

Sustainability Podcast

“Sustainability and Fundamentals: 12 Years On”

Transcript, 18 July, 2025

Bentley Kaplan

Hello, and welcome to the weekly edition of Sustainability Now, the show that explores how the environment, how society, and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

And on today's show we are going to explore the links between sustainability and company fundamentals. For several years we have seen numerous studies highlighting how MSCI ESG Ratings correlate with performance metrics at the level of a portfolio or equity market. But today, we are going to get into the guts of individual company financials. And there's a little bit here for everyone from sustainability analysts to investors and even to corporates, planning their capital allocation strategies. Thanks for sticking around. Let's do this.

So, do companies that manage their sustainability risks see positive financial outcomes? And do investors that incorporate sustainability considerations into their portfolios see better risk-adjusted returns or greater resilience over time? These are key questions – mental Post-it notes that many of my colleagues keep returning to. Answering these questions definitively in the early days of sustainability or responsible investing wasn't easy. Company coverage was modest, time series brief, and the data not always well-structured, but as time passed, running analyses across thousands of companies over multiple years became much more feasible.

And one reason for that is the MSCI ESG Rating. Now, you'll hear the line that our ESG Rating is a measure of how well a company is managing its financially relevant sustainability risks. But what we're looking at here, in practical terms, is how efficiently companies use resources (be that human resources or natural resources), how effectively they manage operational risks, like making sure their production facilities are efficient, safe and regularly monitored, as well as making sure they have reasonable oversight of their supply chains, the quality of their products or cybersecurity protections, and crucially that their governance process are structured to make sure that the company can effectively oversee its employees/operations and that the board is set up to represent the best interests of shareholders.

And in addition to offering this unique insight into companies, our ESG Rating has a couple of other things going for it – including broad company coverage and historical data. So it really

offers an opportunity to understand how sustainability data correlates, or doesn't, with financial performance. And in 2017, in a series of papers titled The Foundations of ESG Investing, MSCI researchers hypothesized several ways that investing in companies with higher ESG Ratings, might translate into better outcomes for portfolios.

It's a great paper, truly. Worth reading in full, and you should do so, right after my voice fades into the outro music. But the research left us with some key takeaways. One of them is that my colleagues found that top-rated companies were less sensitive to systematic risks – those that affect a whole market. And these top-rated companies also had less idiosyncratic risk, or share price volatility that wasn't explained by the broader market. So ESG Ratings were offering clear signals in terms of financial outcomes. But another key takeaway is that these results were relevant for an overall equity market portfolio, but they didn't explore the connection in terms of how individual companies might be measuring their performance.

The authors called for more work with longer time series, and testing out links between ESG Ratings and individual company fundamentals. And all of that is also a long way of introducing my guest for this episode, Yu Ishihara, out of MSCI's Singapore office, somebody who very much heard that call. Yu has just published research in the paper titled Insights on ESG Ratings and Business Performance: Exploring the Links Between Sustainability and Corporate Fundamentals. It's work that builds on the original 2017 research, but importantly, work that explores a pretty new avenue.

Yu Ishihara

Yeah. So, like you rightly pointed out, MSCI, we have a long history of analyzing and exploring the benefits of integrating ESG information, such as our MSCI ESG Ratings, into and the relationships with long-term equity market performance. But really to kind of get to the heart of why all of this is possible, we have to remember MSCI ESG Ratings, they're not a stock market indicator. They're a company-specific assessment on financially material sustainability risks and opportunities. So, it only makes sense that the ratings can tell us something about the company itself and the fundamental business operations of that company, which then ultimately will transmit to different aspects of market performance, whether it's against stock price or cost of capital or whatever.

And so, that's really what we wanted to focus on in this study. What kind of characteristics about the actual company does an ESG rating capture or potentially signal in a sort of forward-looking manner? By understanding those potential links to fundamentals, it can only better serve to help the market or investors get a better understanding of the benefits afforded to an investment specific to a company's operations that are reflected in higher ESG Ratings. And also for the company itself, the corporate decision-makers who can better leverage this kind of knowledge to make, whether it's more informed capital allocation ,or strategic decision-making when it comes to investing in sustainability initiatives and programs.

