Cracking the ESG code

As ESG performance has grown significantly in importance for companies and asset managers in recent years, it's time to look at the numbers. Is ESG screening a worthwhile tool? In a word, yes. High ESG focus contributes to risk mitigation; our research shows this is mirrored in strong operational and share price performance. We also note that predictive attributes as to future earnings stability and share price volatility suggest that ESG research belongs in company valuation. We argue that companies and investors simply cannot afford not to care.

Key conclusions

- We see solid evidence that ESG matters, both for operational and share price performance
- The relative performance of the top versus bottom ESG performers amounted to as much as 40% in 2012-15
- ESG is largely uncorrelated with our quant factors, and incorporating it adds alpha to our value and quality strategies.

Significant alpha generation from ESG set to last

Our extensive study indicates that since 2012 ESG strategies have generated significant alpha. We find that Europe has outperformed North America but that short strategies have yielded solid returns everywhere. We conclude that changes in MSCI ESG ratings matter and argue that the underlying change in ESG performance drives returns. As the risks and opportunities of ESG become increasingly important, we believe the topic can no longer be ignored.

ESG as a driver for operational improvement

We find a consistent correlation between ESG ratings and operational metrics. For example, companies with top ESG ratings have higher ROE and ROCE, and lower net debt/EBITDA than the market. Returns, margins and share prices are also more stable for the top-rated companies and we find that improving ESG performance bolsters stability in returns, implying it is not a lagging indicator. These benefits should yield a justifiable valuation premium, which we also see in the market; particularly in Europe.

ESG screening becoming a necessity

AuM in European funds that use ESG screening techniques or blacklisting have increased by an annual rate of 29% since 2007, with a particularly large increase after 2012. Exclusions is the most common screening technique, although we expect increasingly sophisticated methods to be more widely adopted in the future. We expect further increases in ESG positioning in the Nordics and the rest of Europe to sustain and continue to improve the performance of higher-rated ESG companies.

ESG adds alpha to already proven quant factors

We find ESG of great interest as an addition to our quantitative framework. An intuitive auto-correlation between ESG and quality, which share a lot of characteristics, did not materialise, but ESG added alpha to our quality strategy. ESG's aim to capture future risk reduction could be a way to avoid quality deterioration. ESG and value combinations generated less alpha but showed downside protection in times of crisis. Overall, we argue the relative valuation between ESG rating groups can be used as a timing indicator.
Executive summary

With ESG performance having steadily grown significantly in importance for both companies and asset managers, we take a dive into the numbers, screening MSCI ESG ratings and scores against various metrics. Strong ESG performance contributes to risk mitigation, but as we show in this report it is also an indicator of strong operational and share price performance. ESG ratings are, surprisingly, uncorrelated with our quant factors, which makes it an interesting addition to the quant toolbox. From a practical perspective, we find that ESG ratings can be a leading indicator of future earnings stability and predictor of share price volatility, suggesting to us that ESG research should rightfully be a component of company valuations. In short, we argue that we are at a point where companies and investors cannot afford not to care.

Why ESG and why now?
Topics related to ESG (Environment, Social and Governance) are growing in importance, especially in Europe and in the Nordic region in particular. Public interest is growing at a rapid pace, as is the interest of the relevant regulatory authorities. This is effectively forcing companies and investors to adapt and implement ESG risk management into operations and investment decisions.

ESG-related risks can translate into poor operational performance for companies, and impact flows for asset managers
If not handled correctly, ESG-related risks have the potential to harm companies financially, both directly and indirectly. Breaches of environmental regulations, human rights abuses or governance issues, such as corruption, can result in fines, directly impacting the company, but can also harm reputation and lead to a significant loss of revenue if customers abandon businesses during a scandal. This risk in itself ought to be enough for an investor to stand up and take notice of ESG performance in investment decisions. Another reason for asset managers to pay attention is the reputational risk of being associated with the ESG-related breaches, which could hamper future inflows or even drive outflows.

Companies that invest in ESG are generally of higher quality
Our findings in this report clearly show that caring about ESG is a sound course of action. Companies that score higher on ESG demonstrate better operational performance, with regards to both the level and the stability of returns.

Hence, we conclude that the benefits of incorporating ESG into investment decisions reach far beyond risk mitigation. ESG-based screening has been generating significant alpha since 2012, both on the long and short side. Regardless of the causality between strong operational performance and strong ESG performance, our findings are a clear indication that companies and investors cannot afford not to care.

2012 is when ESG really started to matter as a quant factor
Our extensive study indicates that, since 2012, ESG strategies have generated significant alpha. Europe, where ESG focus is greater, has outperformed North America, but short/underweight strategies have yielded solid returns everywhere.

