GENERALI INSURANCE ASSET MANAGEMENT

Core Matters

Big-improver ESG laggards show to outperform

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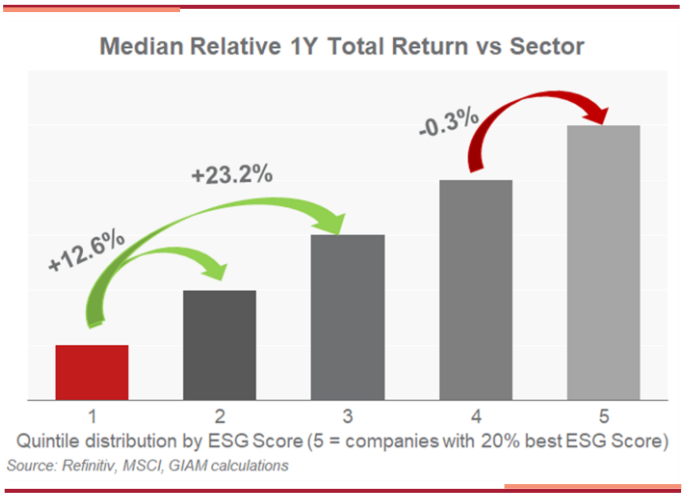
Our Core Matters series provides thematic research on macro, investment, and insurance topics

- Equity portfolio managers have become increasingly conscious of the importance of ESG factors in portfolio construction.
- We notice that traditional and ESG indices are quite similar in terms of both total return and Sharpe ratio, but focusing on single stocks, things can be different.
- In this respect, does the level and/or the momentum of a single company's score drive overperformance? To answer this question, we look at the return from improving ESG laggards among the biggest 400 European listed companies (MSCI Europe index) in the last 10 years. We try to gauge if there is any overperformance generated by an increase in ESG scores of low and very low-ESG rated companies.



- We find that combining current ESG level and its momentum can be a winning strategy. Companies with a low but improving ESG profile tend to outperform the market and their industries, even when corrected for the respective relative earnings revision momentum.
- This can be useful in building portfolios, by including, among others, also companies that are left behind in the score ladder but, crucial assumption, are judged by the specialised analyst or fund manager to be on the right path to step it up.
- A stock screening can be implemented to identify potential targets for activist campaigns, in order to gain from the improvement of the score, should such campaign be successful. An activist investment approach towards ESG laggards has the potential to create a tangible reduction in their ecological and social footprint, while also creating financial overperformance.
- A broad, experienced, collaborative ESG team that is integrated across the investment process is crucial for identifying the ESG laggards on the verge of improving, while avoiding the ones that will not.

CONTENT

1. Introduction

ESG analysis is at the heart of our sustainable investment strategy. We aim to deepen our understanding of companies by going beyond ESG scores, using a broad and detailed framework to find buying opportunities even among so-called "ESG laggards". Our view, informed by our proprietary analysis, is that a combination of financial as well as ESG analysis can enable active managers to identify companies set to improve their ESG score and outperform the market.

2. ESG and non-ESG index performance

Historical total returns (TR) of traditional MSCI indexes and of their ESG counterparts have shown limited differences in the last 5, 10 and 15 years:

Annualized Total Return Diff. (ESG - Classic)				5Y Beta	AVG Sharpe Ratio Diff.
MSCI Index	5Y	10Y	15Y		
World	0.0%	0.1%	0.0%	0.99	0.00
EMU	1.2%	1.1%	1.0%	0.98	0.06
Europe	0.6%	0.6%	0.4%	0.97	0.04
USA	0.1%	-0.1%	-0.2%	0.99	0.00
North America	0.0%	-0.1%	-0.2%	0.99	-0.01
EM	0.2%	1.7%	2.7%	1.03	0.09
Pacific	-0.5%	0.0%	0.3%	1.00	-0.01

Calculations performed in local currency. Beta is ESG vs non-ESG index.
Source: Refinitiv, GIAM calculations as of 21/09/2022

