ESG Matters - Global

When bad news hits good companies

Thematic Investing

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Headline risk too big to ignore, even for "good" companies

Environmental, social, and governance (ESG) controversies can be costly, and even highly regarded companies are subject to reputational risk. We estimate more than $600bn of market cap for S&P 500 companies has been lost to "ESG controversies" such as data privacy issues or governance failures in the last seven years alone. Traditional ESG ratings often do not reflect emerging controversy risks in real time, and alternative data providers like RepRisk or Truvalue Labs, which leverage natural language processing to assess such risk, can be a useful adjunct, in our view. Our analysis of one such provider (RepRisk) found evidence that controversy data may help inform short-term investment performance.

Own well-ranked ESG names but beware controversy risk

Our backtests found RepRisk's controversy data to be an effective alpha signal for a broad universe of US companies. Russell 3000 stocks with falling (less risky) controversy scores consistently outperformed those with rising (riskier) controversy scores by up to 3ppt per year from 2007 through 4/2020. Results were more mixed on a sector basis, though our work suggests controversy data has been a better signal of alpha in Real Estate, Utilities and Financials. Interestingly, stocks highly ranked on ESG metrics or highly owned by ESG funds were not immune to reputational risk (see below for more on our backtesting). "Good" companies with high ESG scores as measured by Sustainalytics tended to underperform when their RepRisk scores jumped (i.e. risk increased).

A particularly effective signal in small caps

ESG controversy data provided a useful tool for assessing ESG risk in small caps, where ESG disclosures are more limited. Based on our backtests, we found that while RepRisk scores were a particularly effective alpha signal for small – where annualized alpha based on either low vs. high RepRisk scores or rising vs. falling RepRisk scores over 1/3/6 mos. ranged from 5-6ppt, vs. 2-4ppt within large caps.

Low ESG risk rewarded handsomely in Europe

Within Europe, low ESG risk stocks commanded persistently higher valuation premiums to high ESG risk stocks over past decade. Moreover, our analysis showed high ESG risk stocks underperformed the equally-weighted MSCI Europe index by 26ppt since 2008, while low ESG risk stocks outperformed. Backtested results were fairly consistent across sectors, with a majority showing stronger risk-adjusted returns with an ESG Risk overlay. In Styles, controversy data reduced portfolio risk, while Quality and Large caps noted improved returns as well. Finally, within ESG popular stocks in Europe, those with low ESG risk outperformed those with high ESG risk by 20ppts over the last 5 years.

Lower ESG risk exposure favored across Asia Pacific

In Asia-Pacific, we also found controversy data provided a meaningful signal on stock outperformance . Similarly, our backtesting found companies which posted improving controversy risk (less risk exposure) outperformed those with deteriorating risk, while companies with no change underperformed those with improving profiles.

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Refer to important disclosures on page 21 to 23.
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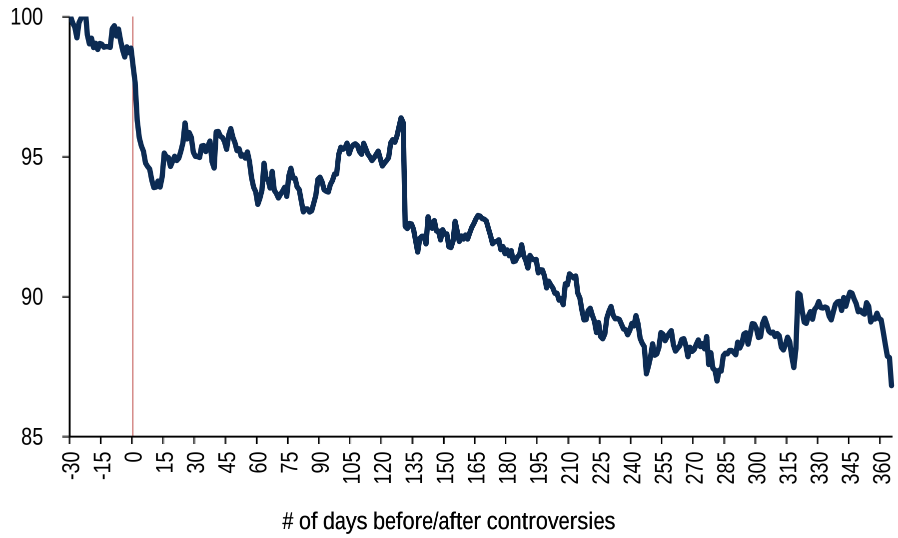
ESG controversies are costly: mind reputational risk

