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TRANSCRIPT

Perspectives Podcast

“Investment Trends in Focus: Quarterly Roundtable Q4 2024”

Transcript, 17 October, 2024

Adam Bass (00:03):
This is MSCI Perspectives, bringing to light insights and analysis to help global investors tackle today's challenges. I'm your host, Adam Bass, and today is October 17th, 2024. And truth be told, it feels like mid-October, here in New York anyway. Combine that with my kids putting the finishing touches on their Halloween costumes and the stores already having Christmas decorations up, and it's hard not to start looking toward the end of the year. On today's episode, we try and curb that instinct a bit. We check in with MSCI's Chief Research Officer, Ashley Lester, for this quarter's round-table. Ashley, along with his panel of experts, review the state of the markets and what investors may be celebrating or not for the rest of 2024. Here's that discussion. I'll see you on the other side.

Ashley Lester (01:05):
Hello, and welcome to the MSCI Perspectives Quarterly Roundtable. Each quarter, a panel of MSCI experts share their opinions on some of the largest questions in investment today. What's happened recently and what's coming just around the next corner. I'm Ashley Lester, the Chief Research Officer at MSCI.
(01:23):
The third quarter was the quarter when the market's view of inflation finally turned. Although labor markets remained tight, nominal yields fell in the lead-up to the Fed's big 50-basis-point cut in September. Meanwhile, equities kept moving ever upwards, and the most dramatic moves upwards of all were in China.
(01:42):
Today, we'll dig into the Chinese stimulus package and seek to understand its implications for Chinese markets and beyond. We might discuss some geopolitical implications of the shifting locus of world growth. And last, we will turn to ESG and sustainability. Here, we'll discuss some key new research into the links between ESG and investment. Does the best evidence say that ESG is expensive virtue signaling? Or does it say that ESG is actually a key tool in the arms arsenal of well-informed investors? We'll find out later on.
(02:14):
Before we get started, I'll first introduce our panelists. I'm joined today by Cheng Lyu, one of our key China experts, by Yuliya Plyakha Ferenc, a specialist in equity markets and factors, by Afsaneh Mastouri, our lead fixed-income researcher, and by Xinxin Wang, an expert on investment materiality of ESG. Welcome to the podcast, everyone.
(02:37):
Let's start with the big picture. Afsaneh, I mentioned that the third quarter was pretty dramatic in fixed-income markets as expectations around inflation and monetary policy shifted decisively. Talk us through it.

Afsaneh Mastouri (02:48):
Sure. Thank you for having me on the panel today. That was certainly one of the interesting quarter for fixed income. Yes, we came into the quarter with inflation that was persistent for about six, seven months. Declining,

re-entered the region of 2- 3% for the CPI, and their expectation for the reverse in the monetary policy, that was disappointed at the first quarter because of the resurge of inflation gained momentum again.
(03:16):
But it's interesting, if you step back out of it and look at the beginning of the quarter and end of the quarter in terms of the performance of the asset loss, it has gone through a roller coaster. We had build up for the Fed meeting in September. We still rally both in terms of the rates and the credit of spreads to a degree, which was, soon after the rate cut announcement, reversed. So it's good to dig a little bit deeper there, what's happening there.
(03:43):
The one thing is that the road from here is going to be bumpy. It's not going to be a straightforward end of the tightening cycle. There are multiple reason, but I think one of the reasons that investors should keep eye on that, we keep eye on that is the trajectory of inflation. The inflation mechanism this time around is very different from the last cycles. We are in an environment that the tension between China and US and the trade tension between China and US is going to be one of the main drivers of inflation.
(04:16):
Another driver for the rates that going forward, independent of the front end of the curve, independent of the monetary policy, is going to be the [inaudible 00:04:25] spending of the government across the globe, specifically in develop market. So constantly it's going for the bond investors and credit investors, but specifically on the rate side of their portfolios, it's going to be constant pull and push. But between the projections of inflation and realize the inflation and the drivers that they are defining the long-term rate.
(04:47):
I just want to highlight one thing about the credit spread. We came to the year with the credit spreads that they were fairly tight historical level. It was a very, very good environment for credit. We did not have a hard landing. We had quite muted number of defaults. Thanks to expansion of the private credit market, the credit facilities stayed available. We really didn't experience the tightening as we have experienced in the previous cycle when the banks would withdraw credit. So the environment estate quite favorable for corporates and that's one of the reasons that we continue to see that inflation is coming down, growth is not necessarily giving in, and employment stays fairly strong. So a nice environment for different asset classes even though it has its own risks.

