



ESG integration for investment performance

Testing of Regnan ESG materiality research

The environmental, social and governance (ESG) performance of companies is increasingly in the spotlight in a world where information and opinion travel fast. Shareholders have also recognised ESG as relevant to company performance and risk, prompted at least in part by the value destruction that becomes apparent when shortcomings in these areas are suddenly revealed.

A subset of investors, identifying as 'responsible investors' take a particular interest in these issues. This group has diverse motives and practices. Many seek to express values-based judgements via their investments, but by far the largest proportion seek to use ESG as a way to make superior (more informed) investment decisions – by better understanding assets, strategy, future revenues and growth prospects.¹

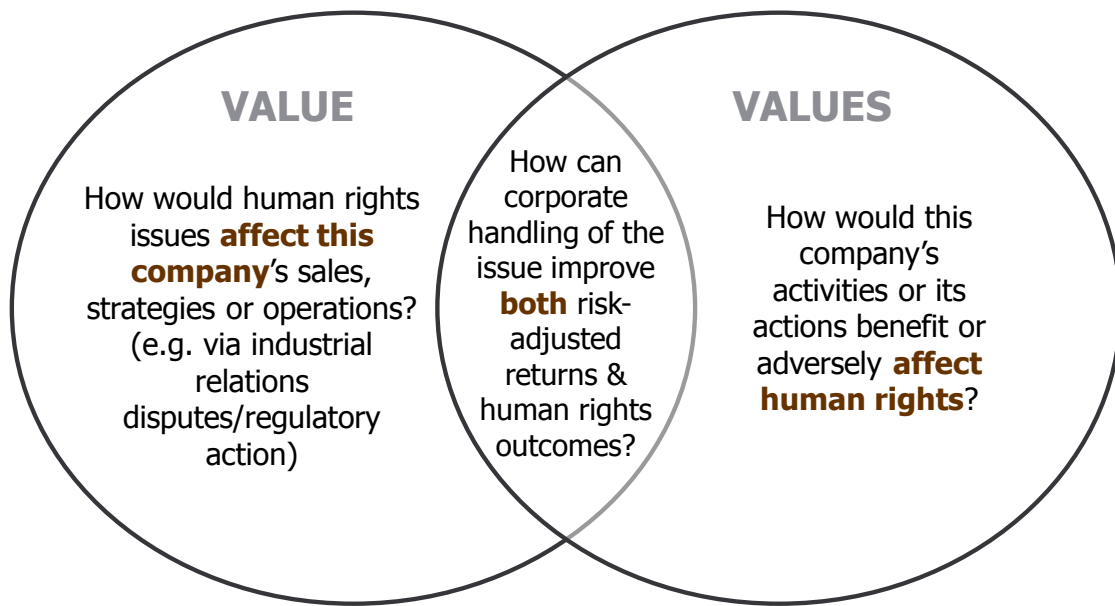
Until recently, most academic and industry research into the investment performance implications of ESG failed to observe an important distinction between values-

focused and value-oriented approaches within responsible investment. Both share interests in many themes (like climate change) and tools (like proxy voting), and they are consequently often conflated. But differences between the two have important consequences for investment outcomes:

- Values-based approaches apply judgement based on ethical considerations, for instance excluding tobacco from portfolios because of its injuriousness to human health. No financial rationale is required, even when it may exist.
- Value-based approaches view issues through an investment frame, albeit an extended one. In the case of tobacco, this might include analysis of the likelihood that tobacco company profits will be impaired by increased regulation or future liabilities.



Figure 1 | Value and Values: Distinct concerns, with often overlapping content. Human rights example.



MATERIALITY MATTERS

There is strong evidence that ESG information can add to investment performance, when it is well targeted to **material** issues. A 2015 study by a team at Harvard University found that after controlling for firm-level predictors of investment returns,² a portfolio of firms rated in the top quartile on **material** ESG issues subsequently generated significant outperformance (alpha) of 4.83% per annum. Firms which performed in the bottom quartile on material ESG issues subsequently underperformed.³

The same pattern emerged for subsequent performance on accounting measures (rather than just stock market-related measures) suggesting that this difference could not be attributed to shareholder sentiment alone; ESG performance appears to contribute to firms' underlying value.⁴

These results are not altogether surprising. If an issue is material, it means there is a strong business case for addressing it. And if there is a strong business case for addressing an issue, a company's performance with respect to that issue will, by definition, have implications for its financial success, and improve its ability to sustain its business going forward.

