The impact of ESG momentum on valuations

How changes in ESG ratings affect price

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Can you do well by doing good? Environmental, social and governance (ESG) investing has undeniably begun its ascent to the mainstream. This trend not only suggests investors are more readily prepared to pursue a responsible agenda, but also that they believe it doesn't have to come at the expense of returns. In fact, there is compelling evidence showing investors can invest for a better world and still make money.

Many recently published studies[1] support the notion of a relationship between companies ranking highly on ESG criteria and positive share price performance. While these studies have used varying criteria, and haven't all come to the exact same conclusions, it is now widely accepted that ESG factors and financial performance are connected. In this insight piece, we take a deeper look at recent results from MSCI Inc.

Causality or correlation

In its paper from November 2018, *How markets price ESG*,[2] MSCI went further than previous studies and sought to establish whether there is causality between ESG scores and equity prices. Does the improvement in a company's ESG score directly drive share price performance? Or is it more coincidental?

The conundrum is that other factors clearly do have an influence over share price performance. Companies with high ESG scores often boast strong balance sheets, decent growth profiles and good management. Are these the factors driving a company's stock price? Or do changing ESG ratings have a bigger impact?

The goal of MSCI's research was to explore this causality further.

ESG momentum

MSCI used a discounted cash-flow (DCF) model to analyse whether improving corporate management of ESG risks, measured by changes in ESG scores – or as MSCI calls it, 'ESG momentum' – is predictive of share price performance.

MSCI defines ESG momentum as "the financial value of changes in companies' ESG profiles". This means dynamic or changing scores are likely to be more predictive of performance than static ones. From a data perspective, this means measuring the "year-on-year changes of MSCI industry-adjusted ESG scores".

[1]Studies include Barclays, *The case for sustainable bond investing strengthens*, by Dynkin, Desclee, Dubois, Hyman, Polbennikov (Oct 2018); Russell Investments, *Targeting the ESG issues that can impact performance - the material ESG score*, by Steinbarth (March 2018); AQR Capital Management, *Assessing Risk through Environmental, Social and Governance Exposures*, by Dunn, Fitzgibbons, Pomorski (March 2017).
[2]Study may be found online at: https://www.msci.com/www/research-paper/how-markets-price-esg-have/01159646451.

A differentiated model

To effectively measure ESG momentum and its impact, other factors were neutralised. The model isolated ESG factors and measured their impact on the change in a stock's value. At the same time, it controlled for other drivers of performance such as quality, value and volatility – i.e. those factors not explained by systematic (market) factors or specific (company) factors. ESG momentum is powerful in this respect, as it has been historically uncorrelated with other specific equity style factors.

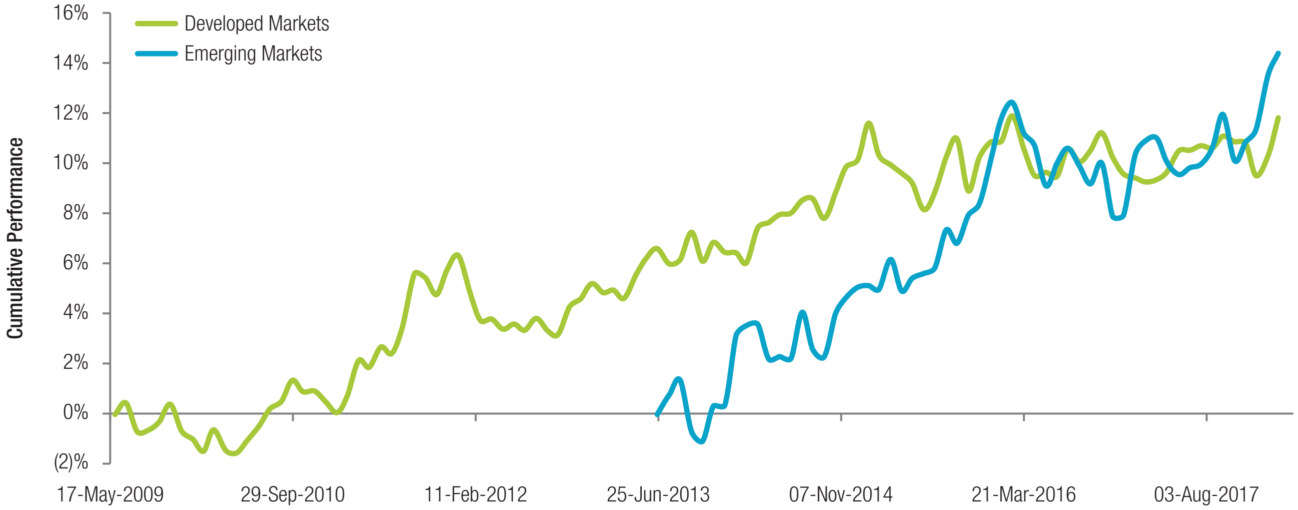
Most models are predicated on back-testing of correlations between ESG scores and stock performance – they do not seek to address the more fundamental aspect of whether one directly causes the other. The MSCI model aimed to achieve exactly this.