So, that's really what we were trying to get at. We understand that ESG Ratings has led to certain aspects of market performance, but really it's about understanding, well, what about the companies is it capturing that's maybe leading to that performance?

Bentley Kaplan

Right. So, as Yu says, the ESG Rating is actually a pretty intuitive tool to assess individual companies. And he set out to test how this company-level assessment might correlate with specific measures of financial performance.

Now, to run his research, Yu looked at companies in MSCI's ACWI IMI, a global index of large, mid, and small-cap companies that at a given point in time contains a little over 8,000 companies. And for these companies, he looked at their Industry-adjusted Score, which is effectively a 0 to 10 score that directly translates into an ESG Letter Rating. The study period was 12 years, running from December, 2012, to December, 2024. And Yu essentially looked at changes in financial indicators year over year, through this period, and he controlled for size sector and region.

What he wanted to see was whether top-rated companies grouped into equally-weighted quintiles showed differences in financial indicators to bottom-rated companies. And he looked at factors like earnings quality, growth, investment quality, leverage, profitability, and variability. In addition to looking at the overall ESG scores, Yu also looked at whether these differences were reflected across the component environmental, social, and governance scores.

What he found was that company fundamentals in general, but not in every case, showed expected differences between the highest and lowest-rated companies. And that would be things like higher earnings quality, higher investment quality, and lower variability. And that companies with the highest environmental, social, and governance scores respectively, compared to those with the lower scores, also show differences across these metrics, but not always to the same extent and not consistently across all metrics.

So, there is something here. ESG Ratings aren't just aligning with top-level portfolio or equity market metrics. They're also telling a story about corporate fundamentals. And rather than trawling through all of Yu's results, it's maybe worth digging deeper into two aspects, where not only were results clear but also statistically significant. The first set of results were in the way that a company's overall ESG rating correlated with variability in cash flows and sales.

Yu Ishihara

Yeah. At the risk of sounding a bit dry here, what we actually found is that higher MSCI ESG Ratings led to lower variability in sales and cash flows on a relative basis, meaning higher ESG-rated companies experienced lower variability compared to their lower ESG-rated peers.

What's probably more interesting is actually thinking about what that means, lower variability in sales, which sounds quite technical, but if you just put it another way, it's just talking about sales stability. So, higher ESG-rated companies tend to have more stable operations. That should sound pretty intuitive. Higher ESG Ratings means better sustainability risk management practices and programs. So, that could then mean things like they're less susceptible to shocks, like supply chain shocks, because they have better oversight, less susceptible to workforce strife, like strikes, because they have better labor management programs, or they're heavily investing in transition technologies to address climate change either in their operations or their end markets.

That's the big picture takeaway. But then we actually dug into more specifics and we noticed that the same pattern held true for most sectors to varying degrees. I'd like to talk about two sectors in particular. One was the energy sector and this was actually the sector where this sort of difference manifested itself the most. So, the highest-rated ESG companies in the energy sector tended to have the lowest variability relative to lower-rated peers, and they had the biggest spread there. It's probably not known to be the most stable sector in the world, and so, I do think the fact that ESG Ratings indicate a certain aspect of business stability within that sort of context of being in a volatile industry, speak to something quite powerful about what these ratings might be potentially telling you about how a company manages itself.

And I guess it's only fair to talk about the other side of the coin, which is the utility sector. And this is actually the one sector where we found this relationship didn't really hold. And so, if you start thinking about the utility sector and what kind of business models are in there, think electricity providers, water utilities, most of these companies, they tend to operate in fixed fee or tariff-based operations. So, think relatively stable demand, fixed pricing. And what this in turn should tell you is the concept of revenue, certainly variability or volatility, I don't want to say it's not relevant, but it's probably not as important as say, earning an adequate rate of return on your assets.

Bentley Kaplan

Right. So, Yu found that the group of top-rated ESG companies had significantly lower variability in cash flows and sales compared with bottom-rated companies. Noteworthy for both investors but also companies themselves.