The challenge for responsible investment research is to identify information that is both material enough to be relevant to performance outcomes, while also being additional to what the market has already integrated into valuation.

This was the challenge assigned to Regnan back in 2007 when we began developing company ESG ratings on S&P/ASX200-listed companies.

*“We find that firms with good ratings on **material** sustainability issues significantly outperform firms with poor ratings on these issues. In contrast, firms with good ratings on **immaterial** sustainability issues do not significantly outperform firms with poor ratings on the same issues...”*

- Khan, Serafeim, and Yoon (2016) 'Corporate Sustainability: First Evidence on Materiality' (Emphasis added)



REGNAN'S RATINGS

Background

Regnan's 'ValDA' ratings were established to support ESG integration for investment managers and portfolio risk monitoring for both managers and asset owners.

The ratings distil Regnan's analysis of companies' ESG exposures and responses into single scores for specific themes – such as ethics and conduct, workplace health and safety, climate change and board management – and into top level E, S and G scores, expressing Regnan's judgement across those categories.

The top level scores reflect only those issues judged to be **material** for each individual firm, in proportion to Regnan's analysis of their significance. This encodes more granularity and analyst judgement than most other ESG ratings methodologies applied at broader scale (including the one used in the Harvard research mentioned above) which use broad categories (e.g. industry, geographic footprint) to determine each issue's materiality to a given firm.

Regnan's process takes into account:

- The specific exposures each company faces in respect of E, S and G issues (not only which themes are relevant given the company's industry or geography, but also what aspects of those themes could affect a firm's unique corporate assets, operational priorities and/or strategies);

- The nature and quality of firms' governance and management practices that are targeted specifically to identified exposures; and
- The severity of any impact associated with any residual risk (whether from shocks or from more persistent/pernicious negative effects on revenue or growth).

Previous testing of the relationship between Regnan's ratings and share price performance was conducted by Goldman Sachs in 2007 (WHS), 2009 (Ethics and Conduct), 2012, 2013 and 2015, and this too provided clear investment signals.⁵ However, both supply and demand for ESG information and integration have risen strongly during the decade since Regnan's ratings were first launched. If ESG has consequently become well-integrated by investors, we would expect that any out- and under-performance, relative to expectations, to diminish as material ESG information became "priced in".

As part of its tenth anniversary celebrations, Regnan commissioned Dr Darren Lee, an academic specialising in responsible investment, to examine whether its ratings continue to provide additional investment information. The study constructed and compared portfolios based on Regnan ratings over the seven years to December 2016.⁶

RESULTS OF THE TESTING DATA

Proof of concept

The research created a series of test portfolios based on Regnan's proprietary ratings of S&P/ASX200 stocks, and concluded that the ratings "provide significant weight to the argument that significant outperformance (alpha) can be obtained by investing in high rated ESG firms and portfolios".

"Overall conclusion: The results found in the current research provide significant weight to the argument that significant outperformance (alpha) can be obtained by investing in high rated ESG firms and portfolios."