Ashley Lester (05:38):
We're not here to call the direction of markets, but it just seems like I guess the Feds talked for a while now and central banks about data dependent policy regimes in contrast to the previous 10 years or so, which were all about forward guidance in an attempt to manufacture some inflation. It seems therefore your prediction that this is going to be kind of a bumpy road from now on out is kind of consistent with the idea that maybe that's what happens in a normal monetary policy regime. You don't actually know right away what's going to be happening 12 or 18 months from now.

Afsaneh Mastouri (06:10):
Totally agree with you. Totally agree with you. We are in a very different scenario post-financial crisis. And actually more than post-financial crisis, post-crisis in European government market, that was a very wider spread and the programs of austerity didn't help. So central banks were there to do the heavy lifting. It was very important for them to control the trajectory of economy because there was less reason to believe that there would be a major flaring inflation. I think now their concerns have shifted from managing the trajectory of economy and potentially guarding growth to managing an economy which is not heavily sensitive to inflation because again, there are many, many reasons to believe that the stability of inflation under 2% might not be given anymore.
(07:08):
Again, the changes in the supply chains, the offshoring, on-shoring, friendshoring, volatility in oil price, I think one of the biggest factors is fiscal policy around the world that has to create the background for all of this to

happen for the energy security, all the supply chain security and others. So in such an environment, at least up to the point that economies settle from that heavily globally integrated to the situation that all of the supply chains, supply chain security and energy as security is achieved. We don't know how many years it might take, but in this transitory period, the risk of inflation flaring up maybe not to eight or 9%, but increasing to hurt consumer is there. So that's why I think that central banks would stay very focused on inflation, especially Feds.

Ashley Lester (08:05):
As someone who's drawing over as sort of the great moderation of the 1990s, the idea that the Fed would cut by 50 at a time when unemployment starts with a four and there's no financial crisis, it is pretty startling. Not only is there no financial crisis, but you mentioned the real economy, it's almost just though I've read some papers lately saying there's been no landing at all. It's just sort of a gradual glide path. Yuliya, what about equity markets over the course of this period when fixed income markets really determined that it was important to cut rates quickly?

Yuliya Plyakha Ferenc (08:39):
Thank you very much, by the way, for having me here. It's a pleasure. Equity markets, to summarize, we're very bumpy this quarter, right? Particularly if you would look at the first performance of the whole year. Let me put it this way. The major markets during the last quarter were growing, but say US, a little bit less growing as expected or compared to other markets. If you would look at the developed markets during just one quarter where there were this building up of the uncertainty up to the rate cuts and then the resolution of the uncertainty when the rates were cut, then we have seen that developed markets experienced like two troughs during one quarter. One at 7%, another one is at 4%, which is quite substantial. And that of course all this is uncertainty triggered somehow natural benefits. For example, low volatility or those investors who would be holding portfolios that are built to experience low vol or to have lower volatility compared to the whole market.
(09:45):
And as such last quarter those mean vol strategies were performing well, indicating that that was a safe haven for those who were able to rotate on time, of course. What we also have seen, for example, that momentum strategies, so those strategies that actually are built on the stocks that have been performing quite well during the last year, these strategies also reverted and needless to say, the magnificent seven stocks just experienced negative performance rotation, which also was accompanied by actually huge volatility as well, right? And we looked a little bit into the historical performance of exactly these magnificent seven stocks and was interesting to see that the third quarter of last year and the year before and actually the whole half a year usually starting from the middle of the year tend to be less beneficial for those magnificent seven stocks. So these big caps that are actually influencing and moving all markets across the globe, they become a little bit less pronounced or less volatile and less running through the roof.

