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ACSI

FINANCIAL MATERIALITY AND ESG

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Institutional investors have a responsibility to act in the best interests of their members. This includes acting to enhance the long-term value of the savings entrusted to them to manage. Investors can help protect and enhance investments over the long term through the consideration of ESG risks in their investment decision-making processes.[1] This report provides a summary of the research and analysis undertaken over many years on the financial benefits of managing ESG risks and opportunities.

SUMMARY

In summary, there is a significant global evidence to support the incorporation of ESG issues into investment practice. There are many studies that demonstrate financial relevance of ESG issues, both collectively, and in respect of environment, social or governance issues separately.

Furthermore, meta studies (that consider the results of multiple individual studies to reach overall conclusions) demonstrate the overall positive financial impact of ESG-focused investing. While there are some studies that do not support the same conclusions, they are in the minority. In all cases, it is important to remember that not all ESG issues are material to every company – skilled ESG investors will identify those that are. Finally, there is evidence that investor engagement with companies on ESG issues – a core component of ESG investing – is financially beneficial. Accordingly, the evidence overwhelmingly supports the financial basis for the incorporation of ESG issues into investment practice.

THE INCORPORATION OF ESG ISSUES INTO INVESTMENT PRACTICE IS WIDELY ACCEPTED GLOBALLY

The PRI, the largest global association of investors integrating ESG issues into investment and ownership practices, now has over 3000 signatories with well over $100 trillion in combined assets under management. According to a 2018 survey by FTSE Russell, more than half of global asset owners are currently implementing or evaluating ESG considerations in their investment strategy.

In 2018, a CFA Institute study of large global fund managers found that by far the most widespread reason for using ESG information in investment decisions is that it is material to investment performance, (flagged by 63% of respondents).

CONSIDERING MATERIAL ESG ISSUES MAKES FINANCIAL SENSE

There is a significant body of evidence demonstrating that considering ESG issues in investment decision-making makes financial sense. Not all ESG issues are financially material to every business, and ESG-focused investors are careful to assess which ESG issues are relevant to each context. For example, while there is a level of systemic risk, climate change transition risk is more relevant to fossil fuel companies than to IT companies; green building standards are more relevant to real estate companies than to consumer goods companies. A 2019 Harvard Business Review study notes that modern ESG-focused investors 'focus only on "material" ESG issues that impact a firm's valuation'.[2]

[1] The CFA Institute and the Principles for Responsible Investment (PRI) provide a useful manual on ESG integration supporting this point, as does McKinsey's Five ways that ESG creates value.

[2] Eccles and Klimenko, 'The Investor Revolution' *Harvard Business Review* (2019).

STUDIES DEMONSTRATE FINANCIAL RELEVANCE OF ESG ISSUES

There is a significant body of existing research that demonstrates the financial relevance of ESG issues in different contexts. As outlined in the paragraph on meta studies below, collectively, research on ESG integration finds a neutral or positive relationship between ESG criteria and company performance. Here we include a selection of individual studies demonstrating the value of ESG-focused investing – thousands are available.

Overall ESG performance

- A 2015 Harvard study showed that when firms improve their performance on material sustainability issues, they subsequently outperform competitors with declining performance on material sustainability issues.[3]
- A 2017 study by Nordea Equity Research reported that from 2012 to 2015, the companies with the highest MSCI ESG ratings outperformed the lowest-rated firms by as much as 40%.[4]
- In 2019, Bank of America Merrill Lynch found that top ESG-ranked companies - outperformed equal weighted S&P500 companies.[5]
- A 2014 study by Harvard Business School found that 180 US companies that developed organizational processes to measure, manage, and communicate performance on ESG issues in the early 1990s outperformed a carefully matched control group over the next 18 years.[6]

Environmental

- A 2019 climate-related study from the University of Maastricht analysed measures of heat exposure for 4,400 firms in 57 countries from 1995 to 2017. The study found that increasing exposure to extremely high temperatures reduces revenues and operating income.[7]
- A 2011 study showed that companies with a high eco-efficiency rating have a higher return on assets compared to companies with a lower rating.[8]

Social

- A 2017 study from the European Corporate Governance Institute used lists of 'best companies to work for' in 14 countries to study the relationship between employee satisfaction and firm performance around the world. The results show that employee satisfaction is associated with superior long-run returns, current valuation ratios and future profitability in some markets, such as the US and UK.[9]

