize our panel data in two different ways. First, we build simple, equally weighted portfolios which are comprised from those indices whose countries have changed EPI ranking from year to year. Then, we estimate panel regressions where in addition to the Fama-French risk factors we also consider the EPI levels and EPI rankings. Our main variable of interest is the EPI index, which we obtain from the joint project between YCELP of Yale University and CIESIN of Columbia

University (2014). Moreover, we obtain freely available online data on global financial returns covering a time span from 2004 until 2014 with 71 countries included. We can see a number of interesting results. In more details, concentrating on the countries that have upgrade their environmental status, they have better stock market portfolios than those portfolios of the countries that worsen their environmental status. We next turn to the estimation results of the regression model which are clear and highly suggestive: the changes in environmental performance for the better (i.e. an improvement of a country’s EPI ranking today) can potentially be linked with higher returns of its stock market in the future. So it appears that it indeed “pays to be green” but considerable future work can be done in further validating this result and exploring practical investment strategies that can both be profitable but also support further improvements in environmental performance.