

Environmental, Social and Governance (ESG) – Reality or Utopia?

Expert Insights from Asset Servicing Live Webcast Series

There is a longstanding perception that ESG-focused investment principles are only beneficial for promoting social good. However, with the emergence of machine learning and other technologies that help to extract insights from big data sets, among other factors, the influence of ESG on investment decisions has grown significantly in recent years.

BNY Mellon hosted a live audio webcast titled “*ESG – Reality or Utopia?*” in August, where Frances Barney, Head of Global Risk Solutions and Asset Owner (Americas), BNY Mellon and Dominic Godman, Partner and Head of Singapore, Arabesque¹ shared their insights on how ESG investing relates to traditional risk and return objectives. They explored the integration of ESG factors into traditional investing approaches, investment products and strategies as well as investment stewardship.

The ESG market is maturing

While sustainable investment practices have been around for a long time; until recently, investment managers’ decisions made were heavily influenced by moral factors. Notably, ESG has evolved from negative exclusion to positive inclusion. The investment managers’ mindset has transformed from eliminating investments in businesses connected with sensitive issues such as gambling or tobacco to those that are geared towards responsible investing that can generate better returns for investors and greater social good.

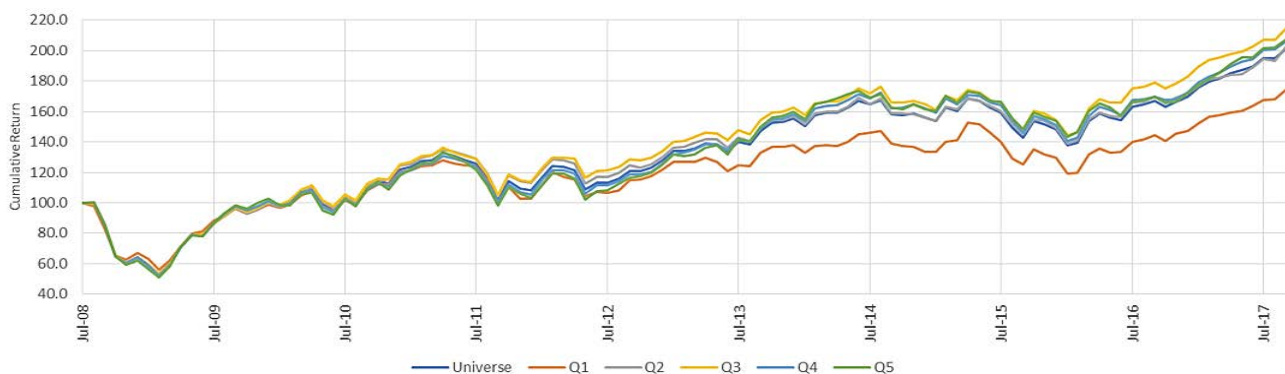
Interestingly, academic studies have shown that there is a strong correlation between ESG scoring models and financial performance of listed companies. Listed companies who have incorporated ESG factors into their governance presented stronger financial performance over time. According to a 2015 review (Freide, Busch & Bassen²), over 60% of 2000+ academic studies has showed a positive correlation (while only 8% showing a negative correlation).

According to insights from Arabesque’s S-Ray™ ESG tool, companies that score well within its model significantly outperform others in the stock market. Between 2008 and 2017, the top 20% of the companies tracked outperformed the bottom 20% in terms of cumulative return by 4.3% annually. (See figures 1 and 2). To illustrate the relationship between scores and stock price performance, Arabesque divides the companies evaluated on the S-Ray into quintiles, based on their Global Compact (GC) and ESG scores. Stocks in GC quintile 1 have the lowest GC scores; stocks in ESG quintile 1 have the lowest ESG scores and so on. The quintiles are re-balanced every quarter.