	5 years					15 years		
MSCI Index	Avg. Excess Ret. (A)	Volatility (B)	Sharpe Ratio (A/B)	Correl. (vs Non ESG Index)	BETA (vs Non ESG Index)	Avg. Excess Ret. (A)	Volatility (B)	Sharpe Ratio (A/B)
World	7.4%	17%	0.4	100%	1.00	5.2%	17%	0.3
World ESG Leaders	7.4%	17%	0.4	100%	0.99	5.2%	17%	0.3
EMU	2.9%	19%	0.2	100%	1.00	2.3%	21%	0.1
EMU ESG Leaders	4.1%	19%	0.2	99%	0.98	3.2%	21%	0.2
Europe	4.8%	17%	0.3	100%	1.00	3.4%	19%	0.2
Europe ESG Leaders	5.4%	17%	0.3	99%	0.97	3.9%	19%	0.2
USA	10.9%	21%	0.5	100%	1.00	8.1%	20%	0.4
USA ESG Leaders	11.0%	21%	0.5	99%	0.99	7.9%	20%	0.4
North America	10.6%	21%	0.5	100%	1.00	7.8%	20%	0.4
NA ESG Leaders	10.6%	21%	0.5	99%	0.99	7.5%	20%	0.4
EM	-0.4%	17%	0.0	100%	1.00	0.7%	20%	0.0
EM ESG Leaders	-0.2%	18%	0.0	98%	1.04	3.4%	19%	0.2
Pacific	1.3%	15%	0.1	100%	1.00	1.6%	19%	0.1
Pacific ESG Leaders	0.9%	15%	0.1	99%	1.00	1.9%	19%	0.1

Source: Refinitiv, GIAM calculations as of Sept. 2022

There is almost perfect correlation (99% to 100%) between traditional and ESG indices, coupled also by a low tracking error[1] of around 2%. On average, ESG indices have a 5Y beta versus their own reference market close to 1, ranging from 0.97 (Europe) to 1.04 (EMs). Volatility levels and Sharpe ratios are also very similar.

Overall, ESG indices deliver a small premium versus traditional one maintaining a similar level of risk, especially in euro area and Emerging Markets.

> *Historical returns of MSCI indexes and of their ESG counterparts are similar by construction*

Such high similarity is not surprising when we look at the composition of a traditional and an ESG index in terms of sector weight: it shows on average limited differences. The MSCI ESG Leaders indexes are built by applying a Best-in-Class selection process, making sure target sector and region weights are consistent with those in the underlying indexes.

Source: MSCI, Oct. 31, 2022

Source: MSCI, GIAM calculations, Oct. 31, 2022

Furthermore, when we look at literature, we observe that different studies find contrasting results concerning the ESG contribution on long-term performances. In the table below you can see that sometimes opposite correlations are reported between firms' ESG ratings and their performance.

[1] Tracking Error (TE) numbers are provided by MSCI and refer to full life of the indexes – from 2007 to 2022. As of 31.10.2022 TEs are: World 1.29% | EMU 2.11% | Europe 1.86% | USA 1.90% | North America 1.76% | Emerging Markets 3.65 % | Pacific 2.08%.

The "-" sign stands for negative contribution, meaning a high ESG score and/or an increase of it is a driver of underperformance, and vice versa:

Variable	Sign	Citation
Long-run returns	-	Di Giuli and Kostovetsky (2014)
	0	Humphrey et al. (2012)
	-	Hong and Kacperczyk (2009)
	-	Bolton and Kacperczyk (2020)
	+	Dimson et al. (2015)
	+	Edmans (2011)
	+	Lins et al. (2017)
	+	Barko et al. (2018)
	+	Statman and Glushkov (2009)

Source: Gillan et al., 2021

> *There is not a definitive view in literature about the ESG contribution to portfolio performance.*

