How so-called "ESG laggards" can drive alpha

Companies that have a poor ESG score but are on track to improve tend to drive outperformance over companies with static ESG records, explain the Investment, ESG and Research teams at Generali Insurance Asset Management[1] (GIAM). GIAM is part of the Generali Investments platform.

- We believe there is value, both financially and in social and environmental terms, in engaging with so-called ESG laggards to help them improve.
- Companies with a low but improving ESG profile tend to outperform the market and their industries.
- 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.

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.

ESG momentum: Why improving ESG laggards are important

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. Our research shows that improvement in ESG characteristics is not only reflected in a company's share price but also its underlying financials, leading to greater long-term value for investors.

ESG laggards that want to improve their ESG 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 investing when a company focuses on improving its ESG approach before the rest of the market catches up. This is why, at GIAM, we believe there is value, both financially and in social and environmental terms, in engaging with ESG laggards to help them improve.

Does the ESG score or the ESG momentum drive outperformance?

Does the ESG score or the ESG momentum of a single company drive outperformance, or a combination of both?

To answer this question, our Insurance & Asset Management Research team 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 lowest 20% of companies by ESG score, with fourth quintile being the top 20%.

We found that combining current the ESG level with momentum could be a promising strategy. An increase of one notch from the first quintile (lowest ESG scores) lead 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.

Similar results were found relative to the whole market and using the average instead of the median, even after controlling for the earnings momentum.

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: 1st quintile = worst 20% companies by score. Source: Refinitiv, GIAM calculations

Pay attention to activist investor campaigns

Moreover, stock screening to identify potential targets for activist investor campaigns may generate outperformance, should such campaigns be successful. 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 20%) in the past 5 years. 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.

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.

Conclusion

In summary, specialist asset managers should take care not to ignore companies that have a lower ESG score if, and only if, they 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 while generating financial outperformance for investors.

GENERALI INVESTMENTS
www.generali-investments.com

1. Full legal name is Generali Insurance Asset Management S.p.A. Società di gestione del risparmio