#WhyESGMatters

Why does ESG matter to equity investors?

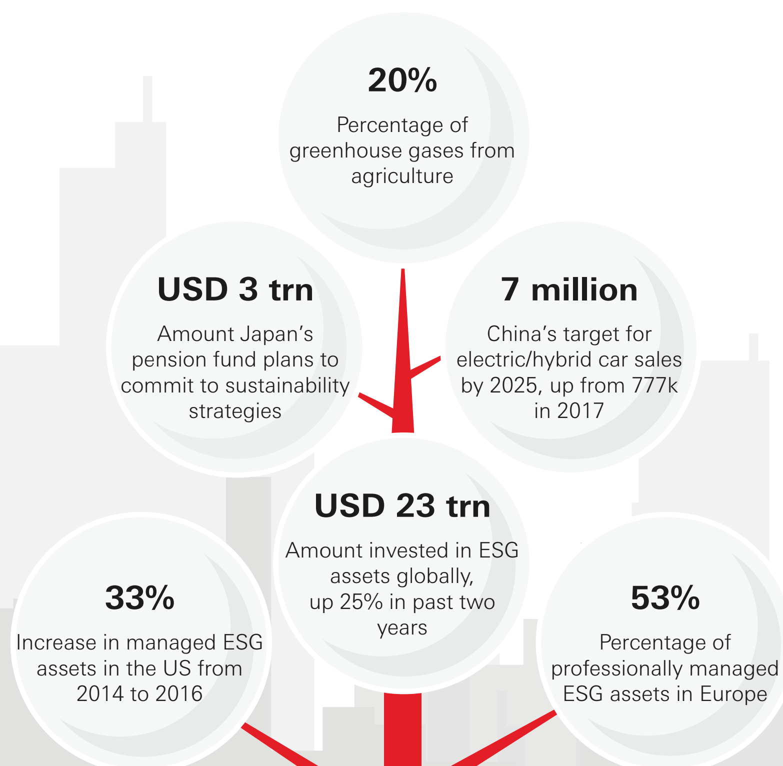
HSBC

Introduction: Why does ESG matter to equity investors?

Environmental, social and governance (ESG) changes are happening faster than ever, reshaping how people live and invest. Understanding how investment portfolios will be impacted by these changes is crucial. Our series of #WhyESGMatters aims to deliver thought-provoking analysis and highlight why ESG is becoming increasingly important for investors to consider in their investment decisions.

In this first issue we focus on why ESG investing matters to equity investors. We believe that ESG factors are going increasingly mainstream and can be used to drive investment outperformance. Investment strategies incorporating ESG are growing fast and now account for over a quarter of professionally managed assets globally. In addition, our analysis shows that 40-50% of medium-term factors driving company performance are ESG issues.

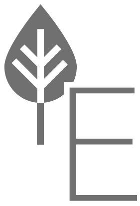
Did you know?



Source: 2016 Global Sustainable Investment Review, Ministry of Industry and Information Technology, MSCI, HSBC
Environmental, social and governance (ESG) investing aims to generate long-term financial returns whilst contributing positively to society

1. ESG going mainstream

Examples of common ESG issues



Climate change impact
Air & water pollution
Waste management
Energy efficiency
Water scarcity

Human rights
Consumer privacy
Gender equality
Data security
Health & safety

Board structure
Company ownership
Financial reporting
Business ethics & culture
Executive remuneration

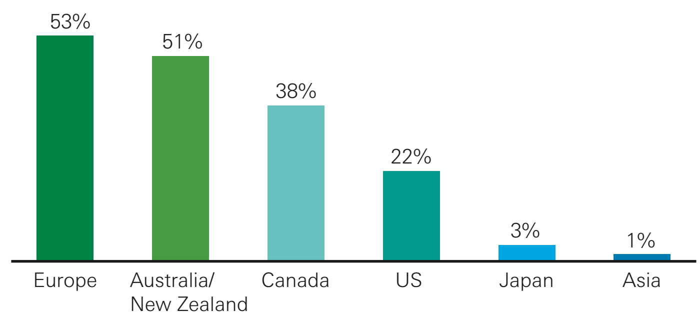
ESG going mainstream
ESG investing aims to generate long-term financial returns whilst contributing positively to society. We believe that its adoption is set to grow at an accelerating rate over the coming years, driven by asset owners, risk mitigation and return objectives.

Every country in the world is now part of the Paris Agreement, which aims to limit global warming, whilst broader regulatory and ESG disclosure pressure continues to grow. Integrating ESG into mainstream financial analysis is also gaining relevance.