There are at least three reasons for this lack of unanimity in results. First, there is a problem of quality of data: third-party ESG data rely heavily on voluntary company disclosure, which moreover can be backward-looking and limited in scope. Secondly, each score provider carries its own procedure and may arrive at different results. Lastly, there are so many lenses and angles when looking at the ESG matter, making extremely difficult to come up with an accurate and comprehensive score. This can be observed in the correlations among ESG ratings, for the same companies, published by different providers (Sustainalytics, RobecoSAM, Vigeo Eiris, Asset4, KLD and MSCI). In most cases, correlations are quite low, and this is especially true while looking separately at Social (S) and Governance (G) pillars' scores.

Correlations between ESG Ratings

	KL SA	KL VI	KL RS	KL A4	KL MS	SA VI	SA RS	SA A4	SA MS	VI RS	VI A4	VI MS	RS A4	RS MS	A4 MS	AVG
ESG	0.53	0.49	0.44	0.42	0.53	0.71	0.67	0.67	0.46	0.70	0.69	0.42	0.62	0.38	0.38	0.54
E	0.59	0.55	0.54	0.54	0.37	0.68	0.66	0.64	0.37	0.73	0.66	0.35	0.70	0.29	0.23	0.53
S	0.31	0.33	0.21	0.22	0.41	0.58	0.55	0.55	0.27	0.68	0.66	0.28	0.65	0.26	0.27	0.42
G	0.02	0.01	-0.01	-0.05	0.16	0.54	0.51	0.49	0.16	0.76	0.76	0.14	0.79	0.11	0.07	0.30

Correlations between ESG ratings at the aggregate level (ESG) and at the level of the environmental dimension (E), the social dimension (S), and the governance dimension (G) using the common sample. The results are similar using pairwise common samples based on the full sample. SA, RS, VI, A4, KL, and MS are short for Sustainalytics, RobecoSAM, Vigeo Eiris, Asset4, KLD, and MSCI, respectively.
Source: Berget et al., 2020

3. ESG Momentum: improving ESG Laggards

ESG scores are not static, but mutable and ever changing as they reflect company's actions and plans. ESG momentum refers to how a company's ESG characteristics change over time. Those with positive momentum are improving their ESG practices. Examples could include setting more competitive carbon reduction targets or improving gender diversity on the board of directors. Companies with low ESG scores that want to improve their standing can understandably face scepticism from investors. Many investors prefer to invest in companies that already have a strong ESG track record, in order to lower potential risks. This means there can be an opportunity to enhance returns by being among the first to invest in a company which focuses on improving its ESG approach.

> *Does the level and/or the momentum of the ESG score drive overperformance?*

To answer this question, we analysed companies included in the MSCI Europe in the last 10 years, dividing them into quintiles based on their Eikon Refinitiv ESG Score. The first quintile represents the worst 20% of companies by ESG score, with the fifth quintile being the top 20%. Improvers, firms moving up from one quintile to the next, are not excessively rare. **On average, around 16% of companies in the first quintile** (c. 80, showing the worst score) **reported an improvement every year**: **14%** had a one-notch upgrade (from first to second quintile) and **2%** had a two-notch upgrade (from first to third quintile).

AVG Yearly Change in ESG scores: quintile movements

Type of movement	% on total	yearly n° of firms
No change	72.5%	265 - 290
Increase	15.0%	31 - 68
Decrease	12.4%	36 - 67
Increase from **first quintile**	**16.3%**	6 - 17
First to Second quintile	14.2%	6 - 16
First to Third quintile	2.1%	0 - 3

Source: Refinitiv, GIAM calculations. Avg total firms analysed: 389

For each company, we calculated the total return performance in absolute, as well as in relative terms vs the European index and the sector, over a one-year horizon from the score publication. This approach should limit any potential outperformance related to the economic cycle and sector bias. Finally, we also controlled the outcomes for the effect of a change in 12-month forward earnings.