So next, I asked him to give me a little more context on the second set of significant results that he found. Specifically that companies with the highest governance scores had significantly

higher asset turnover and gross profitability than companies with the lowest governance scores.

And a quick footnote here, when Yu talks about profitability, we're thinking about two concepts that are potentially contributing. The first is profit per unit of sale, or profit margin. And the second is how efficiently you're generating sales from your assets, or asset turnover. Here's Yu to pick that apart a little further.

Yu Ishihara

So, this one's, I actually think, particularly interesting to talk about. We found evidence that higher governance scores tended to be associated with higher future profitability. And so, the first thing I think we need to understand is think about what exactly do better governance scores represent? And MSCI ESG Ratings and ultimately our governance scores, we take into account a lot of different factors to determine good governance, but what it ultimately should be telling you is that the company has better oversight of strategic and management decisions. And these could include things obviously around capital allocation, pursuing opportunities, working capital management, or even things like general balance sheet efficiency.

And what I think is particularly important about all those factors I just mentioned is that obviously these all contribute to higher asset turnover, which is what the evidence shows, but they tend to be a lot more about internal decision-making. Whereas, if you think about profit margins, yes, management and oversight certainly plays a part in managing cost structures, setting pricing strategies, but a lot of profit margin is also determined externally, what industry you operate in, what kind of competition you face. And so, again, it kind of makes sense then that higher profitability, associated with higher governance scores, might be coming from some of the factors that there's much more internal control over, i.e., operational efficiency, balance sheet efficiency. And again, we looked across sectors and we found that this trend once again held for most sectors across time.

So, I think if you put that all together, it can help us contextualize what higher governance scores are telling us about companies tendencies for higher profitability, which is signaling that yes, they do make more money per unit of sale, so higher margins, but really it's about optimizing your assets for a better operational efficiency.

Bentley Kaplan

Right. So, there is an intriguing link between better governance and higher asset turnover. Again, like the link between an overall ESG score and variability in sales and cash flow, this gives investors a thread to pull on and makes a potential conversation starter for the C-suite.

And Yu's research makes it feel, to me, a little like we're standing on a stepping stone. Part of a network being built from sustainability data and ESG ratings on one side towards financial outcomes on the other. Working from the research originally put out in the Foundations of ESG Investing, Yu has joined some dots. He's looked below portfolio-level metrics and into company fundamentals.

But as Yu would go on to reflect, this might be a stepping stone, but it's not the finish line. Expecting a single ESG score or sustainability assessment to align perfectly and significantly with multiple financial outcomes isn't realistic. And sure, there is a lot to take note of here, but there is also much more to explore.

Yu Ishihara

We also looked across a wide variety of other fundamental ratios and different aspects of fundamentals, and because we didn't find the evidence that necessarily supported that there was a strong relationship between those and fundamentals, one could question maybe the significance of ESG Ratings in terms of how they transmit to a company's operations, but I actually think it's okay. I think it's actually probably correct that there may not be a signal with every single aspect of fundamentals embedded within an ESG Rating, because if we think about it, sustainability risks or opportunities, they can happen in different shapes and flavors across all different types of companies.

Some risks might be pretty obvious, like large financial shocks that show up on financial statements, think of things like corporate scandals, an oil spill. And some of them might be smaller and they might manifest over longer periods of time, and these things we would classify as erosion risks. And so, these risks might be too small to be noticed in financial statements or even the companies themselves may not recognize them as a recurring risk or being driven by something like climate change. Or even in some extreme instances, maybe the risk just hasn't happened yet or the way that this risk is going to manifest itself on an industry-by-industry or a company-by-company basis could potentially be different.

And so to that end, I think kind of refocusing on the fact that ESG Ratings aren't a market signal, they're company assessments. And so, that's why I think, again, the takeaways here where we find that companies that have higher MSCI ESG Ratings and higher governance scores, they tended to be more operationally stable businesses that generate higher profits due to higher efficiency.

