TRANSCRIPT

Deconstructing ESG Ratings Performance

*Featuring: **Linda-Eling Lee***, Global Head of ESG Research; ***Guido Giese***, Executive Director, Core Equity Research

Linda-Eling Lee: Hello, I'm Linda-Eling Lee. I am the Global Head of ESG Research at MSCI. Thank you so much for joining us. We are trying to find new ways to bring our research insights to you more quickly and in a more digestible format. I'm based in New York and I am joined today by my colleague, Guido Giese, who is part of our Core Equity Research team and he is based in London.

The global growth in ESG investing has spawned a cottage industry of research investigating the potential financial benefits of ESG. There are a lot of these studies that point out some outperformance, but frankly, some of the results can really differ depending on which ESG methodologies were used. So, we would always caution that the relationships between ESG and performance in any study is difficult to generalize without a really good understanding of the underlying components of the ESG signal and how you're actually putting those components together.

So we've done a lot of research at MSCI on the topic of ESG and performance and that's partly because we benefit from having the longest live history of ESG datasets in the field.

Now, not all ESG data is actually appropriate for testing ESG and performance. What's really the most relevant for understanding financial risks and returns is data that come from rating companies that are based on industry specific financial materiality.

So I'm really happy to share with you today some of our most recent findings from using over 13 years of ESG ratings live history to examine ESG performance over time and by sectors. So, our new report is titled "Deconstructing ESG Ratings Performance." And I'd like to start by asking Guido to give us a little bit of background for the study and to ask him what's new in this report.

Guido Giese: Yeah. Thank you, Linda. So last year we published a research report in The Journal of Portfolio Management called "Foundations of ESG Investing," where we identified the economic transmission channels that explain a causal relationship between companies, ESG characteristics and risk and return, which is summarized on this slide here.

And in brief, we found that companies with high MSCI ESG ratings, outperform companies with low ESG ratings, they showed lower frequency of stock specific incidents. So, accidents, fraud cases, and they showed lower levels of systematic risk.

The key question that we are addressing in the new study is what has been driving these results? Was it the E, the S, or the G? Which key issues that underlie the writing model have been driving this financial results? And the third question we address is what is the role of the waiting model? How important is the waiting model to construct an ESG writing methodology?

Linda-Eling Lee: So Guido when it comes to ESG performance, is it mainly a G thing? We know that investors typically assume that G in ESG is more robust and is more important than the E and the S.

Guido Giese: Many, many investors ask this question. And it turns out the answer to the question depends on the time horizon. So, we tested our E, S, and G scores over one-year horizon. So, looking at the score and financial risk and return the year afterwards and over the short term one-year time horizon. In fact, it turned out governance showed the strongest financial results. So over one-year time horizon governance was clearly the champion.

However, we also looked at longer periods of time. So, we lose the 13 year back testing period, which you'll see in the following chart, where we basically compared the top quintile, where just the bottom quintile in terms of performance for the E, the S, and the G score. And we found over 13 years, actually, the performance results were much more balanced. In fact, all three pillars have shown outperformance during the 13-year study period. So, the answer is, it really depends on the time horizon.

Linda-Eling Lee: Yeah. So, Guido, let's talk a little bit about what we think actually accounts for this difference and why is governance really more short term than perhaps a lot of investors might assume?

Guido Giese: Yeah. To answer this question, we looked into our rating model, which you'll see summarized on this slide here. It consists of 37 key risk issues, which underlie the E, S, and G pillar. And we found something very interesting, our analysis.

We found that there are two types of ESG key risks. We found that there are key risks that we call "event driven risks." So, these are key risks that describe the likelihood of companies suffering a severe incident, like a fraud case, an oil spill, which can hit the stock price in the very near term. And then there's the second type of E risk, which materialize over longer periods of time. And we call them "erosion risks" because they can lead to erosion of the stock price over many, many years.

Now, what we found is that the G score has a higher proportion of event driven key risk issues. And that's why governance shows stronger financial relevance in the short term, whereas E and S have a higher proportion of these erosion factors. That's why they are more long term in their financial relevance.

Linda-Eling Lee: So we've always thought about these two different types of ESG risks, conceptually, in terms of looking at the key issues in the model, but how have we actually tried to verify these empirically?

Guido Giese: Yeah. We spent quite some time to understand how we verify these empirically. So, event risks, we realized these can be verified empirically by looking at the frequency of companies suffering severe drawdowns. And what we found is that companies with good ESG ratings showed clearly lower frequency of companies suffering severe drawdowns compared to companies with low ESG ratings. So, the frequency of drawdowns is how to identify and measure these event driven risks.

By contrast, when it comes to long term erosion risks, here we looked at long term stock performance. I want to show you an example. What you show in the following slide is the performance of the top versus bottom quintile portfolios and using the environmental score in the utilities and materials sector. Why did we choose these sectors? Because the materials and utility sector, they are very much exposed to environmental risks in what we see here during the past 13 years, companies with poor E score, environmental score, have clearly underperform their peers that have a good E score so clearly, environmental issues are a good example for long term erosion risk that can harm the stock price of companies over longer periods of time.

Linda-Eling Lee: What we've been talking about is that E, S, and G issues, dry performance at different extents and different time horizons. So, a natural question is why we would actually choose to bundle that together into an aggregate overall ESG rating? I know that this is a question that you get a lot. Doesn't it actually dilute the performance of the most important factors in E, S, and G?

Guido Giese: Yeah. This is a standard argument from financial literature, actually. Financial literature says you should not add up too many indicators because otherwise they might dilute each other. But the important thing here is to mention is that our ESG writing model does not just add up 37 key risk issues across all companies. Our rating model is based on a very industry specific selection of the most relevant key issues for that industry and on an industry specific rating of E, S, and G to come to an aggregate ESG score.

The question is, has that actually worked, has it added value and has that mitigated the risk of diluting material information? Now, the answer is on the next slide. So here we compared the financial performance.

Once again, we look at that top ESG rating quintile versus the bottom ESG rating quintile, over 13 years and we compared our actual ESG rating with a hypothetical rating that is based on just equal rating, the E, S, and G pillar scores. And what you can see is that the actual rating that uses an industry specific rating of E, S, and G has very clearly outperform the simplistic equal rating of E, S, and G, which means it is absolutely important to have industry specific rating scheme for E, S, and G, because otherwise you might not capture what is relevant in each industry, and you may lose performance by diluting too many signals, but the industry specific rating scheme has clearly worked.

Linda-Eling Lee: Great. So, what have we learned?

So first that time horizon matters, right? G matters more in the shorter term over one-year time horizon. Whereas what we've seen is that environmental and social issues can become more significant over a longer timeframe.

Secondly, we can think of the ESG as capturing two types of risks: event risks versus erosion risks. So, the market seems to price more quickly that ESG issues, that capture event risk things like fraud or accidents, but really over a multiyear period, the poor management of ESG issues that are less event driven, like carbon emissions, that can actually erode company's competitiveness and financial performance over time.

And then finally, how you actually aggregate can actually add a lot of value if you do it right. How you go about picking different ESG issues and weighting them for each industry to make up an overall ESG composite score or an ESG rating, that weighting scheme itself can actually make a big difference to financial performance over time. If you just put the E, S, and G components together in an arbitrary way that just has been less effective than being prospective and being dynamic by adjusting these industry relevant issues and weights annually. So, it's really important to keep in mind overall that the point of integrating ESG is to actually capture forward-looking emerging risks and opportunities.

If you'd like to learn more, and there's a lot more details in the paper, you can come and download the paper at msei.com/research. Thank you very much for joining us.

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