Is sustainable investing a positive or negative contributor to outperformance? And how patient do investors need to be to capitalize on any positive effects? Our research results answer these questions, and our conclusions on the required time horizon may come as a surprise for investors hesitating to introduce sustainable investing, write Gabriel Herrera and Michael Brenneis.

Sustainable Investing: Encouraging Evidence for Investors

Sustainable investing and ESG (environmental, social, and governance) investing are often thought to be something for investors with a very long-term investment horizon. In fact, the various agendas bear quite long-range target dates to achieve the stated objectives, like the Paris Agreement 2030 or the EU Climate Action 2050. Climate risk and other ESG risks are generally perceived to be long-term economic and reputational risks. Academic papers[1] indeed found a positive link between risk-adjusted returns and the environmental footprint of a portfolio, suggesting that this relation is "particularly pronounced for institutions with longer investment horizons."

This may be an 'early-days' phenomenon, and one could expect these correlations to rise over time, as rating criteria should converge to global standards

This seems to suggest that investors wanting to reap the benefits of sustainable and ESG-related investing must lengthen their investment horizon and be very patient to capitalize on their ESG strategy. Such understanding may deter certain private and institutional investors from adopting a serious sustainable investment strategy and fully integrating ESG considerations into their investment decision process.

Our research suggests that investors can immediately benefit from fully integrating ESG considerations into their investment decision-making, as the benefits of sustainable investments unfold also in the short term. This is encouraging evidence for all investors, and a strong incentive to wait no longer with full ESG integration into all portfolios.

Methodology issues and the search for relevant ESG scores

When evaluating available ESG rating data, one quickly realizes that different providers come to different conclusions regarding specific ESG scores of individual companies. In fact, correlations between data of different providers tend to be surprisingly low. This may be an 'early-days' phenomenon, and one could expect these correlations to rise over time, as rating criteria should converge to global standards.

ESG ratings are an outside assessment of a company's communi-cated statements and policies, and its observed behavior. Surprises are therefore inevitable: in early September 2015, for example, Volkswagen AG was named Best in Class for automotive sustainability by the prestigious Dow Jones Sustainability Indices. Only a few days later, the big emissions cheating scandal, revealing significant issues in corporate governance at Volkswagen, became public. The quality of individual ESG data must therefore not be taken for granted. Nonetheless, it is likely that the quality of such ESG ratings will improve as more and more resources are devoted to its analysis, and more data will become subject to mandatory regulatory disclosure.

Last, but not least, the availability of ESG data has historically been quite low, and only recently has it increased to cover the vast majority of equity investment universes, which is a precondition for efficient investments with a global market reach.

Fundamental reasons why ESG ratings are valid predictors of future outperformance

Since mid-1990, formal ESG ratings were limited to larger companies, which typically employed a dedicated central "ESG" department tasked with achieving good ratings. ESG considerations were definitively not mainstream, not for most investors and also not for the companies themselves. Many academic studies in the earlier periods showed contradictory results. Some argued that ESG investing would have to come with a significant cost (lower investment returns), while others found positive correlations.

We believe that the increased public climate awareness, the significant surge in ESG investing over recent years, and the widely extended coverage of companies globally with ESG ratings have significantly changed the importance of ESG as a predictor of future outperformance. We see three main reasons for that:

1. **ESG management has become a strategic core function of senior management**

Given the mainstream attention, potential reputational issues, as well as strategic ramifications of ESG, one can certainly claim that, today, good management teams do take ESG issues very seriously and make it a matter of personal responsibility. It is not anymore a topic left to be handled by a dedicated group which is far from the day-to-day operations of the company. A good and improving ESG rating can thus be seen as an excellent proxy for well-managed companies. Well-managed companies are more likely to be strategically and financially successful and therefore have a higher probability to outperform, not only in the long term, but also in the shorter term.

2. **ESG management has become a key function in operational risk management**

Environmental disasters, mismanagement of social issues, and shortcomings related to corporate governance have always been potentially damaging to the concerned company. However, the reputational, financial, and disruptive risk of such events has grown exponentially in recent years as social media, the press, regulators, and the general public react much more forcefully to any type of corporate scandal. This is likely to increase further and therefore constitutes risks that can threaten the survival of corporations. Thus, a well-managed ESG dimension becomes essential to mitigate operational risks of a company. This improved risk management will provide for better investment returns by reducing the potential impact of financial disasters.

3. **High ESG scores are a magnet for investment flows**

The constant shift into ESG investments by the vast majority of the investment community in coming years will induce a steady flow away from badly rated companies into better rated companies. This could lead, at some point, to

Figure 1: Outperformance of different ESG clusters over different time horizons in developed markets. Source: In-house research, Artico Partners (used with permission).

