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ECONOTE No 98 Assessing the impact of ESG on share prices and of Covid19 on ESG. 27/1/2021

Summary

The origins of "responsible investment" go back several decades but the rise of the environment crisis refocused the issue. In 2004-5 an IFC publication popularized the acronym ESG, Environment, Social and Governance, as the three key areas of business practice and of investors' concern. ESG quickly turned into a system of ranking, not dissimilar to credit, but using, of course, very different criteria and weights. Now ESG is a multi-billion USD industry with more than 600 Rankers and a large number of different rankings and scores, all propelled by the huge demand for ranking by the investment industry and by the businesses themselves.

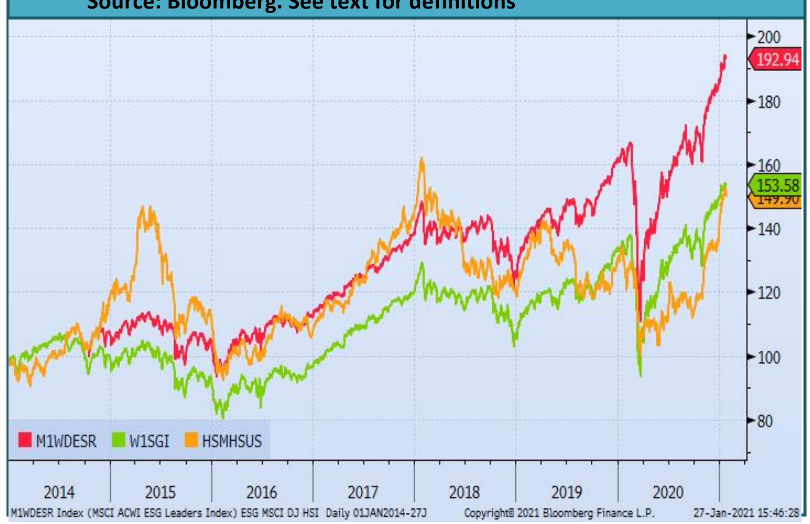
Investment Conclusions

The rise of the ESG industry led to problems including absence of scoring standardization and of poor correlation among the various indices. There is also the "massaging" of data to achieve high scores and the practice of "green washing", that is exaggerated "green scores" which also questioned the veracity of green bonds. Covid 19 added a new dimension to ESG as to the socially responsible performance of businesses during the pandemic. The industry and the quality of the rankings are bound to change dramatically.

The mechanics of ESG rankings

An important reminder: **The Enviroment,Society and Governance are not just scores of how "good" a firm is, but far more importantly, are indicators of risks facing the company in terms of enviromental and societal risks as well as risks of poor governance.It is importntat to emphasize this, as the "E" part of the ESG has tended to dominate the public discussion.**There are now more than 600 ESG Rankers and the increase in the size of the industry has been followed by a frenzy of M&A, especially by the larger players such as MSCI and DJ.The following is a simplified , indeed a composite, of various rankers' practices of the way the ESG scores and ranks are estimated.**First,** depending whether the index is sectoral, country specific or regional, a market capitalisation weighted sample of liquid and adequate free float shares of companies are chosen.**Second** a variable number of areas or perfromances for each firm are given alpha/numerical scores.At a minimum these might include Organisation governance,Human rights,Labour practices,Enviroment,Fair operations,Consumer issues and Involvement with the community. **MSCI,** possible the biggest of the Rankers, collects data from firms on 37 areas including: **E** (Climate change,natural resources,pollution, enviromental opportunities),**S** (Human capital,product liabiity,stateholder opposition) and **G** (Corporate governance and behaviour).The aggregate of these scores then gives the ESG ranking for the firm for that year or time period.