Bentley Kaplan

And that is it for the week. A massive thanks to Yu for his take on the news with a sustainability twist. And as always, I do want to say thank you very much for tuning in. If you like what we're doing and what we're about, then let us know. Drop us a review, rate the show on your platform of choice, and tell a friend or a colleague about this episode. Thanks again, and until next time, take care of yourself and those around you.

The MSCI ESG Research podcast is provided by MSCI ESG Research, LLC, a registered investment advisor under the Investment Advisors Act of 1940, and a subsidiary of MSCI Inc. Except with respect to any applicable products or services from MSCI ESG Research, neither MSCI nor any of its products or services, recommends, endorses, approves, or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments, or trading strategies.

And MSCI's products or services are not intended to constitute investment advice or recommendation to make or refrain from making any kind of investment decision, and may not be relied on as such. The analysis discussed should not be taken as an indication or guarantee of any future performance, forecast, or prediction. The information contained in this recording is not for reproduction in whole or in part without prior written permission from MSCI ESG Research.

Issuers mentioned or included in any MSCI ESG Research materials may include clients of MSCI or suppliers to MSCI and may also purchase research or other products or services from MSCI ESG Research. MSCI ESG Research materials, including materials utilized in any MSCI ESG indexes or other products, have not been submitted to nor received approval from the United States Securities and Exchange Commission or any other regulatory body. The information provided here is as is and the user of the information assumes the entire risk of any use it may make or permit to be made of the information. Thank you.

About MSCI

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain

insight into and improve transparency across the investment process. To learn more, please visit www.msci.com.

This document and all of the information contained in it, including without limitation all text, data, graphs, charts (collectively, the "Information") is the property of MSCI Inc. or its subsidiaries (collectively, "MSCI"), or MSCI's licensors, direct or indirect suppliers or any third party involved in making or compiling any Information (collectively, with MSCI, the "Information Providers") and is provided for informational purposes only. The Information may not be modified, reverse-engineered, reproduced or disseminated in whole or in part without prior written permission from MSCI. All rights in the Information are reserved by MSCI and/or its Information Providers.

The Information may not be used to create derivative works or to verify or correct other data or information. For example (but without limitation), the Information may not be used to create indexes, databases, risk models, analytics, software, or in connection with the issuing, offering, sponsoring, managing or marketing of any securities, portfolios, financial products or other investment vehicles utilizing or based on, linked to, tracking or otherwise derived from the Information or any other MSCI data, information, products or services.

The user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF THE INFORMATION PROVIDERS MAKES ANY EXPRESS OR IMPLIED WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE INFORMATION (OR THE RESULTS TO BE OBTAINED BY THE USE THEREOF), AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, EACH INFORMATION PROVIDER EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES (INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF ORIGINALITY, ACCURACY, TIMELINESS, NON-INFRINGEMENT, COMPLETENESS, MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE) WITH RESPECT TO ANY OF THE INFORMATION.

Without limiting any of the foregoing and to the maximum extent permitted by applicable law, in no event shall any Information Provider have any liability regarding any of the Information for any direct, indirect, special, punitive, consequential (including lost profits) or any other damages even if notified of the possibility of such damages. The foregoing shall not exclude or limit any liability that may not by applicable law be excluded or limited, including without limitation (as applicable), any liability for death or personal injury to the extent that such injury results from the negligence or willful default of itself, its servants, agents or sub-contractors.

Information containing any historical information, data or analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. Past performance does not guarantee future results.

The Information should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. All Information is impersonal and not tailored to the needs of any person, entity or group of persons.

None of the Information constitutes an offer to sell (or a solicitation of an offer to buy), any security, financial product or other investment vehicle or any trading strategy.

It is not possible to invest directly in an index. Exposure to an asset class or trading strategy or other category represented by an index is only available through third party investable instruments (if any) based on that index. MSCI does not issue, sponsor, endorse, market, offer, review or otherwise express any opinion regarding any fund, ETF, derivative or other security, investment, financial product or trading strategy that is based on, linked to or seeks to provide an investment return related to the performance of any MSCI index (collectively, "Index Linked Investments"). MSCI makes no assurance that any Index Linked Investments will accurately track index performance or provide positive investment returns. MSCI Inc. is not an investment adviser or fiduciary and MSCI makes no representation regarding the advisability of investing in any Index Linked Investments.