¹ Arabesque is a global asset management firm, using self-learning quant models and big data to assess the performance and sustainability of companies. Company website: <https://arabesque.com/>

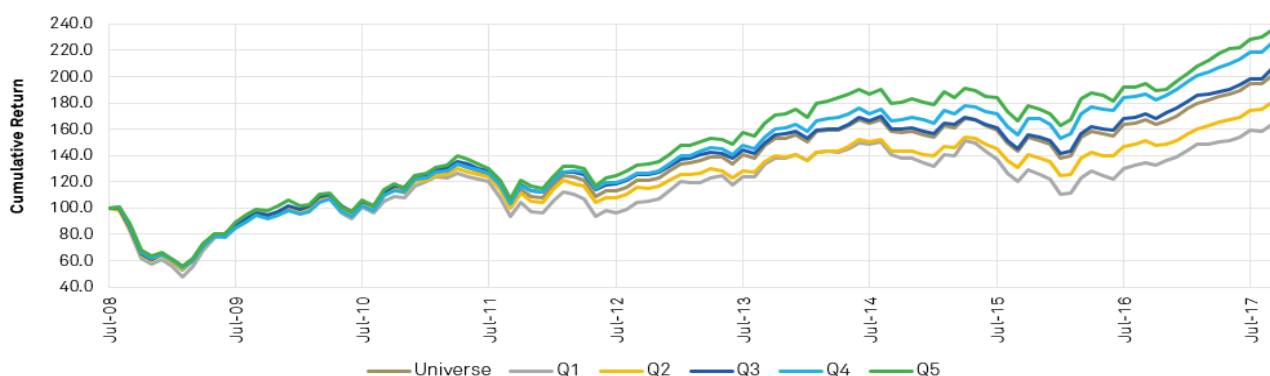
² https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610

Figure 1: S-Ray™ GC Score: Companies with the Lowest Scores Underperform the Stock Market³
The Bottom 20% underperform the overall market by 1.7%



GC score provides a normative assessment of companies based on four core principles of the United Nations GC: human rights, labour rights, environment and anti-corruption. The GC score is used to approximate reputational risk facing companies with lower scores. A lower GC score correlates with a higher likelihood of a company losing its license to operate in the future (e.g., due to a major scandal or controversy).

Figure 2: S-Ray™ GC Score: Companies with superior Scores significantly outperform the Stock Market⁴
The “Top 20%” outperform the “Bottom 20%” by 4.3% annually



Approaches to ESG investing

Currently, there are three key approaches to ESG investing:

- **ESG integration to traditional investing.** This deals with the integration of ESG factors into traditional investing and financial analysis to evaluate risks and opportunities. Typically, the decision-making process does not place considerable weight on social values but rather the understanding that ESG scoring models can give investors an edge by identifying aspects that are not typically priced by the market.
- **Sustainable investing or responsible investing.** This incorporates ESG objectives into investment products and strategies, such as exclusionary screens, ESG investments and impact investments
- **Corporate engagement.** The third approach has emerged as a form of investment stewardship as it involves engagement with companies to protect and enhance the value of clients’ assets.

³. The chart compares the cumulated share price performance of the universe, vs stocks in S-Ray GC quintiles 1-5. Stocks in S-Ray GC quintile 5 outperform stocks in S-Ray GC quintile 1 by 2.0% per annum. Source: Arabesque S-RAY™

⁴. The chart compares the cumulated share price performance of the universe, vs stocks in S-Ray ESG quintiles 1-5. Stocks in S-Ray ESG quintile 5 outperform stocks in S-Ray GC quintile 1 by 4.3% per annum. Source: Arabesque S-RAY™

One of the major barriers to ESG adoption tends to be the lack of thematic and quality of data for ESG, which can leave investors with an incomplete information to take further investment decisions. With the introduction of a stronger regulatory framework – such as the introduction of mandatory sustainability reporting by Singapore Stock Exchange and Hong Kong Stock Exchange – it is possible for investors to overcome these hurdles.

ESG insights at BNY Mellon

BNY Mellon is at the forefront of ESG. In 2015, our Depositary Receipts business was the first in the industry to make available a wide range of ESG data and insight to help clients understand the implications of ESG factors, and provide them with a roadmap to effectively factor these into their overall capital markets strategy.

BNY Mellon's Compliance Monitoring system has the ability to screen and monitor investments based on social and ethical factors. MSCI ESG data is currently available, which consists of over 50 business issues of concern including, alcohol, tobacco, animal welfare, terrorism and weapons. Our system also includes a full universe data-set for environmental controversy factors. Currently, BNY Mellon Compliance Monitoring service assists in monitoring portfolios of multitude of large asset owners globally, and the service has grown over 400% since 2012.

BNY Mellon Global Risk Solutions are working in collaboration with Arabesque to integrate S-Ray™ ESG and GC ratings data in our Global Risk Solutions Analytics services. Further information will be made available as we near release.

With many developments expected in this space globally, ESG is quickly evolving beyond a responsible investor's utopia into a reality for the wider investment community.

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