ESG factors likely to become more important in the future
We see clear trends indicating that ESG will become an increasingly important factor in the future. We argue that growth in ESG-influenced assets under management and increased interest in ESG screening are both (at least in part) due to evidence that ESG screening has been a solid investment strategy since 2012.
Investing in ESG strategies in Europe has worked well since the beginning of 2013.

Performance divergence is most visible in the worst performers and in the top two ratings.

High ESG-rated companies score better on many fundamental metrics.

ESG ratings are a good proxy for future operational performance.

Highly rated ESG companies are valued at a premium – justified by lower cost of capital and superior returns.

The premium is higher in Europe and the highest in the Nordics, where the focus on these factors is the greatest.

**Fundamental reasons to pay attention to ESG**

We find a consistent correlation between ESG ratings and operational metrics – companies with the top ESG ratings have higher ROE, ROCE and lower net debt/EBITDA than the market average. This relationship has grown stronger in the past few years. A likely explanation is that ESG-related efficiency spending has started to bear fruit, but perhaps also that ESG factors are more in focus for those companies' customers (e.g. customers accepting higher prices for clothing manufactured without child labour, etc). We view this trend as likely to continue.

Returns are also more stable for the top-rated companies and we see that improving ESG performance bolsters stability in margins and returns, suggesting that ESG is a leading indicator for quality improvement.

We find that high ESG-rated companies are valued at a premium and, in general, a higher ESG rating correlates to lower share price volatility. This is likely a result of companies with high ESG ratings being more insulated from earnings shocks. The lower volatility could warrant a lower cost of capital in a CAPM framework, which supports firm valuation in a typical DCF model. In addition, the premium seems justified from a purely operational view, considering higher ROCE levels for highly rated ESG companies. This premium has varied over time, providing investors with solid buying opportunities.

The valuation premium is higher in Europe than in North America, especially in the Nordic region, indicating a greater focus on ESG in Europe. The Nordic region also stands out as a top performer in ESG ratings. We argue that this could lead to more ESG investments from companies as they see increased customer demand in this area, which could allow pricing to compensate for ESG-related costs. Further, as we have noted, ESG investments tend to pay off in terms of higher returns in higher ESG rating categories, so it is possible that while greater ESG may lead to short-term pain, the longer-term gain can be substantial.
Correlation between ESG rating and ROCE has also been quite consistent over time and top-rated companies have experienced increasing ROCE premiums versus the market.

Increased focus from investors set to drive valuations

ESG screening by asset managers can impact flows into ESG-rated companies, impacting cost of capital and with it valuations.

Asset managers are becoming increasingly sophisticated in their approach to ESG.

2011-13 marked a grand increase in ESG-related investment strategies.

Exclusions remain the dominant strategy, at more than EUR 10tn, covering 48% of professionally managed assets in Europe.

We complement our stock screens with ESG.

ESG ratings' potential screening use

By incorporating ESG into our standard quant models, we find that ESG makes a considerable addition to our quantitative framework. An intuitive auto-correlation between ESG and quality, which share a lot of characteristics, did not materialise; instead ESG added alpha to our quality strategy. ESG and value combinations generated less alpha but showed significant downside protection in times of crisis, such as the financials crisis in 2008, when value took a severe beating.
Since 2012, a combination strategy of quality and ESG has generated considerable alpha.

ESG combined with value has added to upside and limited downside since 2012.

ESG as a leading indicator helps explain its incremental alpha versus a plain vanilla quality strategy. A plausible explanation as to why ESG adds alpha to a quality strategy could be found in its potential as a leading indicator, as one of the key purposes of an ESG rating is to identify companies’ future risks and reward companies that handle risks concerning sustainability. Therefore, it can plausibly function as a filter for companies that run the risk of seeing quality deterioration over time. Combining ESG ratings with quality metrics could thus generate a portfolio of quality companies that are less prone to future deterioration, subsequently adding alpha to a pure quality strategy.

Relative value as a timing indicator. At times, investors will be tempted to disregard ESG, eg in favour of looking only at valuation metrics. We argue that using relative valuation between the top and bottom ESG performers could serve well as a timing indicator. Furthermore, except when valuation differences are at extremes, we find that eliminating lower ESG ratings in the screening process yielded good results – it is clearly an investable strategy that has seen solid returns since 2012. That year was a clear turning point for ESG investing, as top-rated ESG companies started turning their valuation discounts relative to their bottom-rated peers into solid valuation premiums a few years later.
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