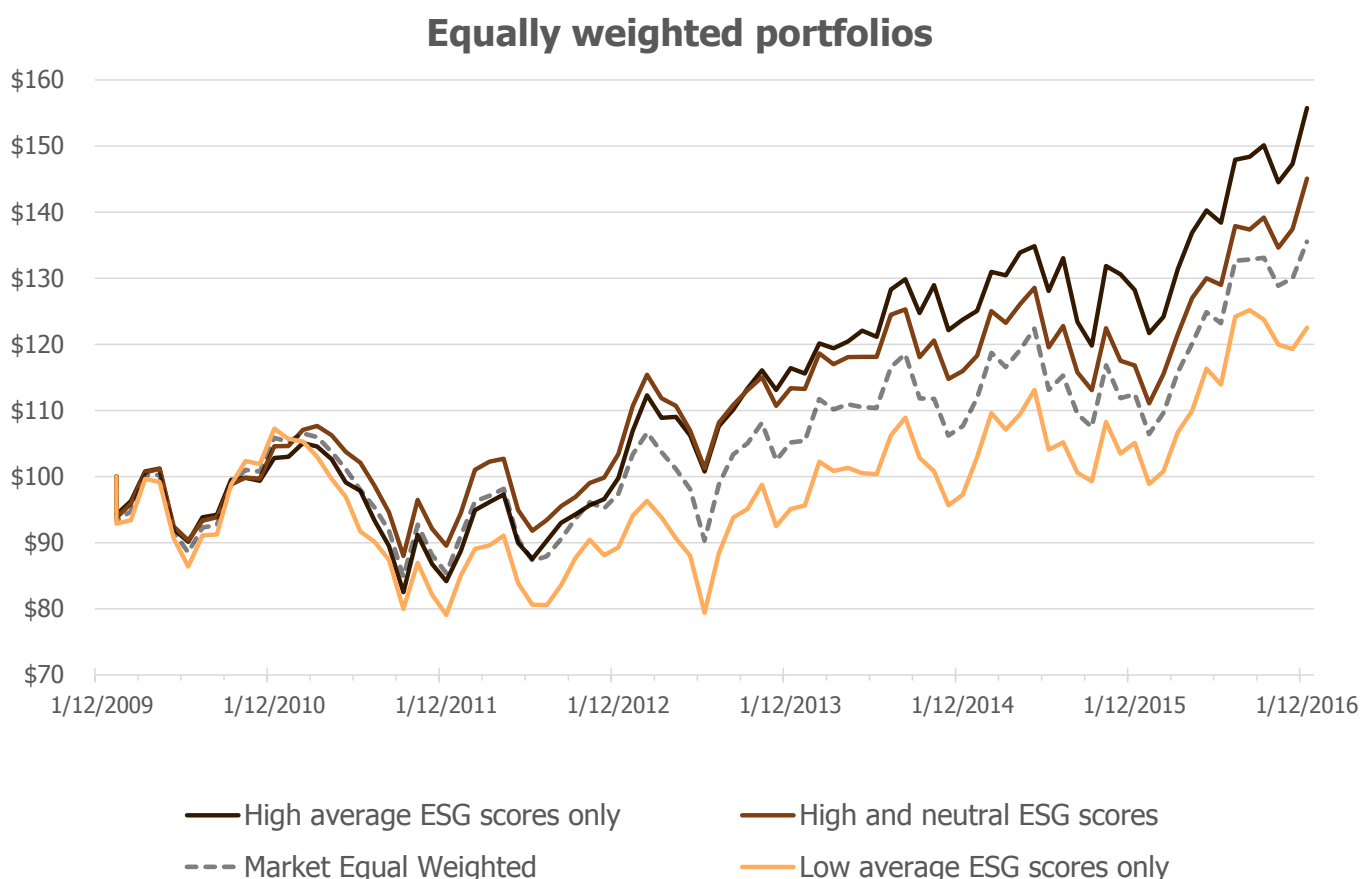
- Dr Darren Lee



Figure 2 illustrates this 'proof of concept' via portfolios based on the average score across E, S, and G ratings,⁷ with stocks equally weighted within the portfolios. It shows:

- A portfolio composed exclusively of firms with **high** average scores **outperforms** the market;
- A portfolio that excludes firms with low scores while including **high and neutral scores** also **outperforms**, but by less than one comprising only high-scoring stocks;
- A comparison portfolio of firms with **low** average scores **underperforms** the market.

Figure 2 | Proof of concept. Equally weighted high conviction portfolios.



