Willis Towers Watson

Sustainable investment

Show me the evidence

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We are often asked by asset owners who have recently been introduced to the concept of sustainable investment:

"What's the evidence?"

This is not an unusual question when we operate in an industry where numbers and quantitative assessments often dominate. Ideas struggle to gain acceptance without empirical proof. Sustainable investment and Environmental, Social and Governance (ESG) factors are no different – and the high burden of proof many investors have imposed has contributed to the slow integration of this area within asset owner portfolios.

ESG has historically been associated with largely nonfinancial concerns, and is still sometimes viewed as a cost rather than another lens with which to assess risk and return. Changing this mindset is no easy task. In this paper we provide a sample of the academic evidence which demonstrates the value of doing so. The studies and meta-studies referenced at the end of this paper show **reduced cost of equity, better stock performance and lower fixed-income spreads as examples of how appropriate management of ESG factors can lead to improved risk and return outcomes.** Further studies also demonstrate the value of effective stewardship, linking corporate engagement with improved investment returns.

The collection of evidence would suggest that not only is there a strong risk mitigation argument to incorporate ESG factors into the investment decision process, but that this, together with stewardship, presents the opportunity to enhance portfolio returns. Willis Towers Watson believes that investors who incorporate ESG and effective stewardship into the investment process will improve portfolio risk and return outcomes over the long term. We expect investment managers to understand the financial materiality of ESG issues for the assets they manage and align their processes to manage the associated risk and capture the opportunities. We also expect managers to be responsible stewards of capital, recognising that this can serve to protect and enhance the value of their investments.

Highlights

- Better ESG scoring companies tend to provide moderately better risk-adjusted returns over the long term[1,2,3,6] and some evidence for lower credit spreads in fixed income.[4,5]
- Governance ('G') is often found to be the most influential factor.[1,5]
- Company engagement appears to have a positive impact on returns.[7,8,9]

The studies we present in this paper highlight the financial impact of ESG factors and stewardship on investing. However, it is important to remember there are other potential impacts across broader environmental and social perspectives that are not captured in these studies but may also be important to asset owners, beneficiaries and wider societal stakeholders. We believe a well-formulated set of sustainable investment beliefs will help asset owners understand their position on how ESG and stewardship is relevant to their mission and goals, both from a financial and nonfinancial perspective.

Where has the evidence been up to now?

Evidence on the value of sustainable investment and stewardship has emerged strongly in the past few years. Historically, there have been a number of issues limiting the availability of compelling evidence on the merits of these areas, and these concerns still remain, in part, for some investors. We outline some of these below. The sustainable investment industry is developing rapidly, and many of these issues are being alleviated as a result.

1. **Data availability:** The vast majority of evidence linking improved return profiles to ESG factors is focused on the listed equity markets. Public companies have historically been the best source of ESG data as certain corporates have improved disclosure around extra financial factors. There is still a long way to go as the data available is limited, not reported on a consistent basis and not all corporates provide ESG-related reporting. We expect the quantity and quality of reported ESG data to improve as expectations around the type and level of information reported improves, and Integrated Reporting (IR) becomes more commonplace. We also expect other asset classes to improve transparency on important ESG metrics. For example, the fixed income market has a greater depth of ESG information available in the last couple of years.

2. **Data consistency:** ESG reporting tends not to be a mandatory requirement for corporates and as a consequence there are no globally applicable standards similar to those in traditional financial reporting. Standards would both guide companies in what to report and facilitate analysis of the data by investors and other stakeholders. There are a number of global initiatives to improve consistency in reporting, including the Taskforce for Climate Related Financial Disclosures and the Sustainability Accounting Standards Board.

3. **Historical availability:** There was a limited amount of meaningful ESG data available over a sufficiently long time period to allow robust analysis. Too short a time frame for any analysis can potentially capture other cyclical factors at play and limit the statistical significance of the study. This issue has alleviated with time.

4. **Qualitative versus Quantitative:** There are certain aspects of fundamental analysis that are considered important for investment decisions but are often difficult to quantify, such as corporate management attitude to risk. ESG factors often fall into this qualitative category. As the industry evolves, methods of capturing some of the more qualitative aspects like culture will perhaps improve.

Conclusion

Many of the factors that have made the availability of academic evidence to support ESG integration more challenging have alleviated over time as consistency, quality and quantity improves. We now have a strong body of compelling evidence to demonstrate the value an awareness of ESG factors can bring to the investment process. Below we present a sample of these studies with a brief summary of the results of each piece of research. The positive financial impact of ESG factors and stewardship is clear.