Ashley Lester (11:02):
So equity markets definitely saw something going on as well. They went on overall moving up, but there was kind of a rotation of leadership and momentum, which has been really strong if my memory serves me correctly, not just in the first half of this year, but also last year. And much of that driven by kind of the mag seven and that type of enthusiasm finally hit a bit of a hiccup over the last quarter.

Yuliya Plyakha Ferenc (11:24):
Correct. Right. So those big stocks basically are dictating what's going on on the market.

Ashley Lester (11:31):

Okay. Do you have any ideas why might that have happened? What was it that broke the trend and the obvious culprit feels like it must be some driver in the interest rate environment that we were just discussing with Afsaneh. Afsaneh, feel free to jump in as well.

Afsaneh Mastouri (11:48):
I'm happy to share what I think it's the dynamic and the mechanism that can potentially address some of this. Obviously it's very hard in an environment that we have technology called revolution. I dare to call what is happening with AI. I'm not the first one, but I dare to use other people's work that the technology called revolution, it's hard to kind of ignore that and just drive, assume that the interest rates or other traditional conventional economic factors are driving the market. But if I step out of it and ignore that the magnificent sevens are the drivers of basically introducing a new technology to the work, I can change a lot of practices that we have as human. If we ignore that, the two things that I think had happened in the first quarter and then into market evolving to the third quarter. One thing is that we started the year with all of the good news about OpenAI and other magnificent seven and technology called innovation.
(12:49):
So there was a rush to take position in these companies. Saying it in short words is that the positioning in this large cap, especially the technology sector, was a stretch when we are leaving the end of the first quarter. The second dynamic, which I think might be less explored is that most of these companies, their valuation is a long-term valuation, it's a future, future income that is driving their current valuation. In an environment that we have got uncertainty about the direction of the rate in the belly of the care, and in long-term direction of the longer term rates, it means that in terms of the discount factor that we are assigning to this cash flows, there is more uncertainty, hence the discount factor can be larger. So there is another underlying mechanism that if the valuation is justified in an environment that the rates, long-term rates can stay high or even go higher. And I think this is another dynamic that help the companies that they have more immediate revenue as a potential to revenue generation, cash flow generation to gain some momentum and attraction in the market.

Ashley Lester (13:58):
Very intriguing. We could keep talking for quite a bit longer, but we've got some even more dramatic market action that we need to consider. I think perhaps sticking with this theme of reversal over the course of the third quarter, but coming from a quite different place, perhaps some of the changes in global market dynamics at recent years where a few years ago we would've seen Chinese markets and certainly the rest of emerging markets, but possibly Chinese markets and the rest of the world all linked. Now instead, what we're seeing is very dramatic action in Chinese markets driven predominantly, I would argue by China onshore action. Perhaps we could start Cheng Lyu with a little bit of an overview just quickly of what was happening in Chinese markets before the big sudden increase in markets that we just saw.

Cheng Lyu (14:47):
Yeah, thanks for your question, Ashley. The China equity market has actually underperformed major global markets over the past three years or so. And the overall valuations of China markets were at a low level compared to its historical range and also lower than those of many other global markets and investors sentiments are quite low. Factors such as very defensive ones and high yield are preferred among domestic and international investors looking for high certainty stocks and high cash flow stocks. So that's what the market situation was before the stimulus measures was announced on September 24. But after the announcement, you can see that Chinese stock market saw a very sharp reaction with a very quick increase in market liquidity and investor sentiment. But after the long holiday, the market retreated, leading to increased the volatility for the overall market. Actually, if you look at the performance of MSCI China from September 24th to October 7, MSCI China surged by 32%.
(16:01):
But since October 8th, which is the first trading day after the long holiday for mainland China, it has dropped by 8%, resulting in the net gain of 22% since the stimulus announcement. And similarly MSCI China A experienced

a similar rise and subsequent decline of nearly 8% in the past three days. But despite the market volatility, the A-share market turnover has remained elevated and it actually hit record high of nearly 2.6 trillion RMB on September 30. And on the first trading day after the holiday, A-share market turnover saw a new high of 3.5 trillion RMB, which is 488 billion US Dollar. And the recent market rally and the high turnover showed that actually investors views about the sustainability of the market rebound have been very divided.