Methodology in brief

Perimeter: MSCI Europe Index (429 companies)

Timeframe: 2012 - 2021

ESG rating source: Eikon Refinitiv

Performance measure: Total Return (1-year following score publication period, usually around June)

In each year **we have pooled the companies** by:

1. ranking quintiles (1st quintile → worst 20% companies by ESG score)
2. change in ranking quintiles
3. a combination of the two (quintile and delta quintile)

We have analysed the **Total Return performance** of different pools:

1. in absolute terms
2. relative to the market (MSCI Europe)
3. relative to the MSCI Europe sector each company belongs to

Finally, we also controlled for the effect if any change in **12m forward earnings**.

We found that combining the ESG level with the momentum could be a promising strategy. Identifying laggards set to improve their ESG score could capture higher performance than the overall market and sector, even when corrected for the respective relative earnings revision momentum. An

increase of one notch from the first quintile (lowest total ESG scores) leads to a higher total return than the same increase from the fourth quintile (second highest ESG scores), relative to each company's own sector over a period of one year. The higher the starting point (quintile) of the ESG-improver, the lower the outperformance.

> *An increase from the bottom leads to a higher outperformance than the same increase from the top*

Similar results have been found relative to the whole market, even after controlling for the earnings momentum: the outperformance related to a one-notch increase from the bottom quintile is higher than the relative positive EPS revision (median vs market: +11.3% TR vs +5.7% EPS change). Furthermore, the outperformance is even higher we look at a two-notch upgrade from the bottom quintile: it provides a bigger excess return (in median vs sector: +23.2%), which is still higher that the relative EPS revision (+19.7%).

QUINTILE CHANGE IN ESG SCORE

MEDIAN	Rel. Vs. Market		Rel. Vs. Sector	
	1Y TR	EPS	1Y TR	EPS
1st → 2nd	11.3%	5.7%	12.6%	6.4%
2nd → 3rd → 4th	5.9%	5.2%	5.5%	4.5%
4th → 5th	-1.2%	3.2%	-0.3%	2.2%
1st → 3rd	22.7%	24.5%	23.2%	19.7%
AVERAGE	1Y TR	EPS	1Y TR	EPS
1st → 2nd	10.2%	21.7%	11.0%	21.1%
2nd → 3rd → 4th	7.2%	6.3%	6.3%	2.8%
4th → 5th	0.4%	-0.8%	0.5%	-3.7%
1st → 3rd	23.7%	22.8%	23.1%	21.8%

Note: 1° quintile = worst 20% companies by score
Source: Refinitiv, GIAM calculations

This result can be useful in building portfolios, by including a basket of companies that are left behind by standard ESG scoring but, crucially, are deemed by the specialist analyst or fund manager to be on the right path to improve.

3.1 Further analysis: including controversies score and analysing Environmental and Social Pillars

We replicated the analysis for the combined ESG score, which includes not only Environmental (E), Social (S), and Governance (G) scores but also applies an ESG controversies overlay. The Controversies Score measure a company's exposure to ESG controversies and negative events reflected in global media and are therefore more subject to abrupt changes.

Even if the results are more uneven, they validate what we have already found: an ESG upgrade from a low starting score is associated with a higher relative total return than the same upgrade from a higher starting score.

QUINTILE CHANGE IN ESG COMBINED SCORE*
** includes an ESG controversies overlay*

MEDIAN	Rel. Vs. Market		Rel. Vs. Sector	
	1Y TR	EPS	1Y TR	EPS
1st → 2nd	9.0%	4.7%	5.9%	5.8%
2nd → 3rd → 4th	2.0%	3.3%	0.4%	2.5%
4th → 5th	3.7%	3.9%	2.4%	3.2%
1st → 3rd	7.7%	4.7%	12.6%	4.9%
AVERAGE	1Y TR	EPS	1Y TR	EPS
1st → 2nd	10.0%	12.0%	9.5%	10.4%
2nd → 3rd → 4th	5.0%	3.7%	4.9%	2.8%
4th → 5th	4.3%	2.8%	2.3%	-2.2%
1st → 3rd	11.2%	12.8%	14.5%	16.9%

