Greenwashing as risk, and how to avoid it

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Many investors currently find it difficult to tell apart actually green companies from allegedly green ones. In this article, we are going to discuss the risk of greenwashing, and discuss what investors have to pay attention to and to what extent the new regulation by the EU (Taxonomy) can help to disclose greenwashing.

Why Greenwashing?

Many people have realised that our economy is undergoing a process of transformation. They treat their environment more cautiously, pay attention to their consumer behaviour, and invest their capital in companies that reflect their own sustainable values. As a result, many investors pay attention not only to yield and the associated risk, but also to whether the business model of the respective company is sustainable and has a positive impact on the environment and society.

Market data suggest that greener companies can finance themselves more cheaply because the yields of green bonds are lower than those of comparable, standard bonds of the same maturity. Green bonds and standard bonds are therefore no complete substitute for each other, given that the former come with a "green discount". This leads, on the one hand, to a situation where companies feel motivated to adjust their business model as it allows them to reduce capital costs. But on the other hand, there are also companies that like to present themselves as greener than they are. Those are companies that engage in greenwashing (i.e. they put on a green hat but are not green at heart).

What you should pay attention to

Because companies have the proclivity of presenting themselves as green as possible, it is even more important to look behind the scenes of companies often and thoroughly. Here, a few aspects are of importance.

A comprehensive and transparent approach including quantitative and qualitative factors reduces the risk of falling for a green marketing campaign. An example: a while ago British Petroleum (BP) changed its logo and started calling itself "Beyond Petroleum", while the business model itself had undergone only minute changes. The setting of goals where it is obvious that they are within easy reach or that are based on outliers in the past to make the present look better are also considered greenwashing.

Also, some companies try to signal environmental consciousness by donating a small part of the profit to NGOs. However, this has no impact on the own business model and its effects on the environment and society. Given the impact that climate change is going to have, companies do not only have to report on their risks, but also has to manage them. This applies to the environment (E score) and to the social level (S and G score).

How not to fall for greenwashing

The heterogeneity and robustness of data are important components for creating a clear and complete picture. While AI constitutes a basis for many financial service providers, analysing official reports and scrutinising them for key words, more specific approaches have to be resorted to as well. Why is it unadvisable to rely only on the scoring results? Because companies have found out that they could increase their score by mixing in a few key words without actually making the underlying business model any greener or adjusting it in any way.

Therefore, it is important to really scrutinise the efforts a company makes when it comes to ESG criteria. Depending on one's focus, one looks at the carbon footprint (E score), at the way the company treats its employees (S), or at supply chain management (G). By thoroughly analysing the business practice of a company, one ensures that even the best PR scams will not show the company in a better light than it deserves.

Room for improvement

Since it takes a lot of effort to provide these data in a transparent fashion, smaller companies (small caps) are often at a disadvantage when subjecting themselves to this process. It is therefore important to compensate for this disadvantage with qualitative research. This active engagement can help to offset the size bias.

The new Taxonomy framework also tries to create better clarity through transparency in the field of sustainable investment. This standardised framework will probably make it harder for companies to portray themselves as greener than they are. Either way, it is important for investors to formulate their own opinion about a company or a sector. The understanding of public institutions does not necessarily have to overlap with one's own ideas of what green means.

Legal note:

Prognoses are no reliable indicator for future performance.

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