APPLYING THEORY TO PORTFOLIOS

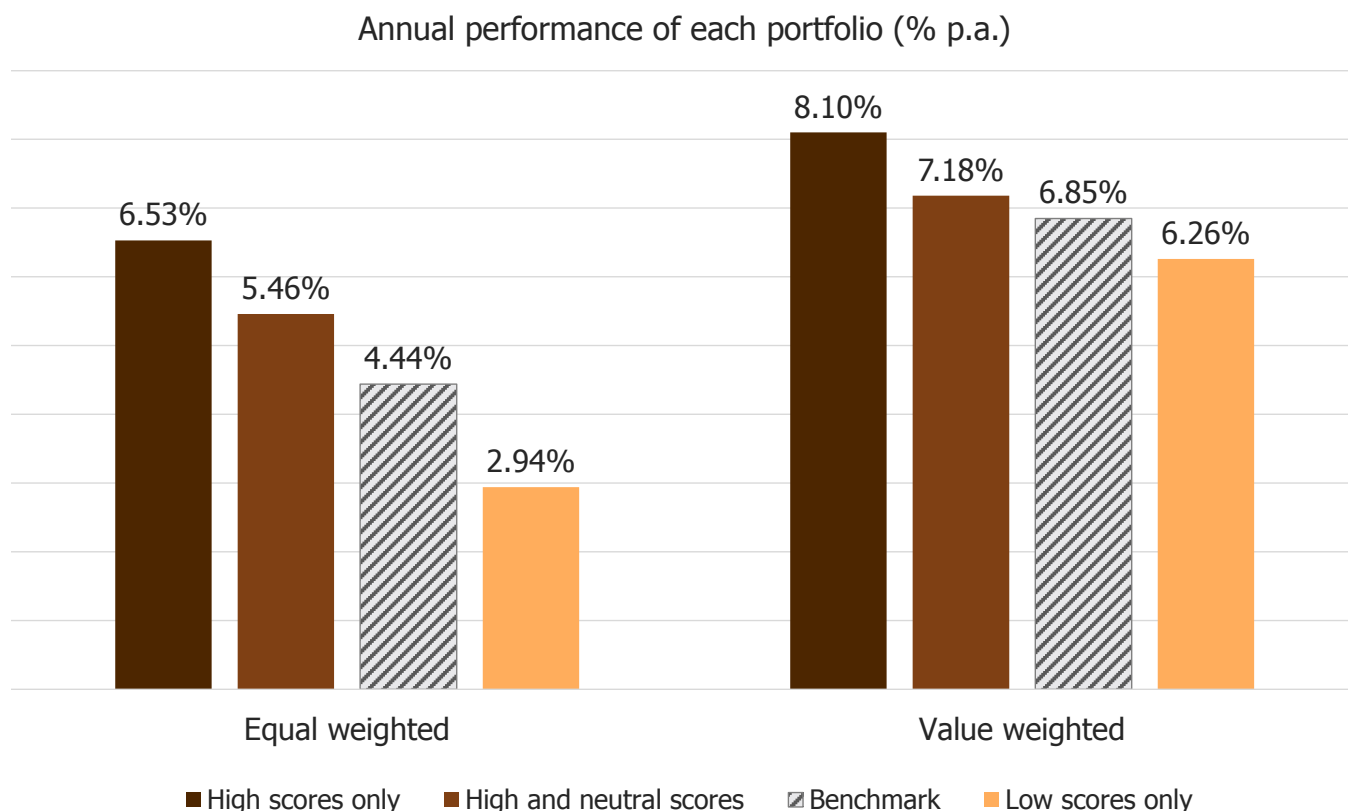
In practice, a range of other considerations inform portfolio construction. Regnan's ratings were also therefore tested against common investment scenarios:

- Portfolios that included both **high and neutral** rated stocks at equal weights. This increases the number of stocks held and therefore diversification (shown in Figure 2);
- Portfolios that included stocks at weights proportionate to their market value (instead of at equal weights);
- Portfolios that combined the above, and included neutrally rated **and** high rated stocks **as well as** holding each stock at a weight proportionate to its market value.

The results continue to show positive performance for relatively higher-scoring ESG portfolios in these scenarios (Figure 3). Outperformance persists, though its magnitude diminishes (reading left to right) as each portfolio's resemblance to the benchmark increases. Returns from a low scores only portfolio are included for comparison.



Figure 3 | Outperformance persists in more realistic portfolios.



Note that none of these portfolios control for other factors (such as size, book to market ratio, etc.) which may impact the results.

Risk

Risk is the core consideration within Regnan’s approach to evaluating ESG. The performance data shows poorer ESG ratings (which we assign when we view the corporate controls as insufficient to fully manage each ESG-related exposure) correspond to poorer investment performance at the stock level.

