The risk-return properties of Investment Strategies based on Environmental, Social and Governance criteria

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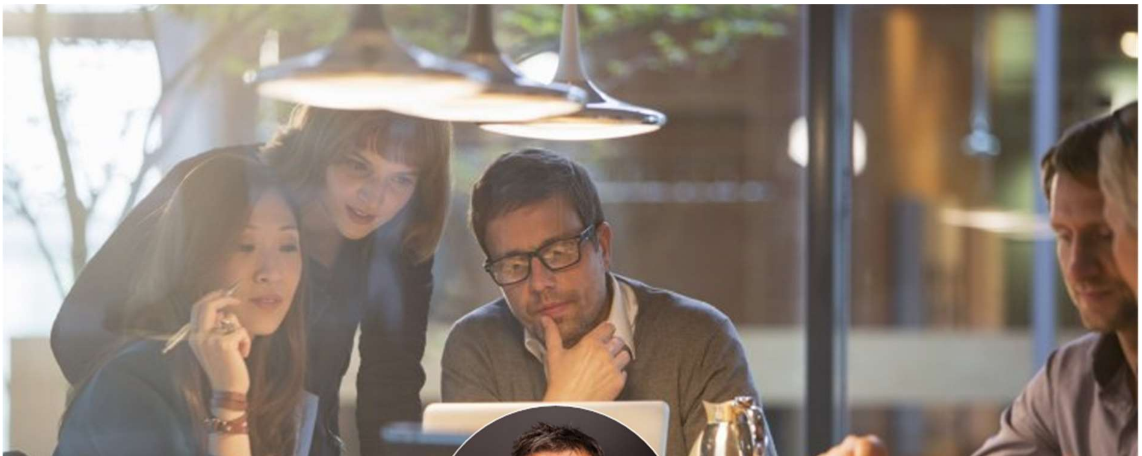

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IN A WORD:

Sustainable finance is defined as *"the incorporation of environmental, social, and governance (ESG) principles into business decisions, economic development, and investment strategies"*[1]. In this paper, we review academic literature and find that in most studies there is either a positive or no link between ESG criteria and corporate financial performance. Moreover, there is evidence that integrating ESG into corporate strategy and culture can lead to the reduction of risks, especially tail risks. We also discuss our conviction that trends related to environmental and social issues will be key drivers of future demand especially in areas such as water and waste management, renewable energies, education and food.

What are Environmental, Social and Governance (ESG) criteria?

Environmental, Social and Governance criteria may be analysed individually or together. In this paper, we review academic research to explore whether using ESG criteria to select investments may lead to a worsening of the risk-return trade-off, all other things being equal. We also look at trends linked to environmental and social issues that should allow companies to benefit from higher demand that will generate more profits, and/or attract investors as a result of a change in their risk-return profile. To illustrate the latter argument, a company may become more attractive because the risks of profit fluctuations or reputational risks are lower.

[1] IMF (2019) Global Financial Stability Report "Lower for Longer", Chapter 6 on sustainable finance. October.

Let's look at some of the key factors for ESG.

Environmental	Social	Governance
Water	Best employer	Corporate governance
Waste and Plastic	Diversity	Board structure & compensation schemes
Clean and renewable energy	Human capital (education and labour rights)	Transparency and risk control
Carbon emissions and climate risk	Health & food security	Compensation and accountability

Source: IMF (2019) and Clark, Feiner and Viehs (2015) [2]

We deem it important to highlight, at this stage, that the providers of Sustainable and Responsible Investments (SRI) use ESG criteria for positive screening of companies and as a negative filter to exclude poor ESG performers and companies based on sector and/or norm exclusions, such as weapons, tobacco, and alcohol.

The risk-return properties of strategies using ESG criteria versus traditional ones

There is a quite a lot of research on this topic. Two main reports provide a summary of a large number of studies. The first is Clark, Feiner and Viehs (2015) and the second is Friede, Busch and Bassen (2015)[3]. Most studies find that there is no negative correlation between ESG and corporate financial performance (CFP). The latest Global Financial Stability Report of the IMF (2019) confirms this theory. Moreover, most reports even find a positive correlation. However, investors should be aware that a portfolio using ESG criteria may behave differently from the overall market in the short term. Indeed, some sectors may have a lower (or higher) weight than the market, thus explaining the divergence in performance. In the long term, the impact on corporate financial performance is usually positive. A comparison of the MSCI global equity market index MSCI and the equivalent ESG MSCI index shows that the latter has outperformed since 2010 (see chart 1). Past performance is not an indication of future performance.

[2] Clark, Feiner and Viehs (2015) "From the stockholder to the shareholder: How sustainability can drive financial performance", University of Oxford and Arabesque Partners.

[3] Gunnar Friede, Timo Busch and Alexander Bassen (2015), "ESG and Financial Performance: aggregated evidence from more than 2,000 empirical studies", Journal of Sustainable Finance and Investment, 5:4, p210-233.

