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ESG and stock returns

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ABSTRACT

ESG stands for environment, social and governance. ESG investing pertains to consideration of these non-financial measures for sustainable, responsible or ethical investment. Some of the examples of ESG factors are - GHG emissions, Energy efficiency, Training and qualification, Staff turnover, Absenteeism rate etc. ESG factors, though non-monetary, have a material effect on the long-term risk and return of investments. High ESG-rated firms can generate higher cash flows, have lower business or operational risks and lower cost of capital. These three factors suggest they have higher DCF value as compared to their peers. Summarily, ESG performance can boost stock returns.

Keywords: ESG, environment, social, governance, stock returns

INTRODUCTION

ESG—environmental, social and governance—describes areas that characterize a sustainable, responsible or ethical investment (ADEC, 2017).

The Financial Times Lexicon defines ESG as "a generic term used in capital markets and used by investors to evaluate corporate behavior and to determine the future monetary performance of companies." ESG "are a subset of non-monetary performance indicators that include ethical, sustainable, &corporate governance issues such as managing an organization's CO_2footprint and to ensure that there are systems in place to ensure responsibility." They are factors in investment considerations, used in risk-assessment strategies incorporated into both risk management processes and investment decisions.

ESG refers to a investing class that is also known as "sustainable investing." This is an umbrella term for investments which seek positive returns & longterm impact on the performance of the business, society and environment. There are various categories of sustainable investing. They include socially responsible investing (SRI), impact investing, values-based investing and ESG.

ESG are three central factors in measuring the sustainability and ethical effect of an organization. ESG factors, though non-monetary, have a material effect on the long-term risk and return of investments. ESG is incorporated into compliance, risk mitigation&investment strategies. Firms which use ESG standards are less risky, more conscientious and are more likely to succeed over the long haul.

The European Federation of Financial Analysts Societies (EFFAS) has laid down areas for the reporting of ESG issues to be used in financial analysis of firm performance:GHG emissions, Energy efficiency, Training and qualification, Staff turnover, Absenteeism rate, Maturity of workforce, Corruption, Litigation risks, and Revenues from new products.

LITERATURE REVIEW

There is ample research on the topic of ESG and stock returns. Below are a few abstracts from the recent literature.

Limkriangkrai et al. (2017), have posited that, this research investigates the independent effects of environmental - E, social - S, corpgovernance - G, & the composite ESG rating on stock returns and corp. financing decisions of the largest stocks in the Australian equity market. Companies with higher composite ESG ratings tend to increase their leverage. As for the individual ratings, we discover different inferences: Companies with low E &high G ratings tend to raise low debt.

Companies with higher G ratings hold low cash, while those with lower G ratings have less dividend payouts. S ratings have no effect on corporate financing decisions. There appears to be no significant difference in risk-adjusted-returns for portfolios based on their ESG rating, effectively suggesting that there are no costs of ESG investments.

Ashwin Kumar et al. (2016), have argued that, conventional finance wisdom suggest that low risk leads to lower returns. However, new mathematical analysis, introduced in this study, implies that firmswhich incorporate Environmental, Social &Fair Governance (ESG) factors show less volatility in the stock performances as compared to their peers from the same sector, that each sector is affected differently by ESG factors, &that high-ESG rated companies generate higher returns. The research assessed, a 2-year period, 157 companies listed on the Dow Jones Sustainability Index and 809 that are not.

Glossner (2017), has opined that, this study finds that environmental, social, & governance (ESG) risks result in negative long run stock returns. A value weighted portfolio of firms with higher ESG risks exhibit a four-factor alpha of −3.5% per year, even when controlling the other risk factorsor company characteristics. The negative alpha stems from unexpected costly ESG incidents and from negative earnings surprises. These outcomes make 3 contributions. First, weak corporate social responsibility (CSR) destroys shareholder value. Second, stock markets neglect to include the consequences of intangible risks. Third, shorting companies with higher ESG risks is a profitable socially responsible investing (SRI) strategy.

