Sustainable Investing Quarterly Insights
July 2018: *Carbon's Impact on Investment Returns*

Friends & Clients:

Last quarter we discussed the need for businesses to lower greenhouse gas emissions in order to hit desired global environmental goals and the role that we as investors can play in encouraging that. This quarter we focus on the connection between a company's carbon footprint and potential investment return. Fortunately for sustainably minded investors, there is a strong correlation between lower carbon exposure and higher investment returns over the long run.

Before we venture into the data, it is important to note that it is only worthwhile to compare a firm's carbon footprint versus companies in similar industries and of similar size. Carbon footprint, as it is typically measured, takes into consideration the CO_2 released during the development of a product (including the supply chain) but does not incorporate the environmental impacts (either positive or negative) of the product itself. For example, coal mining companies on average have a lower carbon footprint than solar energy companies if we just look at production.[i]

With that said, according to research from the Stanford Global Project Center, an investment strategy that bought carbon-efficient firms and shorted (betted against) carbon-inefficient firms would have **outperformed by 3.5%-5.4% annually** from 2005-2015.[ii] This result is not intuitive – if stock returns are driven by earnings and carbon efficiency is costly (otherwise all firms would rationally become carbon efficient), then carbon efficient firms should have lower investment returns. However, this line of reasoning is flawed for two reasons: a) the notion that 'carbon efficiency is costly' is not valid when looked at through a proper time fame and b) businesses continue to face tighter environmental standards, regulations, and enforcement.

Generally speaking, it is true that it takes an upfront investment and higher short-term costs for a company to lower its carbon footprint. However, due to the rapid and extreme price drops in renewable energy sources, an investment in carbon efficiency now typically leads to a positive return on investment (ROI) in a 5-10 year time frame. Furthermore, it also signals to us as investors that the company is more focused on long term earnings growth rather than satisfying investors short-term demands. However, many companies still do not make this investment due to pressure from investors for immediate earnings.

Secondly, companies with higher carbon exposure face a greater risk of future lawsuits, fines, and regulatory actions. These additional costs create a significant downside risk for carbon inefficient businesses which is compounded by the competitive disadvantage these same companies face when forced to comply with tighter environmental standards in a potentially short time period. Keep in mind, omitting the losers in a diversified portfolio is equally as important as including the winners. A lower carbon footprint is just one of the many ways that ESG investing may lead to better investment results. As always, please do not hesitate to reach out to anyone on our team – we look forward to speaking with you soon!

Sincerely,

Barrett Wadsworth
President
Barrett@north-woods.com

Jeremy Wadsworth, CFA
Chief Investment Officer
Jeremy@north-woods.com

[i] Fraser, Alastair. "Are Investment Carbon Footprints Good for Investors and the Climate?" *Policy Options*, 2017, policyoptions.irpp.org/magazines/november-2017/are-investment-carbon-footprints-good-for-investors-and-the-climate/.

[ii] In, Soh Young and Park, Ki Young and Monk, Ashby H. B., Is 'Being Green' Rewarded in the Market?: An Empirical Investigation of Decarbonization and Stock Returns (April 2, 2018). Stanford Global Project Center Working Paper. Available at SSRN: https://ssrn.com/abstract=3020304