We see three main factors driving ESG asset growth:

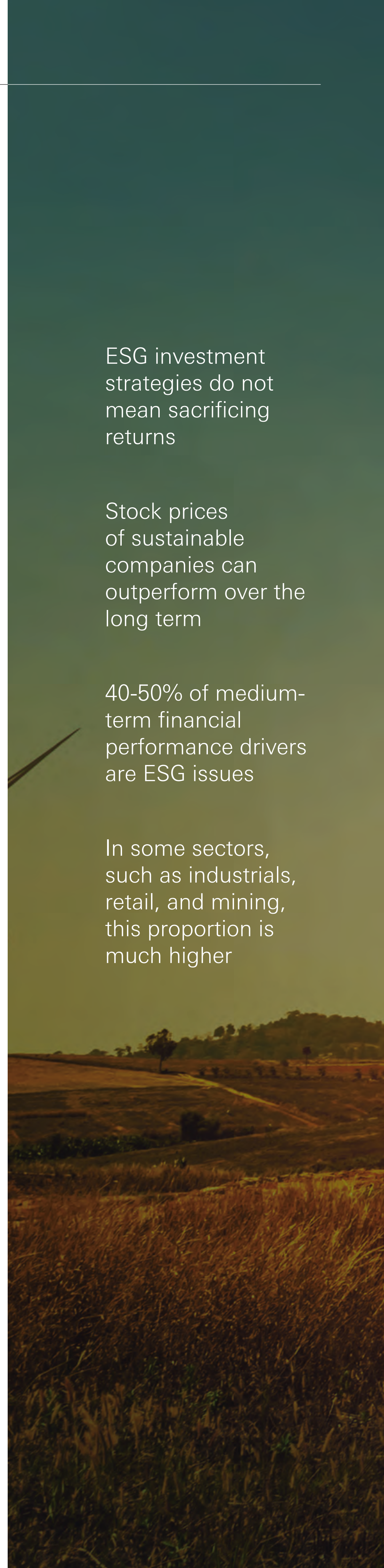
- Demand from asset owners – asset owners worldwide have embraced the notion that long-term sustainability needs to be embedded in their investment processes.
- Risk mitigation – ESG factors can be financially material. For example, climate change presents the risk of damaged assets, changing regulations, and more frequent catastrophic events.
- Creating alpha (returns in excess of the market return) – companies that are focused on addressing, combatting, and developing solutions to ESG concerns can be a source of alpha. For example, companies well positioned for a greener China, a key government focus, could achieve both environmental and financial goals.

ESG assets as % of total managed assets in regions



Source: 2016 Global Sustainable Investment Review

2. ESG drives value



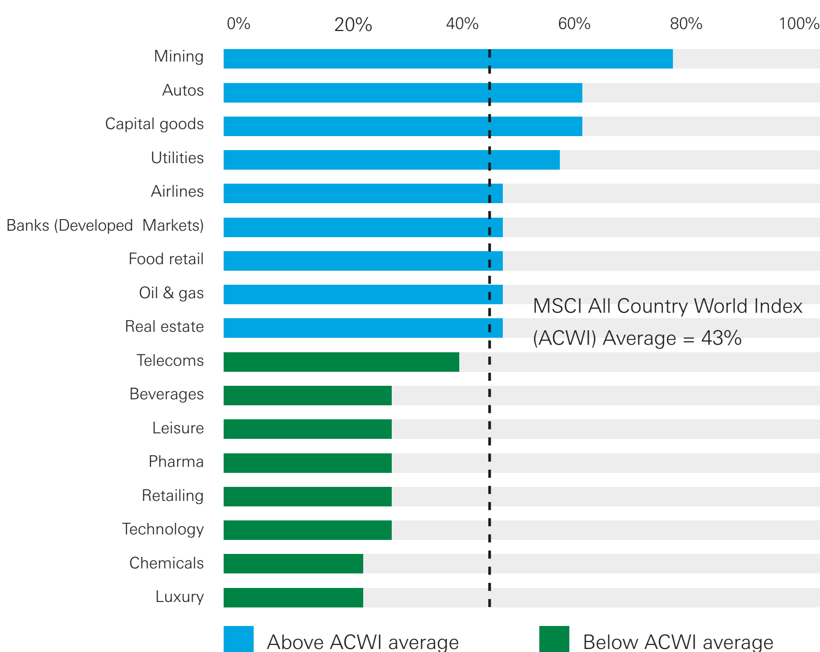
No need to sacrifice returns
ESG is slowly starting to shake the perception that ESG strategies mean sacrificing returns. This is helped by a number of academic studies which say that sustainable companies outperform their counterparts over the long term, both in terms of stock market and accounting performance[1].