Summary table:

Name of study	**What the researchers did**	**Key findings**
Clark, Feiner and Viehs (2015)	Analysed more than 200 academic studies	*"90% of the cost of capital studies show that sound ESG standards lower the cost of capital.* *88% of the studies show that solid ESG practices result in better operational performance.* *80% of the studies show that stock price performance is positively influenced by good sustainability practices."*
Friede, Busch and Bassen (2015)	Analysed more than 2,200 studies	*"Roughly 90% of the studies find a nonnegative relation between ESG and corporate financial performance (CFP). The large majority of studies reports positive findings".* They refer to findings of portfolio studies, which exhibit, on average, a neutral/mixed ESG-CFP performance relationship. They demonstrate that these studies *"are overlaid by various systemic and idiosyncratic risks in portfolios."* Implementation costs also play a role.

Chart 1: Performance of a traditional equity index versus ESG (EMU)

Let's have a closer look at the influence of the different factors.

ESG and corporate performance

Applying ESG criteria to one's investments implies a restriction of the global investment universe. It is thus important to understand which mechanisms in such a restricted universe can explain why the risk-return is not affected negatively. One key mechanism greatly discussed in ESG research relates to the cost of capital at companies. Clark, Feiner and Viehs (2015) highlighted this topic. The report shows that "*90% of the studies find a relationship which points to a reducing effect of superior sustainability practices on the cost of capital*". The main drivers are "*good corporate governance structures, anti-takeover measures, good environmental management, and good employee relations and product safety*".

Another key mechanism discussed in the Clark, Feiner and Viehs (2015) report relates to operational performance. Studies show that all three ESG factors play a positive role. Regarding governance, "*issues such as board structure, executive compensation, anti-takeover mechanisms and incentives are viewed as most important*". When it comes to environmental issues, "*corporate environmental management practices, pollution abatement and resource efficiency are mentioned as the most relevant to operational performance*".

Given that strategies using ESG criteria achieve similar (or better) expected returns over the long term, it is important to focus on the risks.

ESG and risk management

There is a case to be made that integrating ESG into the corporate strategy and culture can lead to a reduction of risks[4]. If companies neglect issues related to ESG they are exposed to higher risks, such as environmental accidents (E), reputational risk linked to labour conditions or gender inequality (S) and risks linked to corporate governance, such as fraud, compensation schemes and lack of risk control (G).

Lee and Faff (2009)[5] find that "*leading corporate social performance firms exhibit significantly lower idiosyncratic risk and that idiosyncratic risk might be priced by the broader equity market*". Ilhan, Emirhan, Zacharias Sautner, and Grigory Vilkov (2019)[6] offer a comprehensive discussion on carbon tail risk. They show that "*the cost of option protection against downside risks is larger for firms with more carbon-intense business models*". This suggests the perception of large tail risks for some firms. The German government's decision to exit nuclear power in the wake of the Fukushima catastrophe had a major negative impact on utility companies. A recent IMF report7 stresses that "Environmental risk exposures can lead to large *losses for firms and climate change may entail losses for financial institutions, asset owners and firms.* The integration of ESG factors into a firm's business model may help mitigate these risks.

Clark, Feiner and Viehs (2015) also discuss why "*inferior ESG standards can pose a threat to a company's reputation*". Beyond environmental issues, this can lead to lasting negative effects on a company's valuation, and even default, in extreme cases. Typical examples are negative newsflow surrounding labour conditions, gender inequality as well as governance issues, such as compliance and risk control.

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[4] See Clark, Feiner and Viehs (2015).

[5] D. Lee and R. Faff (2009) "Corporate sustainability performance and idiosyncratic risk: A global perspective", The financial review, Vol. 44, N°2, May 2009.

[6] Ilhan, Emirhan, Zacharias Sautner, and Grigory Vilkov. 2019. "Carbon Tail Risk."

[7] IMF (2019) Global Financial Stability Report "Lower for Longer", Chapter 6 on Sustainable Finance. October.

Environment and Social issues drive demand for goods and services[8]

There is a growing awareness that human society and the global economy are closely related to the ecosystem, particularly water, waste and energy sources. This has led to government-related actions linked to the Paris Climate Conference (COP21) agreement signed in Paris and the United Nations' Sustainable Development Goals (SDGs) to name just a few. Regarding the environment, we expect a growing demand for goods and services related to water availability, waste management as well as clean and renewable energies. Examples are collection methods, recycling and waste-to-energy solutions. Other areas cover technological innovation and equipment in solar, wind, geothermal energy and hydroelectricity. Other key areas include batteries and related chemicals as well as power and grid equipment makers. We also see potential in the area of education, alternative food, food safety as well as healthy and natural food.

Conclusion

Integrating ESG criteria can improve the risk-return trade-off. Indeed, most studies find a positive or no relationship between ESG and corporate financial performance (CFP). Moreover, integrating ESG criteria may also be seen as a way to reduce risk, especially tail risk. Indeed, the most common tail risks are environmental and carbon risks[9]. Social and governance filters can help reduce 'reputation risk'. In addition to this risk-return argument, we see opportunities related to environmental and social issues. Indeed, there is a growing awareness that human society and the global economy are closely linked to the ecosystem, and in particular, to water, waste and energy sources. This should lead to a growing demand in goods and services in these areas. The areas of education, alternative food, food safety as well as healthy and natural food also offer opportunities.

[8] See also the investment themes 2020 of BNP Paribas WM (theme 6 et 7). https://wealthmanagement.bnpparibas/content/wealthmanagement/voiceofwealth/en/macroeconomics/investment-themes-2020.html.html

[9] Ilhan, Emirhan, Zacharias Sautner, and Grigory Vilkov. 2019.

Reference

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