Ashley Lester (17:05):
Yeah, well, I mean most of the time investors would be pretty happy by being up 22% over the course of three weeks or so, but it's a bit scary if you're up by a third and then down by nearly 10% after that. Let's come back to that theme because that might be, I think, really important in assessing what we think about the credibility of policy and what investors should be thinking about going forward. But let's just start with the impact and the initial rally. Tell us just a little bit more, what was the stimulus that the Chinese government promised to deliver that sparked this rally in the first place?

Cheng Lyu (17:40):
Yeah. The latest measures are actually mostly macro and broad market focused to support the downside risk of property market and to boost the overall investor sentiment by boosting the stock market performance. And we've noticed that many leading sectors are actually the beneficiaries of the stimulus measures. For example, the consumer stable related sectors, property and financial service sectors in both onshore and offshore China market. And after the initial-

Ashley Lester (18:17):
-Were those the ones that were particularly suffering before? So were these bouncing back or was there something else?

Cheng Lyu (18:25):
Yeah, before the market rally, because of the very subdued investor sentiment, defensive sectors, for example, utilities and banks and energy and telecoms, they performed better than these sectors.

Ashley Lester (18:39):
I see. So the sectors within the market are very much kind of behaving according to their established patterns. When the market's going down, the defensive sectors are doing better, and when the market all of a sudden rallied the more aggressive sectors outperform. Is that pretty much the pattern?

Cheng Lyu (18:57):
Yeah, correct.

Ashley Lester (18:58):
So does the stimulus tell us anything? We know that the Chinese government is seeking to reorient much of the economy away, for instance, from real estate development and towards manufacturing and perhaps some other activities. Is the market telling us anything about what it thinks of the likelihood of success of those policies? Is there anything we can read into the sectoral moves that tell us something about where the Chinese government would like the economy to expand?

Cheng Lyu (19:27):
Some investors remain skeptical about the effectiveness of the stimulus citing long-term microeconomic challenges such as the China's aging population, the complex domestic microenvironment, and also ongoing geopolitical tensions. But some investors are optimistic as we have seen that local news report indicate new retail investors entering into the market. And also some investors have taken on additional leverage to take

advantage of the rally. You can see that margin financing in the A-share market has surged very quickly since the stimulus announcement.

Ashley Lester (20:08):
Wow. That's risk appetite for you. Leveraging into that market is pretty exciting.

Cheng Lyu (20:14):
Yeah. Well, this round of rally have been primarily driven by retail investors and domestic and international hedge funds. They are very quick.

Ashley Lester (20:24):
And that might be worth mentioning the role of domestic retail investors to our listeners because their role has historically been quite special in Chinese markets compared to other markets, right?

Cheng Lyu (20:34):
Yeah. The China onshore A-share market has been historically dominated by the retail investors and is still dominated by them today. The retail investors either through trading the stocks directly by themselves or through subscribing different funds products such as ETFs, mutual funds, and their investment behaviors play a key part in driving the China A-share performance. So historically, Chinese retail investors have been very momentum driven. For example, in previous episodes of bull markets, they tend to add leverage very quickly and they may try to overanalyze public news and also they show herding behaviors which could drive the stock price to deviate from their underlying fundamentals in a very short time. And they may also under diversify their investment and these behaviors may increase the market volatility in the short term.

Ashley Lester (21:37):
Indeed. From a theoretical perspective, I'm always reminded that whenever you see herding behaviors you can see kind of multiple equilibria. And so the question of how successful will the stimulus package be overall partly depends on what people think about the answer to that question. It sounds like if the retail investors really believe that the stimulus package is going to be successful, they will act accordingly and that will make the stimulus package more successful. And if they don't really believe it, then they will act accordingly and that will detract from the success of the stimulus package. So the government's success in getting things moving is going to hinge on its success in convincing its domestic population that it's really serious, right?

Cheng Lyu (22:17):
Well, I think the stock market investors reaction will be important for the sustainability of the rally. But another more important question to ask is whether the economy or the fundamental of listed companies can improve after the stimulus package. The listed companies will need to break out of the current deflationary cycle. But a sustained market rally could create a wealth effect which could boost the household consumption and build better business confidence, and this could in return support better market performance.

