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Stock markets: payback time for the good guys

Funds that invest in ethically run companies obtain above-average results – in Europe too.

by **Gabriele Petrucciani**

Investors’ interest in environmental, social and governance (ESG) issues is growing, as witnessed by the increase in assets managed using ESG sustainability criteria. Studies conducted on the American market show that active portfolio management strategies that integrate traditional analysis models and ESG criteria perform better. The same goes for Europe, as the first study on the Stoxx Europe 600 index, conducted by Banor SIM and Politecnico di Milano, shows. “This is the first study in Europe to be coordinated with a similar study on the US market”, comments Massimiliano Cagliero, CEO and founder of Banor SIM. “Harvard Business School in the US, along with the School of Management of Politecnico di Milano and Banor SIM in Europe, have analysed the relationship between performance and ESG criteria in their respective markets, using a shared approach and methodology”. Taking the period 2012 to 2017, companies with the highest ESG ratings obtain higher differential returns, with a similar standard deviation.

The fuller picture

The market seems, in particular, to reward businesses that pursue good practices overall in the three elements -- environment, social and governance -- rather than in any single one of these. In detail, low ESG stocks (i.e. with a poor ethical “report card”) listed in the Stoxx Europe 600 index achieved a cumulative performance of 70.9% (11.4% was the annual average), compared with +80.5% for medium ESG stocks (annual average +12.5%) and +86.1% for high ESG stocks (annual average +13.2%).

The annual standard deviations were 11.36%, 11.2% and 11.19% respectively. The data also show that the best portfolio investment strategies are those that combine ESG ratings with considerations linked to fundamentals analysis, notably the price-to-earnings ratio, as further demonstration of the advantages to be obtained by adopting an integrated approach to asset allocation. An in-depth analysis of the performance determinants for industrial stocks in the index shows that companies with a high ESG rating were more efficient both in increasing sales and improving operating margins, and in their dividend yield. The evidence is consistent with the assumption that adopting best ESG practices is the source of a long-term competitive advantage. So it is no coincidence that integrating good ESG practices has become a priority. And this doesn't just apply to businesses and investors.

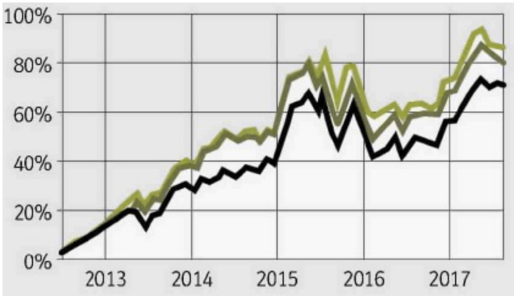
European regulators are also paying closer attention to ESG factors. In fact, the European Commission has tasked a committee with drawing up guidelines that can be applied by the banking supervisory authorities in individual countries. In March a plan with 10 practical actions, referring to communicating and standardising good practice and to the regulatory requirements, was published. In Italy, a law came into force in 2017 giving CONSOB [the Italian Companies and Exchange Commission] responsibility for supervising the dissemination of non-financial information, such as social statements and ESG reports. For listed companies, this year's financial statements, due to be published soon, will be the first to contain non-financial information on environmental and social issues, respect for human rights, and combating active and passive corruption. "On the other side of the Pond people were discussing sustainability issues well before we began to do so here in Europe. The firm commitment to include non-financial parameters in companies' financial statements dates from about 8-10 years ago, and that has undoubtedly created a virtuous circle", says Cagliero. Today there's no longer a strong mandate from American investors for asset management firms that are not ESG-compliant. The flows for firms meeting these criteria have increased. And that has forced companies to adapt and adopt more sustainable measures and behaviours on all three fronts: environmental, social and governance.

Pioneers

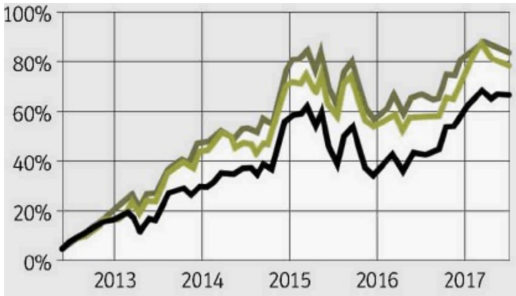
Massimiliano Cagliero, CEO and founder of Banor SIM. With Politecnico di Milano the firm has conducted the first European study on the effects of ESG ratings.

European stocks (Stoxx 600) with good ESG score perform better.

Five-year returns on the basis of ESG rating

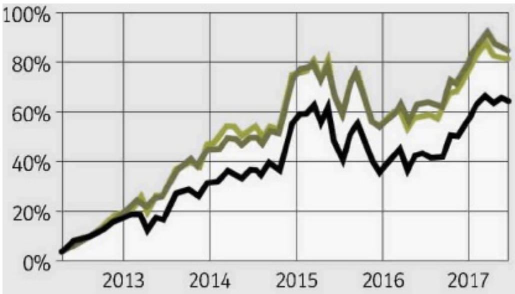


Performance since 2012 of stocks on Stoxx 600 index – environmental rating



Black line: low rating – Grey line: medium rating – Green line – high rating

Performance over last five years of stocks on Stoxx 600 index – social rating



Performance over last five years of stocks on Stoxx 600 index – governance rating