Note: 1° quintile = worst 20% companies by score
Source: Refinitiv, GIAM calculations

To have a more detailed view, we replicated the analysis with individual Environmental and Social scores, as many activist campaigns are based on these 2 pillars. Results point in the same direction, finding that an improvement from the bottom generate excess returns:

QUINTILE CHANGE IN ENVIRONMENTAL SCORE

MEDIAN	Rel. Vs. Market		Rel. Vs. Sector	
	1Y TR	EPS	1Y TR	EPS
1st → 2nd	13.3%	7.0%	12.7%	7.7%
2nd → 3rd → 4th	5.7%	7.8%	4.3%	6.0%
4th → 5th	-0.9%	4.4%	-1.4%	6.9%
1st → 3rd	8.1%	13.5%	11.0%	8.4%
AVERAGE	1Y TR	EPS	1Y TR	EPS
1st → 2nd	15.0%	13.3%	16.3%	9.9%
2nd → 3rd → 4th	7.1%	17.1%	5.3%	16.5%
4th → 5th	1.9%	6.9%	0.8%	4.2%
1st → 3rd	16.6%	16.3%	15.2%	13.1%

Note: 1° quintile = worst 20% companies by score
Source: Refinitiv, GIAM calculations

QUINTILE CHANGE IN SOCIAL SCORE				
MEDIAN	Rel. vs Market		Rel. vs Sector	
	1Y TR	EPS	1Y TR	EPS
1st → 2nd	9.8%	11.8%	11.1%	8.4%
2nd → 3rd → 4th	3.7%	3.4%	3.4%	4.5%
4th → 5th	2.6%	5.1%	1.2%	3.7%
1st → 3rd	19.2%	5.9%	21.6%	6.2%
AVERAGE	1Y TR	EPS	1Y TR	EPS
1st → 2nd	10.6%	25.4%	9.7%	22.8%
2nd → 3rd → 4th	4.8%	10.0%	4.5%	8.0%
4th → 5th	3.8%	5.3%	2.7%	0.5%
1st → 3rd	19.2%	13.2%	18.3%	10.1%

Note: 1° quintile = worst 20% companies by score
Source: Refinitiv, GIAM calculations

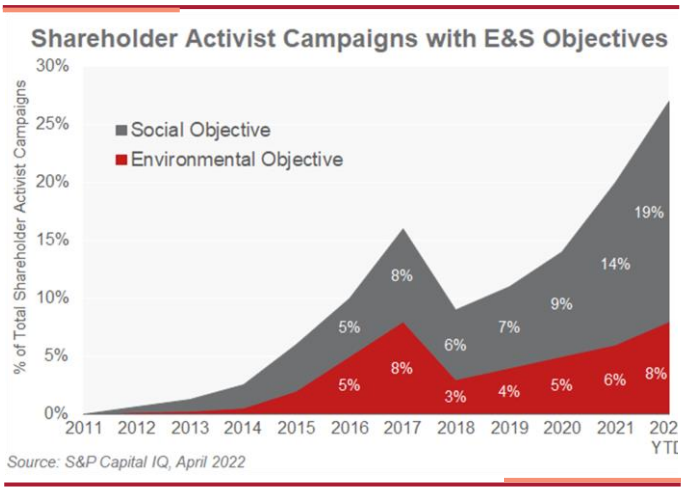
Of course, some caveats apply to this study. First, we only considered Refinitiv Eikon scores. As correlation among scores by different providers is quite low, so results may change when using a different rating source. Furthermore, we only focused on current MSCI Europe members, excluding, at this stage, companies in other geographies or not included in the index. Finally, returns are computed on a 1-year horizon from the expected release date of the ESG Score. As the exact date of release is not available at the moment, it is not possible to perform punctual event studies on scores upgrades. In sum, there is scope to refine and deepen results so far achieved.