Ashley Lester (22:57):
Now, a fascinating feature of Chinese markets compared to markets elsewhere is the important role of state-owned enterprises in the public stock market. Over recent years, SOEs, I believe, have generally tended to outperform private enterprises after a long prior period when SOEs significantly underperformed. What's happened on that front?

Cheng Lyu (23:19):
Well, SOEs actually outperformed non-SOEs for a while because many SOEs companies are in traditional sectors that pay out dividends. And that's what investors in China like since maybe since middle of last year. And for this round of market rebound actually we have seen in addition to the segments that are directly

benefiting from the stimulus policies, other areas which are primarily high-growth and high-tech sectors are also benefiting from the spillover investor enthusiasm and liquidity. And in that part, maybe both SOEs and non-SOE stocks could benefit.

Ashley Lester (24:11):
Again, our conversation we could carry on for a lot longer. Alas, we need to be-

Afsaneh Mastouri (24:13):
-If it's okay, I wanted to kind of draw some parallel between what happened in the last month in China and what happened in 2012 in the Euro. I think that pattern may help us also to have a better understanding of potentially how the things can move forward, even though totally agree with you, we are not in the business of predicting market. In 2012, actually the initial when [inaudible 00:24:35] came with the idea of what a rate takes, basically offer a back stop to the market. So we had a period of volatility post that before its market tested, the willingness of the central bank to actually stay as a provider of the back stop for the market.
(24:51):
So I think one of the things that at least from the developed market people, we are looking into China and we are looking for evidences of that is not necessarily a hundred percent. Further, a stimulus and the larger stimulus, what the word investors outside they are looking for is that the signs that the central bank and also ministry of finance, that up to this point is the state quiet out of this story are developing and introducing mechanisms that can continue to offer back stop if the market melts down back. Or we have scenarios like 2015 that went top and came down and it was quite sluggish movement post that.

Ashley Lester (25:34):
What you remind me of is the extent to which investors are quite used to seeing these sorts of credibility mechanisms that work across a number of markets, obviously in European markets during the Euro crisis. But the other sort of often made comparison I guess, is between China where it's current kind of apparently structural slowdown in growth and its aging demographics, and with Japan, which of course went through this for a long time and which earlier this year finally saw a revival of its equity market, perhaps established at least partly as a result of more credible government commitment to create a more inflationary environment.

Afsaneh Mastouri (26:15):
Yeah, I agree. Agree with you. It's up to... We don't know all of the mechanisms, but I agree with you as well that to step in that path, the first step is that when a government that can offer or preserve or protect the downside, because Japan was a slow and sluggish spread, quite stable and played the role of the carry currency that was coming from a stability of a banking system which was heavily in the loan but managed to stay kind of in pace and control.

Ashley Lester (26:48):
Cheng Lyu, do you know how much the government... Do you have a sense of how much time the government's been thinking about the Japanese example and whether it sees any parallels between its situation at the moment and the Japanese situation of recent decades?

Cheng Lyu (27:02):
Yeah, I'm not sure how long the government has been thinking about that issue, but the capital markets, the investors have been discussing the implication of China economy sliding into something like Japan for quite a long time, maybe for years.

Ashley Lester (27:21):
Switching base a bit. I want to come now to thinking about a core concern of many investors, certainly particularly in western markets over recent years, ESG. And the real question over the last sort of four years or

so of ESG investment in some sense has been, what is this all about? So we saw a huge boom in ESG investing a few years ago. More recently we've seen a lot of political pushback. We've seen some slowing of investment flows, although I think that can easily be overstated. MSCI, of course, is very much right in the middle of this because we are the leading provider of ESG data, particularly aggregated up to ESG ratings of companies. So before we turn to the question of what's the investment materiality of ESG directly and what's the empirical evidence, I'd just ask like to start by asking what is an ESG rating by MSCI meant to tell us. Xinxin?

Xinxin Wang (28:20):
Yep, absolutely. Thank you for having me. So MSCI ESG rating is all about financial materiality. It is factors that impact the fundamentals bottom line of a company. So that's what essentially MSCI ESG rating is about in a very simple way of putting it.