However, it might not apply at the portfolio level, where additional investment risks could be introduced. If portfolios comprised of higher ESG rated stocks proved to be a riskier investment (e.g. due to smaller numbers of stocks included), then it would be difficult to see how ESG ratings could be systematically applied to investment portfolios in practice.

In addition to the enhanced returns, the research considered general risk characteristics of the portfolios. This included absolute volatility (standard deviation of returns), relative

volatility (Beta relative to S&P/ASX200) and returns delivered per unit of volatility.

As expected, the reduced numbers of stocks in the test portfolios resulted in small increases in absolute and relative volatility when compared with the market portfolio. Despite this, the high ESG scores portfolio and low ESG scores portfolio continued to show out- and under-performance on a risk-adjusted basis respectively. This is shown in Table 1.

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Table 1 | ESG portfolios, risk characteristics.

Value weighted portfolios Risk measures	Monthly Standard Deviation	Beta (vs ASX200)	Return/Risk Ratio (Annual return/Annual standard deviation)
High average ESG Score	4.04%	1.07	0.58
High and neutral ESG scores	3.82%	1.04	0.54
S&P/ASX200	3.58%	-	0.55
Low average ESG Score	3.91%	0.99	0.46

Implementing ESG integration

The test portfolios are designed to illuminate the relationship between ESG and investment performance and exclude other stocks entirely. High and neutral portfolios exclude all low rated stocks and the high portfolios exclude all neutral and low rated stocks.

In practice, many investors use graduated approaches to integrate ESG while adhering to other investment requirements. Examples include:

- 'Tilting' to better ESG performers via overweight positions in higher rated stocks and/or underweight positions in low rated stocks (relative to the benchmark).
- Modifying investment criteria based on ESG, for instance, requiring higher

(expected) investment returns from companies with lower ESG ratings, to compensate for additional expected risk.

- Directing active ownership efforts towards improvements in ESG at poorly rated held stocks, with the expectation of benefit from subsequent re-ratings.

These graduated approaches enable investors to systematically include ESG information while managing portfolio characteristics such as size, value and profitability, as well as (any) desired characteristics (such as sector tilts) relevant for the investor's objectives and processes.

CONCLUSION

For fifteen years, Regnan (and its predecessor) has researched and analysed companies' management of their social, environmental and corporate governance exposures. Whether this be ethical conduct, management of hazardous waste, or appropriateness of executive remuneration, Regnan has applied a rigorous methodological approach in its analysis of ESG issues to reach its proprietary ValDA scores.

These issues – and many others we research – are frequently viewed through a values lens.

However, ValDA's unwavering focus remains on value. By supporting investment decision-makers with high quality analysis of those ESG issues which impact company value, ValDA aims to enhance the market's recognition, pricing and integration of material ESG factors. The data overviewed in this paper has provided supporting evidence which affirms the continuing value of this work for investors in Australian companies.



FOOTNOTES

¹ This is evident in research undertaken annually by the Responsible Investment Association of Australasia, which in 2017, found that in Australia, ESG integration strategies represented more than eight times the FUM invested in other RI strategies. <https://responsibleinvestment.org/resources/Benchmark-report/>

² This includes past returns, firm size, book-to-market, turnover, ROE, analyst coverage, R&D intensity, advertising intensity, SG&A intensity, capital expenditure and leverage.

³ See Khan, Serafeim, and Yoon, Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724. Available at SSRN: <https://ssrn.com/abstract=2575912> or <http://dx.doi.org/10.2139/ssrn.2575912>

⁴ Accounting performance was measured by return on sales.

⁵ Goldman Sachs, various 2007-2015.

⁶ The current methodology for governance research dates from 2010.

⁷ This is a mean of any available top level scores (E, S, and/or G) that were current in a given period.

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Regnan - Governance Research & Engagement Pty Ltd

ABN 93 125 320 041 AFSL 316351

Level 9, 387 George Street
Sydney NSW 2000

Level 10, 136 Exhibition Street
Melbourne VIC 3000
Australia

Phone: +61 2 9299 6999

www.regnan.com

Regnan was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors with \$73 billion invested in S&P/ASX200 companies (at 30 June 2017).