$600bn in market cap destroyed by ESG controversies in the last 7 years

Environmental, Social and Governance (ESG) controversies, which can include issues such as oil spills, data breaches, workplace harassment, accounting scandals and other governance failures, can be especially costly and long-lived. Even highly regarded companies are subject to such reputational risk. A case study of ESG controversies found that major ESG-related controversies for large US companies were accompanied by peak-to-trough market capitalization losses of more than an estimated $600bn in the last seven years alone, against a backdrop in which the S&P 500 grew by 6% on average (see "S&P ESG controversy case study" in the Appendix for more information).

Chart 1: More than $600bn of value has been lost due to ESG controversies since 2013

Average peak-to-trough performance of ESG controversy stocks relative to the S&P 500 (market cap weighted, 30 days prior to through 360 days post controversy)



Source: BofA US Equity & Quant Strategy

Assessing ESG risk through RepRisk data

Many traditional ESG ratings providers use company reports and other self-disclosed sources and therefore often do not incorporate information on emerging controversies in real time. Alternative ESG data providers that use artificial intelligence to assess ESG risk may be a helpful tool to augment the investment process by highlighting emerging controversies. RepRisk is one of these providers and leverages natural language processing capabilities to screen hundreds of thousands of documents daily from credible third party data sources around the globe. See the Appendix for detailed methodology for RepRisk scores (referred to as RepRisk Index).

RepRisk assesses the ESG risks companies are exposed to, which can have reputational, compliance and financial impact on a company. RepRisk scores are based on news flow research that is both human and machine-based. Additionally to the risk exposure scores, RepRisk also provides information on the violation of the UN Global Compact Principles (including the severity of the violation).

In this report, we analyzed RepRisk data as a signal for ESG controversy risk to assess their effect on investment performance. We found evidence that in the US, Europe and Asia, stocks with low (less risky) RepRisk scores consistently outperformed those with high (most risky) RepRisk scores over the period studied, based on our backtesting methodology.

We also explored what happens when stocks that are highly rated on ESG or highly owned by ESG funds face emerging ESG controversies. These stocks were not immune to reputational risk. In fact, we found that "good" companies with high ESG scores as measured by Sustainalytics tended to underperform when their controversy ranks jumped (i.e. risk increased).

Backtesting disclosure:
The analysis of ESG controversies on stock price performance based on RepRisk ESG scores in this report is backtested and does not represent the actual performance of any account or fund. Backtested performance depicts the hypothetical backtested performance of a particular strategy over the time period indicated. In future periods, market and economic conditions will likely differ and the same strategy will not necessarily produce the same results. No representation is being made that any actual portfolio is likely to have achieved returns similar to those shown herein. There are frequently sharp differences between backtested returns and the actual returns realised in the actual management of a portfolio. Backtested performance results are created by applying an investment strategy or methodology to historical data and attempts to give an indication as to how a strategy might have performed during a certain period in the past if the product had been in existence during such time. Backtested results have inherent limitations including the fact that they are calculated with the full benefit of hindsight, which allows the security selection methodology to be adjusted to maximise the returns. Further, the results shown do not reflect actual trading or the impact that material economic and market factors might have had on an investor's decision-making under actual circumstances. Backtested returns do not reflect advisory fees, trading costs, or other fees or expenses. Backtesting is hypothetical in nature and not indicative of future performance.