Another point of difference is that many other models pick highly ranked ESG companies based on static scores. By simply selecting those companies which score well on ESG metrics, and excluding those which are perhaps less highly rated, but have shown improvement in their ESG scores, most models only tell part of the story. According to MSCI's model, it is these latter stocks which, having exhibited the greatest positive change in their score, perform best. In other words, both the initial score and the change in this score matter. The MSCI model sought to identify this group of companies.

The proof is in the pudding

MSCI produced the following chart showing historic performance of the top quintile of ESG momentum stocks relative to the bottom quintile, in both developed and emerging markets (over different timeframes given available data). The model was rebased monthly and equally weighted.

Performance of top versus bottom ESG momentum quintile portfolios[3]



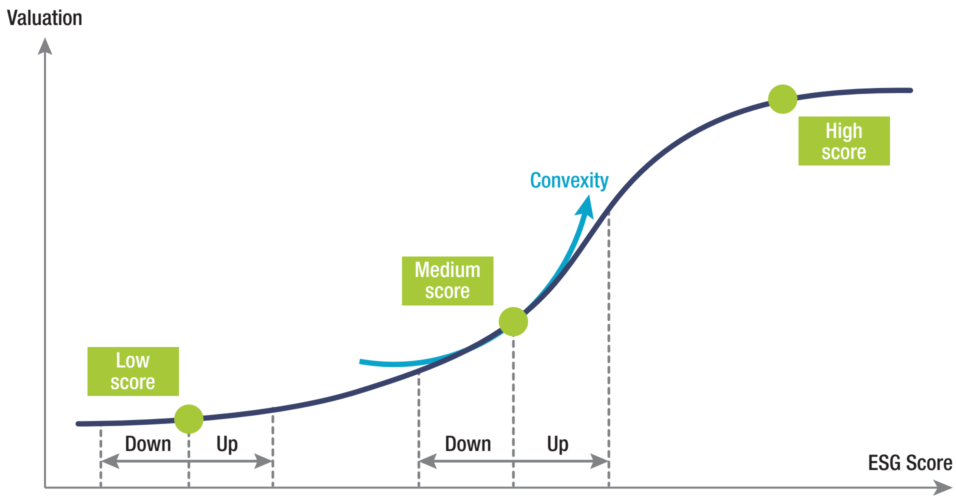
The results show that the top quintile of companies exhibiting positive ESG momentum outperformed the bottom quintile, in both developed and emerging markets. After cross checking against MSCI's risk model (Barra GEMLT), the outperformance of stocks in each basket was found, importantly, to be driven by stock-specific factors and not common or market factors.

[3]Source: MSCI, "How Markets Price ESG", Nov 2018, Giese, Nagy. Data covers two hypothetical long-short indexed portfolios. Developed market performance represents going long for the equal-weighted upper quintile of MSCI World Index, while the bottom equal-weighted quintile goes short. DM data is from June 2009 to February 2018. The emerging-market hypothetical portfolio applies the same methodology to the MSCI Emerging Markets Index, from June 2013 to February 2018, as older data was unavailable. Past results are not a reliable indicator of future results.

Middle-ranked ESG companies performed best

MSCI's research also showed that the greatest potential stock performance came less from the extreme scores (highly or lowly rated ESG companies), and more from those which were closer to the median of the market universe, or middle-ranking ESG scorers. This was where the ESG valuation curve was steepest.

Stylised ESG valuation curve[4]



With the volatility of each group of companies being similar, the model confirmed that the middle-ranked companies' price movements were not driven by higher levels of risk.

The MSCI model was also based on sector relative scoring rather than absolute scoring. This means industries such as energy and utilities, for instance, were not totally excluded. An average but improving ESG scoring oil services company could enjoy a substantial improvement in valuation, but it would be locked out of a model based on absolute measurement of ESG ratings.

> According to MSCI's model, stocks having exhibited the greatest positive change in their score performed best.

Change doesn't happen overnight

The model built in a time lag between changes in ESG scores and subsequent share price movement. MSCI explored the time it takes for ESG scores to be fully reflected in share price performance, with around a year shown to be the optimal period – shorter and longer periods showed less sensitivity. This is partly because positive relative scores tend to subside after a year (positive factors may fade or other companies in the sector could catch up) or they become fully priced into valuations.

Asymmetric returns

Another finding was that the impact on performance from changes in ESG scores, both positive and negative, was asymmetric – those companies having showed an improvement in ESG momentum tended to be rewarded more than those being downgraded were punished.

Conclusion

The MSCI model provided evidence that a change in a company's ESG profile has had an impact on valuation levels and stock prices that is not explained by the general market or other factors. ESG momentum may offer important new insights into how global markets price stocks.

[4]Source: MSCI, "How Markets Price ESG", Nov 2018, Giese, Nagy. For illustrative purposes only.

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