ESG-Ratings with (Out)Performance-Chances? Yes with SUSTAINAMENTALS®!

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Highlights

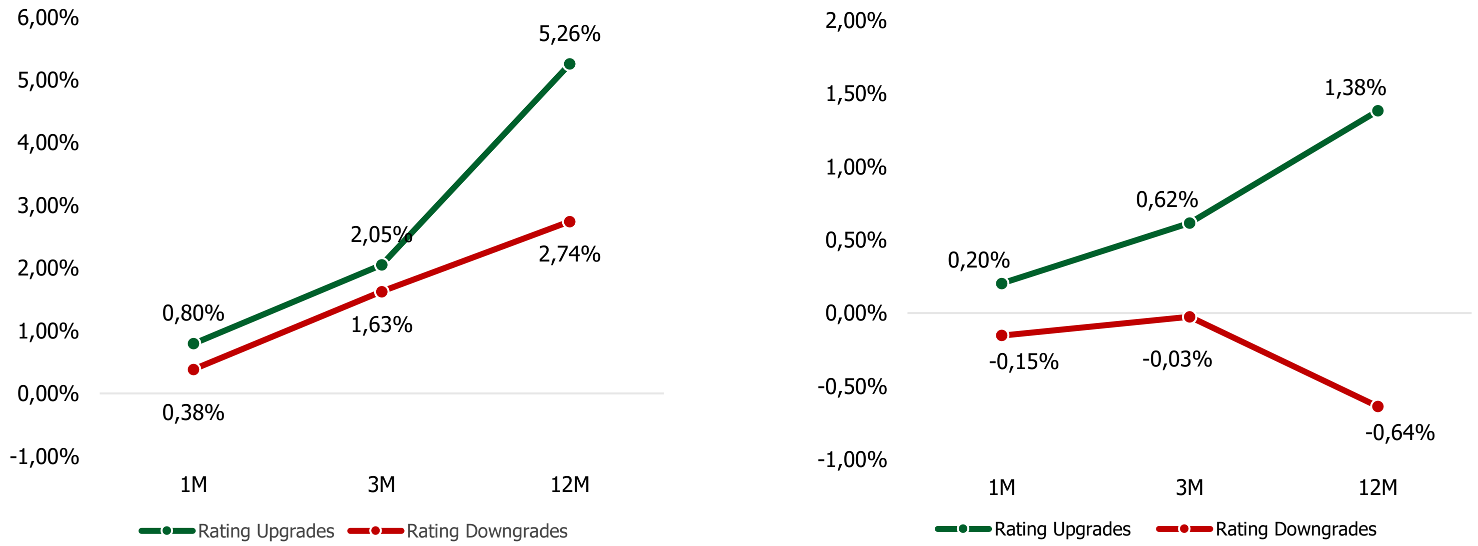
- Despite bias effects, ESG ratings are an important steering parameter for many investors, resulting in performance potential for holistic approaches.
- In recent years, an ESG rating upgrade in Europe has resulted on average in positive absolute returns and relative outperformance, while a downgrade has resulted in underperformance.

Elements of the EU Action Plan for Sustainable Finance (with well-known items such as taxonomy, disclosure regulation (SFDR)) are advancing inexorably and are causing headaches for many financial market participants these days. Not only these actually sensible transparency obligations, but also the consideration of sustainability risks in the investment process have become part of regulatory obligations. For this purpose, many investors resort to ESG ratings, which perform a risk assessment from a sustainability perspective on all three levels (environmental, social and corporate governance) and provide an assessment of the quality of sustainability risk management.

Many financial market participants now manage their sustainable products very specifically according to these ESG ratings - passively screened ESG products in particular almost exclusively feature investments with high ESG ratings. Companies with lower ratings, but which are undergoing a serious transformation or whose sustainable business model has been misunderstood by sustainability rating agencies, are rarely found in these allocations. A good ESG rating can therefore increase the company's visibility on the financial market and can also be beneficial when it comes to refinancing matters. A poor ESG rating can lead to exclusion from many product strategies and make it more difficult to access the capital market. Thus, ESG ratings now have tangible fundamental implications for a company.

At this point, we asked ourselves whether a change in an ESG rating (in this case, from MSCI ESG Research) has an impact on a company's share price and took an empirical look. For our European universe of approximately 3200 companies, we took the ESG ratings since January 2017 and compared the performance impact of a rating upgrade or rating downgrade over different time periods (one month, three months, twelve months). To take account of general market movements, the performance relative to the European market (via STOXX® Europe 600) was also examined.

ABSOLUTE (LEFT) BZW. RELATIVE (RIGHT, VS. STOXX® EUROPE 600) AVERAGE PERFORMANCE BY ESG-RATING-CHANGES



As the graphs impressively show, on average, companies performed positively in both absolute and relative terms after an ESG rating upgrade, while rating downgrades led to an underperformance of the comparative benchmark. Identifying ESG rating changes in advance therefore offers concrete performance opportunities. But how exactly does one identify these companies?

First and foremost, it is important to understand that caution should be exercised in taking ESG ratings as the sole metric and measure of sustainability quality. As we have analyzed elsewhere, ESG ratings suffer from some shortcomings, such as lack of correlation, infrequent updates (“static ratings”), systematic neglect of small caps ("ESG Neglected Firm Effect"). Another important point is their backward-looking nature: since at best present-related data can be analyzed, an ESG rating provides a good insight into the status quo of a company. Future fundamentally relevant sustainability potentials are not taken into account.

In order to identify these, a holistic approach is needed that takes a deep look at the business model, its drivers and management to emancipate from these shortcomings. With our SUSTAINMENTALS® approach, we do just that: we identify companies with high fundamental and sustainability potential and accompany them in their value development over the long term..

SUSTAINAMENTALS®

Our holistic approach of integrating non-financial criteria such as environmental consideration, social aspects and responsible corporate governance into a value-oriented, fundamental investment process combines two worlds: fundamental and sustainability. This approach reflects the simple equation:

SUSTAINABILITY + FUND**AMENTALS = SUSTAINAMENTALS®**

For our clients, this means investing in attractive companies with long-term sustainable business models.

SUSTAINAMENTALS® Insight

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