Ashley Lester (28:39):
Right. So it's a straight out investment materiality function. Now that's really interesting, right? Because there have been hundreds, I would say, of academic papers written assuming that ESG is largely about people's preferences and tastes and suggesting that it's okay to have a taste for ESG so long as you're aware that that's likely to have a cost in terms of your investment performance. But our claim, if I understand what you're saying, is that of course people can have tastes, but that's not what the MSCI ESG rating is all about. That's about investment materiality.

Xinxin Wang (29:13):
Absolutely. Our study essentially has answered one big question, does ESG really matter? And we are talking about environmental, social and governance factors. How do they actually affect a company's financial performance? For a while, as you mentioned, ESG was seen as a nicer hat, check the box, something companies do to look good, and lately it's been getting a lot of pushback, especially in the US. So what we are asking now is really, is ESG more than just a buzzword? Is there a real proof that it can actually impact financial results?

Ashley Lester (29:46):
Right. The key word here for non-ESG listeners is materiality, meaning is ESG providing us with material information about upsides and downsides of making an investment. So tell us about the design of your study. What were you studying with respect to ESG ratings, which was trying to give an answer to this question?

Xinxin Wang (30:04):
So our study using a methodology to compare companies with highest ESG rating versus companies that have the lowest ESG rating companies. And we look at the differences in terms of company fundamentals such as in profitability, earning variability, systematic risk. We also look at their market performance as well. We look at the relative market performance over a decade of time, so it's a very long period of time that we studied.

Ashley Lester (30:33):
I guess in the end, that's probably what investors care most about. Probably those other things I guess are contributing to that performance. But why do we need this study? Because there are lots of ESG funds out there and there are also of non-ESG funds. Can we just compare the ESG funds with the non-ESG funds?

Xinxin Wang (30:49):
Well, first of all, the ESG funds, non-ESG funds, they are defined very loosely and people may have very different definition and methodology when they construct these ESG funds. And also when they construct these ESG funds, the criteria matrix data that they use may not always be aligned with how MSCI look at the issue. So contrasting ESG funds versus non-ESG funds, if I may, not a strictly comparable way or scientific way of really proving whether ESG matter or not.

Ashley Lester (31:23):
I guess one example of why it's not really a clean experiment is that when I was running equity funds, for instance, and including ESG funds, most ESG investors wanted to make sure they excluded certain categories of investments like tobacco or if they had a climate concern, they might've wanted to make sure they didn't invest in major oil companies. But MSCI ESG ratings don't have anything to say about that per se, right? And so there's no necessary connection between oil price spikes and the performance of high rated MSCI ESG companies versus low. So by just narrowing in your study to the good versus the bad ESG companies or high rated versus low rated ESG companies, we're getting a cleaner test. Okay, so drum roll please. What were the results?

Xinxin Wang (32:13):
Yes. What we found is actually pretty compelling. It turns out ESG is not just about warm fuzzies, it's about cold hard cash. Companies with higher ESG ratings connect to lower cost of capital, have higher profitability, lower incidence rate, lower earnings variability, and tend to outperform their lowest rated peers in equity markets.

Ashley Lester (32:34):
Can we say what's driving that? Because ESG, everyone knows it's a slightly strange collection of environment, social and governance. Can we go further and ask which of those seem to be contributing the most and get any insights like what's actually producing this result?

Xinxin Wang (32:52):
Absolutely. For example, what we found is that companies with higher ESG rating tend to outperform their lower rated peers in the stock market. And now let's make sure that correlation does not equal causality, but this pattern has been remarkably consistent over the long term across both develop and emerging markets. And this out-performance isn't just a matter of hype or market sentiment. When we dug deeper into the fundamentals, what we found is that the companies with strong ESG profiles, they were generating stronger earnings and dividends, which ultimately drives the long-term value of investors rather than price appreciation or crowding.

(33:32):
And also, here's where it gets really interesting, we also uncovered a powerful link between ESG rating and the company's cost of capital. So not only company with high ESG rating consistently benefit from lower cost of capital or lower financing costs, both for equity and debt, but also we found that a company's ESG rating can be a leading indicator for a lower cost of capital, which means changes in MSCI ESG ratings, particularly substantial change of two or more notches can signal future shifts in a company's cost of capital.