Astute long-term investors understand that ESG factors are not necessarily nonfinancially related factors, as is often perceived, but rather an additional source of insight into the risk and return profile of an investment. There is a slow change of mindset across our industry as the topic of ESG moves from a perception of nonfinancial to being principally concerned with improving risk and return outcomes. The evidence presented in this paper supports this shift. We believe an investment process that integrates sustainable investment principles will outperform one that doesn't over the long term.

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Summary of studies

1. Clark, Feiner and Viehs, *From the Stockholder to the Stakeholder,* University of Oxford, Arabesque Partners, 2014. This used research from Clark and Viehs. *The Implications of Corporate Social Responsibility for Investors,* 2014.
   - Based on more than 190 sources.
   - "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."

2. Fulton, Kahn and Sharples, *Sustainable Investing; Establishing Long Term Value and Performance,* Deutsche Bank, 2012.
   - Based on more than 100 academic studies.
   - "100% of academic studies agree that companies with high ratings for ... ESG have a lower cost of capital in terms of debt (loans and bonds) and equity."
   - "89% of the studies ... show that companies with high ratings for ESG factors exhibit market-based outperformance."
   - Within ESG, governance ('G') is often found to be the most influential factor.
   - However studies of funds applying an exclusionary approach have tended to achieve mixed results.

3. Friede, Busch and Bassen, *ESG and financial performance: aggregated evidence from more than 2000 empirical studies,* Journal of Sustainable Finance and Investment, Deutsche Bank and University of Hamburg, 2015.
   - A second level review study, covering 60 review studies (3718 underlying studies, and when taking out duplicates, this leads to 2200 unique studies.)
   - The business case for ESG investing is empirically very well founded.
   - Roughly 90% of the studies find a nonnegative ESG-CFP (corporate financial performance) relation. The large majority of studies report positive findings.

4. Nguyen-Taylor, Naranjo and Roy, *The ESG Advantage in Fixed Income Investing: An Empirical Analysis,* Calvert Investments, 2015.
   - ESG positively influences overall CDS spread performance (timeframe 2002-2012.)
   - Environmental and social accounted for meaningful outperformance in CDS spreads, outperformance due to governance was still positive.

5. Desclee, Dynkin, Maitra and Polbennikov, *ESG Ratings and Performance of Corporate Bonds,* Barclays, 2016.
   - Corporate bonds with higher composite ESG ratings have slightly lower spreads, all else equal (timeframe 2007-2015.)
   - Modest incremental return from high ESG rated bonds – governance is the biggest contributor to improved performance.
   - SRI exclusion (companies involved in controversial activities) has reduced average returns while increasing portfolio spreads.

6. Khan, Serafeim, Yoon, *Corporate Sustainability: First Evidence on Materiality,* Harvard, 2015.
   - This paper examines the concept of materiality as it relates to sustainability factors. The paper finds 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."

7. Dimson, Karakas and Li, *Active Ownership, Review of Financial Studies,* 2015.
   - Engagements with investee companies on average generated abnormal returns of 2.3% one year following the initial engagement in the US from 1999-2009.
   - The study examined 2,152 highly intensive engagements on ESG areas for 613 US public firms. The success rate for engagements was 18% and on average it took two to three engagements before success could be recorded, which on average was 1.5 years after the initial engagement.

8. Junkin, Update to *The "CalPERS Effect" on Targeted Company Share Prices,* Wilshire Associates, 2013.
   - Over the five years after CalPERS' engagements, targeted companies on average produced excess returns of 12.3% above the Russell 1000 Index.
   - This analysis evaluated CalPERS' corporate governance effectiveness by measuring the performance of the stocks of the 183 companies targeted by CalPERS from the 1999 engagement process through the 2012 engagement process.
   - Over the three years prior to the initial engagement, the targeted companies on average underperformed the Russell 1000 Index by 38.9% cumulatively.

9. Hoepner, Oikonomou and Zhou, *ESG Engagement in Extractive Industries: Return and Risk,* 2015.
   - Uses the data from Hermes EOS milestones as part of their engagements in the extractives sector – 167 engagements with 56 companies that were broadly split across environmental, social and governance issues.
   - Companies that were the target of engagement generated an average outperformance of +4.4% per annum and were associated with a lower risk profile relative to similar companies. Those that implemented strategies to deal with issues highlighted by the engagement process outperformed those that simply acknowledged the engagement efforts.
   - Further, those companies that responded negatively to attempts at engagement significantly underperformed other engaged companies.

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