Fig. 1: **ESG indices: MSCI (red), DJ (green) HSI (orange) 2014=100**
Source: Bloomberg. See text for definitions



What does it all mean

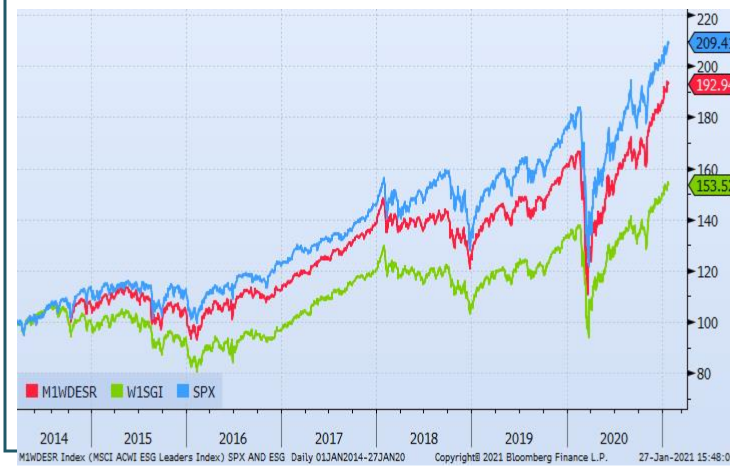
An ESG ranking of AAA versus CCC implies that the first company has a great deal less risks on the ESG fields, and symetrically has better results on pollution control, governance etc than the second company.However, as much of the metrics involved are sterilised and quantified, ultimately, there are enough unmeasurables to make the ranking partially subjective as opposed to purely objective as the Rankers would like to claim.Consider the following three points.**First,** as Fig.1 shows, the overall performance of three ESG indices does not vary in cyclical terms significantly from each other.(MSCI ESG leaders, global , DJ Sustainability world index and, as a HK-China proxy, the HSI's own ESG HK & China index.) Needless to say that as the composition and coverage of these indices varies widely, their proper use would be in comparing a group of similar firms with

FACTBOX: The main criticisms of ESG indices

1.Absence of standadisation in the rules, metrics and terms used by Rankers thus making consistent inter-company comparisons difficult.
3.Low correlation among ESG raters. A Sloan School study (2019) using datasets of five ESG raters, found correlations between scores on 823 companies, on average, 0.61. (A correlation of 1.0 would equal 100%.) For comparison, credit ratings from Moody's Investors Service and S&P Global Ratings are correlated at 0.99.
4.The US SEC and the EU Commission are introducing rules to harmonize ESG ratings issued both by companies and by the Rankers themselves.

Indices some of which are and some of which are not ESG weighted in order to detect any performance differences attributed to ESG rankings. **Second,** this comparison is done on a very simplistic level in Fig.2, which compares the performance of 2 global ESG indices versus S&P 500, the one key index used widely in portfolio performance evaluation. Clearly ESG weighted shares underperformed the S&P. This does not prove that ESG does not matter when it comes to performance but that one needs far more finely calibrated tools to do so in terms of proving cause rather than just correlation! **Third,** there is evidence that high ESG rankings make some difference in performance. Studies by Fidelity and HSBC (spring 2020) found that higher ESG rated companies outperformed lower rated. Between them the studies covered over 3350 companies across the world. The time period covered in both studies included the outbreak of the CV19 pandemic.

Fig.2 :MSCI (red),DJ (green) S&P 500,(blue) 2014=100



Source: Bloomberg

Where do we go from here ? What about Covid 19 ?

One of the more "metaphysical" long term criticism of ESG focused funds was that they were likely to sacrifice performance in order to attain high scores.A recent study seems to contradict this. Morningstar has shown that over a 1,2,3,5 and 10 year periods ESG strategies in 745 European based funds outperformed those of non-ESG funds.The onset of CV19 created another area of conflict and of interest on ESG weights.Firms are aware that their social and HR performance during the pandemic will be closely judged in their ESG ranks and, hence, more than ever, Rankers are focusing on the **"Covid 19"** factor.In addittion to this, some governments and the EU have made financial aid to corporates conditional on the money being used for "green investment" or at least the investment can be seen to be carbon neutral.This re-emphasis was triggered by the spectacular fall of CO2 emissions during the first months of the pandemic proving clearly that emissions can be controlled by the crude lockdown policies and ,hence, can be controlled by better calibrated and less forcefull measures.Going forward, there are clearly two on-going developments which will persist and accelerate.**First** the emphasis and competition for better ESG scores and their nealry obligatory use by all corporates, including SMEs.**Secondly** a centralisation and standardisation of the methodology used to arrive to ESG scores thus injecting comparability and consistency in the metrics.This development however will increase competition among Rankers if they are perceived to be offering near identical products and company scores.