In addition, a 2015 meta-study review[2] of more than 200 studies on ESG factors and resulting company performance found that 80% of studies showed that prudent sustainability practices have a positive impact on investment performance.

ESG drives financial performance
Our analysis shows that ESG issues make up an estimated average of 43% of the key medium-term (2-5 years) financial performance drivers, and they are relevant in every sector (chart below). This rises to an average of 50% for emerging markets. In some sectors, such as mining, autos and capital goods, this proportion is much higher.

Further, our findings suggest that share prices of companies with improving ESG metrics have far outperformed those that are lagging. On the flip side, companies with high ESG scores but weak momentum over the last five years significantly underperformed. This highlights that it is the direction of travel and the ongoing progress with ESG issues that really drives share price performance.

Ranking of ESG issues as % of key medium-term sector drivers



Source: MSCI, HSBC Global Research
1. Examples include, Eccles, Ioannou, Serafeim, 2011 "The Impact of Corporate Sustainability on organizational processes and performance", and Khan, Serafeim, Yoon, 2015 "Corporate sustainability: first evidence on materiality"
2. From the stockholder to the stakeholder: how sustainability can drive financial outperformance

3. ESG investment strategies

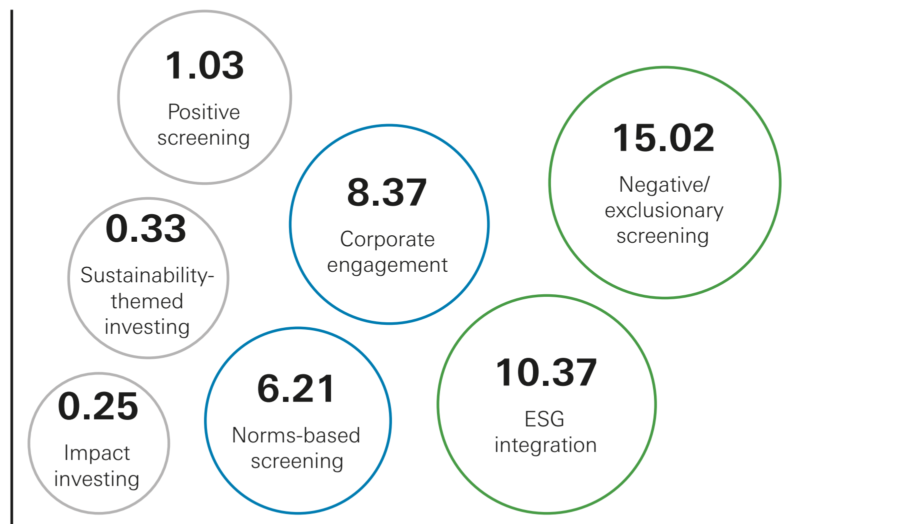
Negative screening is the most widely used ESG investment strategy

Investing in companies with strong ESG scores and positive ESG momentum is also a popular strategy

Approaches to using ESG differ significantly
While ESG is increasingly becoming a mandate, many institutional investors still wonder how to integrate it into their investment processes. Negative/exclusionary screening still dominates, especially in Europe, but institutional investors are also focusing on integrating ESG factors into their process in order to maximize risk-adjusted returns.

Although we expect that negative screening will continue to represent the majority of ESG assets globally, investors are also focusing on companies that score well on certain ESG factors and have positive ESG momentum. Our analysis shows that companies with low and improving ESG metrics have significantly outperformed those with high and falling metrics.

ESG assets by strategy (USD Trn)



Source: 2016 Global Sustainable Investment Review

Conclusion
ESG factors have become both too widespread to ignore, and too relevant for asset owners to overlook. Investment strategies incorporating ESG have seen rapid growth in recent years and now account for over a quarter of professionally managed assets globally. We believe that ESG factors can be used to drive portfolio outperformance and investors should consider these factors when making investment decisions.

Example ESG strategies	Definition
Negative/exclusionary screening	Focused on excluding the "sin" stocks, e.g. cluster munitions, alcohol, tobacco, and gambling
ESG integration	The systematic inclusion by managers of ESG factors into traditional financial analysis
Corporate engagement	The use of shareholder power to influence corporate behaviour
Norms-based screening	Excluding investments that do not meet minimum standards of business practice based on international norms
Positive screening	Including stocks of companies that show positive ESG performance
Sustainability-themed investing	Including stocks of companies that pursue sustainable development
Impact investing	Targeting specific environmental or social outcomes along with financial returns

Disclosure appendix

Additional disclosures

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