4. Pay attention to activist investor campaigns

Stock screening to identify potential targets for activist investor campaigns may generate outperformance, should such campaigns be successful. With activist ESG investing we refer to the combination of the sustainable investing approach and shareholder activism. Investors aim at influencing companies' policies through direct engagement or through voting rights. **Activist campaigns with a focus on environmental and social issues have gained momentum in the past years, doubling in proportion of total campaigns** (from 10% to almost 30%) **in the past 5 years**.

> *The weight of activist campaign over total campaigns doubled in the past 5 years*

This growth has been sparkled by **three main trends**: investors' recognition of ESG as a driver of value creation, the shift towards stakeholder capitalism and the increased focus on social factors, which was amplified by the covid-19 pandemic. **Campaigns focused on social issues are the most prominent** and experience a very high growth, especially from 2018.



Top themes for activist campaigns in the E&S space focus mostly on:

1. Human Capital & Work Force (S)
2. Climate Change & Emissions (E)
3. Social Opportunities and Community (S)

We found evidence in broker research and especially in academic literature – see Dimson et al. (2015), Barko et al. (2021) and Naaraayanan et al. (2021) among others – validating our findings. There is direct evidence that ethical investing and strong performance can go hand-in-hand, say Barko et al. in their study. Engagement from activist investors seems most beneficial – both in terms of ESG performance and financial performance – for firms with ex-ante low ESG performance, suggesting that these investors play an important role in helping firms understand how they can improve outcomes for all their stakeholders.

Literature review: activist ESG investing

A variety of studies have been conducted on the efficacy of activist ESG campaigns. Results are varied and highly dependent on the underlying assumptions, but some interesting facts emerged:

- Dimson et al. (2015) showed that successful engagements addressing environmental, social, and governance concerns are followed by positive abnormal returns. They also noted that success is more probable if the engaged firm has reputational concerns but a high capacity to implement changes. For this reason, collaboration among activists is instrumental in increasing the success rate of the engagements.
- A paper by Barko et al. (2021) shows that ESG activism produces strong performance improvement. Targeted firms in the lowest ex-ante ESG quartile (low overall score) outperformed matched peers by 7.5% in the year after the end of the engagement. Engagement from activist investors seems most beneficial – both in terms of ESG performance and financial performance – for firms with ex-ante low ESG performance. These investors play an important role in helping firms understand how they can improve outcomes for all their stakeholders.
- Naaraayanan et al. (2021) found that activist investing also had very good positive tangible ESG impact. Targeted firms were able to reduce their toxic releases, greenhouse gas emissions, and cancer-causing pollution. These improvements came through an increased capital expenditure on new abatement initiatives.

Market research also found that even a simple strategy of screening ESG laggards improves financial performance:

- Rockefeller AM (2020) created a score that ranks a company's improvement in performance on material ESG issues relative to industry peers. A back tested, hypothetical portfolio of top quintile ESG improvers outperformed bottom quintile ESG decliners by 3.8% annualized in an analysis covering US all cap equities from 2010 – 2020.
- A Barclays Systematic ESG Research Study (2022) found that ESG momentum generated a positive and economically significant return premium: bonds and stocks of US firms with larger improvement in their ESG scores earned higher returns after controlling for the ESG level effect

5. Final Remarks

In summary, specialist asset managers should not ignore companies that have a low ESG score if, and only if, these companies are on track to improve. We believe that accurate ESG analysis and effective engagement is of paramount importance to spot investment opportunities in companies adequately equipped to improve their environmental and social characteristics, because it could generate financial outperformance for investors.

An activist investment approach towards ESG laggards – among other ESG strategies – may contribute to a tangible reduction in their negative ecological and social footprint, while also generating financial outperformance for investors.

A broad, experienced, collaborative ESG team that is integrated across the investment process is therefore crucial for identifying the ESG laggards on the verge of improving, while avoiding the ones that will not.

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