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MARKET INSIGHT

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> "Companies with improving ESG credentials tend to achieve higher returns than companies with deteriorating ESG credentials."

FIGURE 1
ANNUALISED RETURNS OF HIGH AND LOW CONTROVERSY RISK PORTFOLIOS

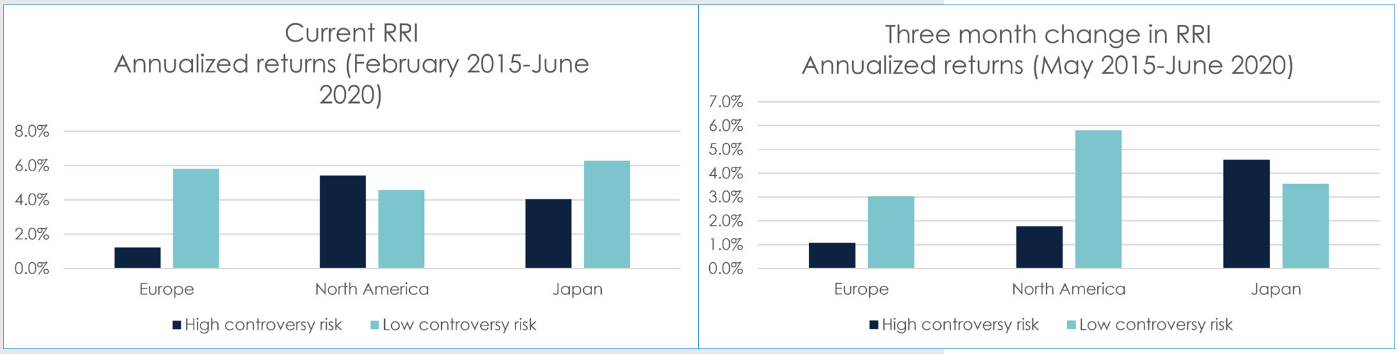

TABLE 1

			Betas			
Region	Indicator	Annualised alpha	Market	Size factor	Value factor	Momentum factor
Europe	ΔRRI 1 month	**2.4%**	0.03	0.11	0.00	0.01
North America	ΔRRI 3 month	**4.8%**	**-0.11**	-0.06	**-0.11**	-0.11
Japan	ΔRRI 1 month	**-3.6%**	0.02	0.00	-0.10	-0.10

DOES IT PAY TO LOVE THE ANGELS AND HATE THE SINNERS?

OVERVIEW

There is no doubt that the widespread investor interest in sustainable investing is good for society, but is it beneficial for investors? Our research shows there is no real return difference for companies subject to either high or low ESG controversy risk. However, companies with improving ESG credentials tend to achieve higher returns than companies with deteriorating ESG credentials. What therefore matters for future performance is the dynamics of the firm's ESG risk exposure.

TRUST WHAT YOU CAN SEE

Controversies measure a firm's reputational risk related to ESG issues (e.g. lawsuits, fatalities, etc.) and can be viewed as the direct consequence of a firm's inability to properly integrate ESG into its corporate strategy. If investors view this inability as a factor that can jeopardise a firm's prospects, firms that are experiencing severe controversies ("sinners") will likely under-perform those that are experiencing either little or no controversies ("angels"). There is one particular advantage of using controversies rather than ESG ratings for this type of assessment: public controversies don't solely rely on information released by the firm, thus mitigating the impact of "greenwashing".

The RepRisk Index (RRI) dynamically quantifies firms' reputational exposures to ESG and business conduct risks. It relies on a natural language processing algorithm to quantify the impact of ESG issues on a firm's reputational risk by screening over 90,000 external sources of information (print media, social media, etc.) in 20 different languages.

We use three distinct indicators to quantify reputational risk: the RepRisk index (RRI), its one month change and its three months change.

ASSESSING THE IMPACT OF ESG RISK

At the beginning of each month, we sort stocks based on their controversy risk indicator. For each indicator, we track the performance of a portfolio containing companies in the top decile of ESG risk, the bottom decile, and the difference between the bottom and top decile during the next month. We rebalance the portfolio each month based on the value of the controversy risk indicator, and report the absolute performance of the portfolios in each region and their risk-adjusted performance.

CHANGES IN ESG RISK MATTER FOR FUTURE PERFORMANCE

In this study, we used RepRisk data between February 2015 and June 2020. The left panel of Figure 1 reports that firms with low controversy risk outperform those with high controversy risk in both Europe and Japan. However, here the outperformance is not statistically significant.

The right panel shows that in both Europe and the U.S., companies with low controversy risk outperformed those with high controversy risk. The annualised return differential is statistically significant in North America.

Table 1 reports the risk-adjusted returns of a portfolio that invests in low controversy risk firms (bottom decile) and shorts firms with high controversy risk (top decile). For each region, we report the indicator that yields the most significant risk adjusted performance from a statistical point of view. Numbers in bold are statistically different from zero.

In Europe and North America, the alpha of the portfolios that invest in stocks that are experiencing a strong decrease in controversy risk and shorts those that experience a strong increase in their risk is positive and statistically different from zero. Conversely, Japanese firms that have increasing controversy risk outperform those that have decreasing controversy risk. In North America, companies with high controversy risk appear to have a higher market beta and a higher exposure to the value stocks than those with low controversy risk. Additional results can be found in our technical paper that is available on Asteria's website.

Our findings show that shorting "sinners" and buying "angels" does not harm performance but does not generate statistically significant alpha. However, companies that have decreasing controversy risk tend to outperform companies that have increasing controversy risk. Investors should therefore focus on the "sinners" that are on the road to redemption and avoid the "angels" that sin.

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