According to Nagy et al. (2015), institutional investors' interest in Environmental, Social and Governance (ESG) criteria has grown considerably over the past few years, however some remain concerned that the inclusion of ESG factors in their investment process comes at the cost of weaker risk adjusted returns. In this paper, we track down that this performance trade off does not always necessarily happen. We analyze stock performance of 2 strategies constructed using MSCI's ESG information:

- The "ESG Tilt" strategy over-weights stocks with higher ESG ratings; and,
- The "ESG Momentum" strategy over-weights stocks which have improved their ESG ratings over recent time periods.

We track down that both the strategies outperformed the global benchmark indices over the last 8 years, while improving the ESG profile of the portfolios as well.

According to Auer and Shuhmacher (2016), using a new dataset of environmental, social and corporate governance (ESG) organization ratings and state-of-the-art statistical methodology, this article analyses the performance of socially responsible investments in the APAC region, the US and Europe. By using a variety of portfolio screens on the sector level, our analysis generates the following insights. First, regardless of geographic area, sector or ESG criterion, active selection of high-or lowrated stocks do not provide superior riskadjusted performance as compared to passive stock market investments. Second, in the APAC region and in the US, investors concentrating on ethical utility derived from their portfolio choice can follow an ESGbased investment style and still acquire a performance similar to the wide market. However, depending on the sector focus and the ESG criterion that is used, investors in Europe tend to pay a price for socially responsible investing.

Moreover, Chong and Phillips (2016), Sassen et al. (2016) and Giese et al. (2017) have dealt with various aspects of ESG investing.

Does ESG affect stock performance? MSCI perspective

Are ESG characteristics tied to stock performance? Numerous studies have assessed the relationship between companies with strong ESG characteristics and corporate financial performance. The major challenge has been to show that positive correlations — when produced — explain the behavior. As the classic phrase used by statisticians says, "correlation does not infer causation" (Giese, 2017).

Instead of conducting a pure correlation-based analysis, MSCI focused on understanding how ESG-characteristics have led to monetarily significant effects. This way, they avoided the risk of data mining and they can differentiate between correlation and causality.

MSCI examined how ESG information embedded inside stocks is transmitted to the equity market. They created three "transmission channels" inside a standard discounted cash stream (DCF) model. They are called the cashflow channel, the idiosyncratic risk channel &the valuation channel.

These channels are based on the following rationales:

1. Cashflow channel: Higher ESG ranked firms are more competitive &can generate abnormal returns that lead to higher profitability and dividend payments.

2. Idiosyncratic risk channel: Higher ESGrated companies are better at managing organization specific business&operational risks and hence have a lower likelihood of suffering incidents that can affect their share price. Consequently, their stock prices exhibit low idiosyncratic tail risks.

3. Valuation channel: Higher ESGrated firms tend to have low exposure to systematic risk factors. Hence, their expected cost of capital is low, leading to high valuations in a DCF model framework.

CONCLUSION

ESG is the latest management buzzword. ESG stands for environment, social and governance. ESG investing pertains to consideration of these non-financial measures for sustainable, responsible or ethical investment. Some of the examples of ESG factors are - GHG emissions, Energy efficiency, Training and qualification, Staff turnover, Absenteeism rate, Maturity of workforce, Corruption, Litigation risks, and Revenues from new products. ESG factors, though non-monetary, have a material effect on the long-term risk and return of investments. ESG is incorporated into risk mitigation, compliance and investment strategies.

In order to explain whether ESG impacts stock returns, MSCI has broken it up into three channels: first, high ESG-rated companies are more competitive and hence can generate higher cash flows, second, high ESG-rated companies have lower business and operational risks and hence display lower idiosyncratic tail risks, and third, high ESG-rated companies have lower cost of capital and hence have higher valuations. All in all, these three factors impact the DCF valuation of the firms and firms with highly rated ESG can generate superior returns.

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