[3] Khan, Serafeim and Yoon, 'Corporate Sustainability: First Evidence on Materiality', Harvard Business School Working Paper 15-073 (2015).
[4] Nordea Equity Research, 'Cracking the ESG code', *Nordic Ideas* (2017).
[5] Bank of America Merrill Lynch, *ESG from A to Z: a global primer* (2019).
[6] Eccles, Ioannou and Serafeim, 'The Impact of Corporate Sustainability on Organizational Processes and Performance', 60(11) *Management Science* (2014).
[7] Pankratz, Bauer and Jeroen, 'Climate Change, Firm Performance, and Investor Surprises', SSRN (2019).
[8] Guenster, Bauer, Derwall and Koedijk, 'The Economic Value of Corporate Eco-Efficiency', *European Financial Management* (2011).
[9] Edmans, Li, and Zhang, 'Employee Satisfaction, Labor Market Flexibility, and Stock Returns Around the World' European Corporate Governance Institute - Finance Working paper No. 433/2014 (2017).

Governance

- The long-running Credit Suisse research on global corporate gender diversity found that companies with one or more female board directors outperform those with none on a sector-adjusted basis. Credit Suisse found an even stronger correlation between performance and higher proportions of women in management.[10] In the Australian context, 2020 research by Ownership Matters found that boards with more than 90 per cent male directors have underperformed boards with at least one woman since 2011.[11]
- A 2019 study found that a firm's governance rating 'reliably forecasts measures of firm operating performance.'[12] There are many studies on this point, for example a 2010 study found a significant positive relationship between corporate governance ratings and performance.[13]

ESG META STUDIES PROVIDE HIGH-LEVEL EVIDENCE ABOUT ESG-FOCUSED INVESTING

Meta studies demonstrate the overall financial impact of ESG-focused investing. ESG meta studies look at the results of multiple individual studies to reach overall conclusions about the financial impact of ESG issues in a wide range of contexts. For example, a 2014 Oxford University meta study[14] analysed results of 190+ underlying studies, and found that:

- "90% of the studies on the cost of capital show that sound sustainability standards lower the cost of capital of companies."
- "88% of the research shows that solid ESG practices result in better operational performance of firms."
- "80% of the studies show that stock price performance of companies is positively influenced by good sustainability practices."

A comprehensive 2015 meta study[15] analysed more than 2000 empirical studies on the relationship between ESG criteria and corporate financial performance and found that:

- 90% of these studies found a neutral or positive relationship between ESG criteria and company performance (the majority found a positive relationship).
- Across the 644 studies that focused solely on E, S and G criteria, the majority found positive relationships with company performance for each area (59%, 55% and 62% respectively). Very few studies found a negative relationship between E, S and G criteria and company financial performance (4%, 5% and 9% respectively).[16]

[10] Credit Suisse, *The CS Gender 3000 in 2019: The changing face of companies* (2019).
[11] Ownership Matters, *Many are called, few are chosen: An analysis of the composition of ASX 300 boards from 2005-2020* (2020).
[12] Plazzi, Torous and Yilmaz, 'Does Corporate Governance Matter? Evidence from the AGR Governance Rating', Swiss Finance Institute Research Paper No. 16-54 (2019).
[13] Renders, Gaeremynck, and Sercu, 'Corporate-Governance Ratings and Company Performance: A Cross-European Study', 18(2), *Corporate Governance: and International Review* (2010).
[14] Clark, Feiner and Viehs, *From the Stockholder to the Stakeholder*, University of Oxford, Arabesque Partners (2014).
[15] Friede, Busch and Bassen, 'ESG and financial performance: aggregated evidence from more than 2000 empirical studies', 5(4) *Journal of Sustainable Finance & Investment* (2015).
[16] Friede et al, above, p 223.

ALSO, THERE IS EVIDENCE THAT INVESTOR ENGAGEMENT WITH COMPANIES PAYS OFF

There is also strong evidence that engagement pays off. A 2015 Cambridge University study[17] analysed the outcomes of investor engagements with US public companies from 1999-2009 and found that:

- Successful engagements generated 'cumulative size-adjusted abnormal return' of 7.1% in the year following the engagement.
- There was no market reaction to unsuccessful engagements.

Similarly, a 2013 study[18] found that company engagement by US pension fund CalPERS had a significantly positive financial impact on companies, with targeted companies on average producing excess returns of 12.3% above the Russell 1000 Index.

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[17] Dimson, Karakas and Li, 'Active Ownership, *Review of Financial Studies* (2015). See also Kirsten Temple, 'Can engagement add alpha?', *Investment Magazine* (2015).
[18] Junkin, *Update to the "CalPERS Effect" on Targeted Company Share Prices,* Wilshire Associates, 2013.

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