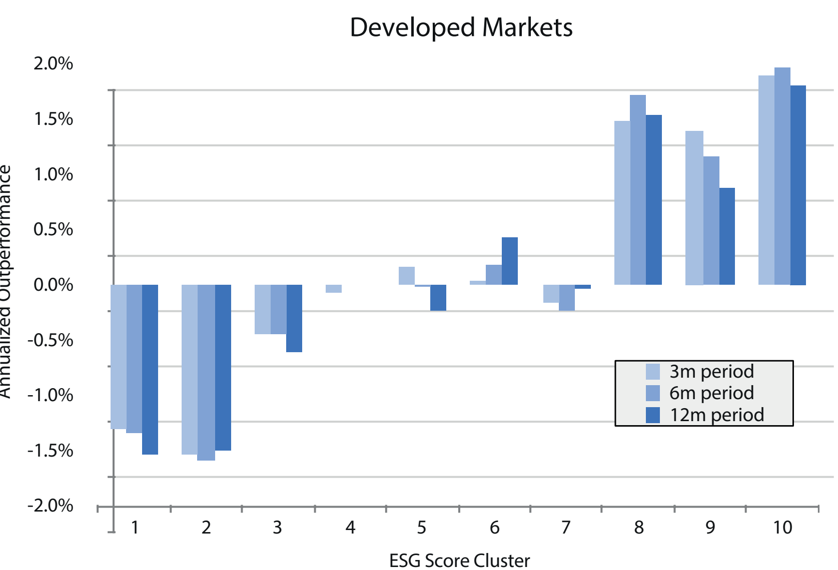
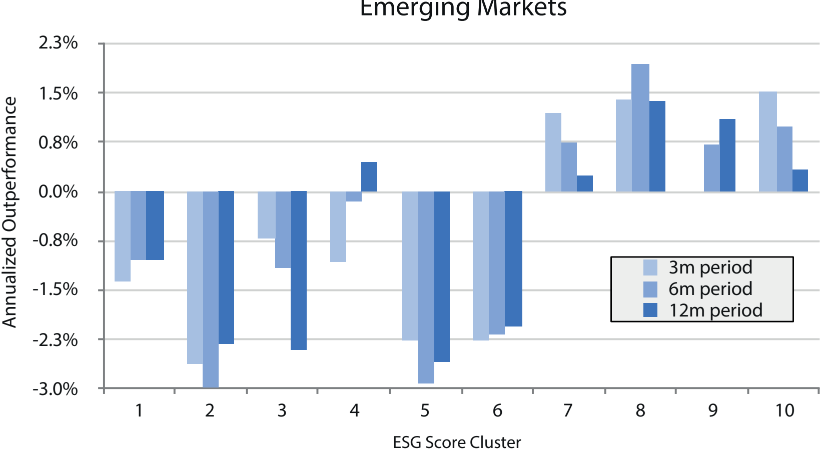


Figure 2: Outperformance of different ESG clusters over different time horizons in emerging markets. Source: In-house research, Artico Partners (used with permission).



overvalued ESG companies, as badly rated companies will be neglected by investors. The positive performance impact will depend on the direction of flows. Short term, it will certainly be positive and could last for the entire decade. Therefore, companies with positive ESG ratings will benefit from increased investor interest and consequently have a higher probability to outperform.

Statistical evidence for ESG as a predictor of future outperformance

We have tested the relationship between outperformance and ESG ratings (see Figures 1 and 2). Based on the MSCI ESG database, we have developed a country- and industry-adjusted ESG score for our analysis. Our data confirms the hypothesis that high ESG scores lead to higher outperformance probabilities. This test was done for multiple investment horizons and in different investment universes. The charts in Figures 1 and 2 show the average annualized outperformance of stocks from ten different clusters of ESG scores, with cluster one holding the worst-scoring companies, and cluster ten the best-scoring companies.

Good management teams do take ESG issues very seriously and make it a matter of personal responsibility

The lines represent different time horizons applied for this study, with holding periods ranging from three, six, to 12 months. As can be seen, investors systematically investing in the highest clusters according to ESG scores can expect an outperformance compared to those investing in the lowest clusters. Moreover, it seems that investors do not need patience to capitalize on their ESG strategy; ignoring trading costs, investors can achieve similar or even slightly higher outperformance if holdings are adjusted more frequently.

Conclusion: Do not wait any longer!

In this article, we have laid out the three main fundamental reasons for why sustainable and ESG investments should provide for a higher probability to outperform. Furthermore, we have also tested the hypothesis and conclude that there is a higher outperformance probability for companies with a superior ESG score.

We also tested three different time horizons of decision making based on ESG scores. The resulting evidence suggests that the expected outperformance based on superior ESG scores is even slightly more pronounced over shorter-term horizons.

Integrating ESG and sustainability principles into investment processes is a promising strategy to improve risk-adjusted returns.

In contrast to some widespread belief, investing in a sustainable and responsible manner does not require excessive patience by investors, nor very long investment horizons to achieve a higher probability of outperformance. This is encouraging evidence for all investors (whether short- or longer-term oriented) to start integrating ESG and sustainability considerations fully into their investment processes. Now.

ENDNOTE

1. See, for example, Gibson, R. and Krueger, P. 2018. The Sustainability Footprint of Institutional Investors. Swiss Finance Institute Research Paper No 17-05, European Corporate Governance Institute – Finance Working Paper No 571/2018.

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