Index returns do not represent the results of actual trading of investible assets/securities. MSCI maintains and calculates indexes, but does not manage actual assets. The calculation of indexes and index returns may deviate from the stated methodology. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the index or Index Linked Investments. The imposition of these fees and charges would cause the performance of an Index Linked Investment to be different than the MSCI index performance.

The Information may contain back tested data. Back-tested performance is not actual performance, but is hypothetical. There are frequently material differences between back tested performance results and actual results subsequently achieved by any investment strategy.

Constituents of MSCI equity indexes are listed companies, which are included in or excluded from the indexes according to the application of the relevant index methodologies. Accordingly, constituents in MSCI equity indexes may include MSCI Inc., clients of MSCI or suppliers to MSCI. Inclusion of a security within an MSCI index is not a recommendation by MSCI to buy, sell, or hold such security, nor is it considered to be investment advice.

Data and information produced by various affiliates of MSCI Inc., including MSCI ESG Research LLC and Barra LLC, may be used in calculating certain MSCI indexes. More information can be found in the relevant index methodologies on www.msci.com.

MSCI receives compensation in connection with licensing its indexes to third parties. MSCI Inc.'s revenue includes fees based on assets in Index Linked Investments. Information can be found in MSCI Inc.'s company filings on the Investor Relations section of msci.com.

MSCI ESG Research LLC is a Registered Investment Adviser under the Investment Advisers Act of 1940 and a subsidiary of MSCI Inc. Neither MSCI nor any of its products or services recommends, endorses, approves or otherwise expresses any opinion regarding any issuer, securities, financial products or instruments or trading strategies and MSCI's products or services are not a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such, provided that applicable products or services from MSCI ESG Research may constitute investment advice. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. MSCI ESG and climate ratings, research and data are produced by MSCI ESG Research LLC, a subsidiary of MSCI Inc. MSCI ESG Indexes, Analytics and Real Estate are products of MSCI Inc. that utilize information from MSCI ESG Research LLC. MSCI Indexes are administered by MSCI Limited (UK).

Please note that the issuers mentioned in MSCI ESG Research materials sometimes have commercial relationships with MSCI ESG Research and/or MSCI Inc. (collectively, "MSCI") and that these relationships create potential conflicts of interest. In some cases, the issuers or their affiliates purchase research or other products or services from one or more MSCI affiliates. In other cases, MSCI ESG Research rates financial products such as mutual funds or ETFs that are managed by MSCI's clients or their affiliates, or are based on MSCI Inc. Indexes. In addition, constituents in MSCI Inc. equity indexes include companies that subscribe to MSCI products or services. In some cases, MSCI clients pay fees based in whole or part on the assets they manage. MSCI ESG Research has taken a number of steps to mitigate potential conflicts of interest and safeguard the integrity and independence of its research and ratings. More information about these conflict mitigation measures is available in our Form ADV, available at <https://adviserinfo.sec.gov/firm/summary/169222>.

Any use of or access to products, services or information of MSCI requires a license from MSCI. MSCI, Barra, RiskMetrics, IPD and other MSCI brands and product names are the trademarks, service marks, or registered trademarks of MSCI or its subsidiaries in the United States and other jurisdictions. The Global Industry Classification Standard (GICS) was developed by and is the exclusive property of MSCI and S&P Global Market Intelligence. "Global Industry Classification Standard (GICS)" is a service mark of MSCI and S&P Global Market Intelligence.

MIFID2/MIFIR notice: MSCI ESG Research LLC does not distribute or act as an intermediary for financial instruments or structured deposits, nor does it deal on its own account, provide execution services for others or manage client accounts. No MSCI ESG Research product or service supports, promotes or is intended to support or promote any such activity. MSCI ESG Research is an independent provider of ESG data.

Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.