(34:08):
And this suggests that market is recognizing ESG rating as a credible signal for a company's overall risk profile and is also adjusting its expectations for future financing costs accordingly. And think of it like this. Imagine you are a lender deciding where or which to give a loan to two companies. One has a greater track record on environmental sustainability and social responsibility while the other has been embroiled in controversy and lawsuits. And which company would you feel more confident to lend money to? So essentially, investor and lenders are making the same calculation. They see companies with strong ESG performance as less risky and they're willing to offer them more favorable financing terms, and this lower cost of capital can be a huge advantage, allowing companies to invest more in growth, innovative products and even weather economic storms more effectively.

Ashley Lester (35:08):
So let me just make sure that I've got the message. So higher rated ESG companies typically generate greater shareholder returns over time or have done through the past is sort of switching hat from the investor to the company. The company cares directly how much does it cost them to access capital markets? Is it costly for them to issue a new debt, for instance? And what you are saying is that companies that improve their performance on ESG rating typically, subsequently, for instance, issue debt cheaper than they did before, or

maybe their equity gets cheaper. So that's pretty huge. Now you've offered one interpretation of it, which is that the capital markets see the rating change and react accordingly.
(35:54):
Of course, I'm not sure that you can necessarily distinguish between that and an alternative theory that it's just that the company is doing something right, which is captured by the ESG rating change earlier than it's captured in the other mechanisms in the market. I guess it's hard to tell the difference between those two theories. Now, when I was an equity investor, the common understanding of the world was that to the extent that ES and G were investment material or relevant, that was basically all about governance. And that just stands to reason, right? Because a better governed company will do better for shareholders in the long run than a worst governed company. So I think that's pretty straightforward. Is there any evidence that any of this E and S stuff adds value?

Xinxin Wang (36:44):
So absolutely. Our research definitely support the link between good governance and strong financial performance in the global market as well as especially in the developed market. In emerging market, the relationship may be a little bit less straightforward as governance structure evolve and also investor priorities can vary, and that's what we found. The country factor, for example, in emerging markets, seems to dominate a lot more than the developed market.

Ashley Lester (37:12):
What about S? Is S useful or is G doing all the work in ES and G?

Xinxin Wang (37:18):
S is the middle child and tend to be overlooked traditionally, but surprisingly what we found is that actually provide the highest relative return between the highest rated companies versus the lowest rated companies with the long history that we studied.

Ashley Lester (37:34):
Wow. So there must be more to S than what people think there is. What are the factors that determine whether a company does well on S or not?

Xinxin Wang (37:43):
Absolutely. So MSCI look at social, as a matter of fact, maybe you should call it something else because social tend to be thought of as something woke, in the US at least, but it can not be any further from the truth. In MSCI, under the social pillar, what we are talking about is human capital, product liability, stakeholder opposition, and social opportunities. For example, under human capital we are talking about labor management, how well you manage your labor force, health and safety, human capital development, are you developing your talent. Things like that. Or on the product liability, we are talking about safety and quality, consumer financial protection, privacy and data security.

Ashley Lester (38:26):
I see. So it's a bit, is your product likely to kill the consumer? Are you likely to train your workforce so that it's more productive? These seem like fairly basic sort of questions. I've thought in the past sometimes that maybe we should have called it EFG, where F is for fundamental. This just seems like fundamental stuff about a company, right?

Xinxin Wang (38:45):
Absolutely. These are common sense, business common sense.

Ashley Lester (38:49):

Terrific. Well, look, as always on these discussions, I would love to keep going, but I fear that our time is up for another quarter. By the next time we meet in January, the US will have voted towards the end of this year of elections. So we will know who the next US president will be. We'll have some more Fed rate decisions, and who knows what will happen in the world of AI. Whatever awaits, you can be sure that you'll hear some fresh angles on it when we rejoin you in January.

Adam Bass (39:20):
That's all for this week. Our thanks to Ashley, Afsaneh, Yuliya, Cheng Lyu and Xinxin, and of course to all of you for listening. For more on MSCI's quarterly look at the markets, you can explore our in-focus publications. They're all available on the research and insight section of MSCI.com. Until next time, I'm your host Adam Bass, and this is MSCI Perspectives.

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