ESG dissection of European equities

An empirical analysis of ESG factors and pillars and the implications for European equity markets

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Key points

- Our research shows the highest-rated ESG stocks have generated an average outperformance of 29 basis points versus the STOXX Europe 600 index over a three-month investment horizon[1]
- This outperformance appears to be driven by the environmental and social pillars, which are the only ones to generate a premium when applying this bucketing strategy
- Companies with a one-notch ESG rating downgrade tend to underperform regardless of the pillar that declines

Responsible investing has gained significant traction over the past decade, with environmental, social and governance (ESG) factors attracting greater attention[2]. ESG scoring systems enable investors to examine these aspects when making investment decisions. While some aspects of the data available need improving[3], there is a broad agreement that the evolution of these tools is continually getting better. ESG investing is continuing to gain prominence and an increasing demand for ESG investments appears to be outstripping supply[4]. ESG principles require regulation, and certainly Europe seems to be ahead of the curve on this front (Exhibit 1).

In this paper, we investigate whether a three-month risk premium arises, based on ESG scores – as well as from each of the individual environmental, social and governance pillars.

Given the structural lead in Europe with regards to these principles, we based our study on Europe's STOXX 600 market index and on the ESG scores provided by MSCI, which we believe has the most comprehensive database. Of course, a multitude of scoring agencies exist and as such there will be discrepancies between them[5]. Therefore, any analysis based on different ESG scores could potentially lead to different results.

[1] European stock market STOXX 600 Index, three-month excess return i.e., three-month absolute return – three-month Stoxx Europe. Q#: refers to Quintile bucketing. Study sample starts in October 2017.

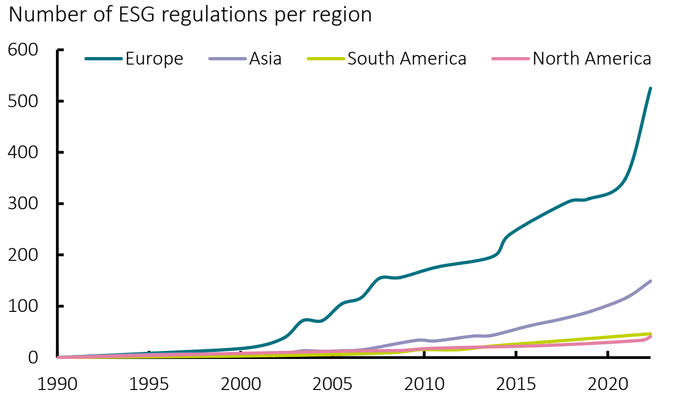
[2] "Overview of sustainable finance", European Commission, 6 July 2021)

[3] 'The ESG premium", McKinsey, 12 February 2020

[4] "Asset and wealth management revolution 2022: Exponential expectations for ESG", PwC, 2020

[5] Berg, F., Kölbel, J., Rigobon, R., "Aggregate Confusion: The Divergence of ESG Ratings", SSRN, 26 April 2022

Exhibit 1: Europe as a guide



Source: Principles for Responsible Investment and AXA IM Research, February 2023

Valuation: A discreet pattern

This section investigates valuation levels by ESG rating quintiles – to see if a particular pattern within the European stock market emerges, i.e., a higher premium for better rank (Exhibit 2).

Exhibit 2: Average 12-month forward PE by score quintile (Q)

	ESG	E	S	G	Market
Q1 - Best	20.5	21.0	20.0	20.3	
Q2	21.4	20.3	22.1	21.5	
Q3	20.1	19.2	20.3	21.2	20.6
Q4	20.9	19.7	19.8	21.0	
Q5 - Worst	19.5	22.5	20.9	19.0	

Source: IBES and AXA IM Research, January 2023

The highest-rated ESG stocks (ESG column, Q1 row) is trading at a minimal discount of about -0.4% relative to the market's next 12-month price-to-earnings (PE) ratio. We note the ESG first quintile (Q1) basket is currently trading at a -9% discount; this drop can be explained by the derating this basket of stocks underwent in 2022. Q2 is trading with a premium of about 4% which has remained relatively constant despite last year's sharp market correction – explained by the overweight in the consumer staples and financials sectors, both of which have repriced relative to the market. Overall, investors do seem to have less appetite for stocks with poor ESG ratings, as suggested by the PE discount of -5% on average for Q5 versus the market.

The environmental pillar as a standalone shows valuation levels which follow a consistent ranking, except for the worst-in-class bucket Q5. The highest-rated companies (Q1) are valued at a premium of about 2.5% relative to the market and the premium erodes as the environmental score declines. The Q1 valuation was quite resilient over 2022, trading at a 10% premium on average. The premium in Q5 can be mostly attributed to the appreciation of defensive sectors relative to the market in the past year, by +126 basis points (bps) to a 36% premium. Indeed, Q5 historically comprises 13% of Food, Beverage, and Tobacco and 7% of Pharmaceuticals.

The social and governance pillars do not appear to display a discernible pattern in terms of multiples. The Social pillar's Q2, which consists of A and BBB rated companies, is trading at an average premium of 7% relative to the market, while Q1, composed of higher-rated companies (AAA, AA and A), trades at a discount of about -7%. In the governance pillar, the potential for improvement in European equities may have some way to go as very few stocks in the STOXX Europe 600 index are rated AAA (just 11 out of 600 companies as of October 2022).

Best-in-class strategy offers some reward

Below we examine whether a strategy which favours companies with high ESG ratings or its individual pillars provides a tactical source of alpha over the market (Exhibit 3).

Exhibit 3: Average three-month excess return by score quintile

	ESG	E	S	G
Q1 - Best	29	29	20	-9
Q2	-65	-24	-34	-43
Q3	15	-57	-50	-8
Q4	-54	-18	-73	-71
Q5 - Worst	-110	-114	-48	-56

Source: Bloomberg and AXA IM Research, January 2023

Starting with the ESG factor, the 'long' best-in-class strategy is in our view the soundest. Over a three-month horizon, this strategy delivers an average excess return of 29bps against the market providing a positive outcome nearly 60% of the time. Moreover, we note this factor has shown consistency during a highly difficult 2022, performing slightly above average by 34bp. However, the Q5 sector was heavily impacted. The worst quintile underperformed the market by -7.5% pulling the long-term average down to -110bps from 20bps before 2022.

In the environmental pillar, the long best-in-class strategy has provided an excess return of 29bps over three months on average, albeit just, as the hit ratio at 48% is below 50%. The best-in-class strategy in the social pillar has delivered an excess return of 20bps with a positive hit ratio (57%). Finally, the governance pillar – implemented as a long-only strategy – does not seem to have generated any excess return over a three-month horizon.

Stock picking: Some reward down here

In this final section we study the average performance of downgraded/upgraded stocks to assess whether re-ratings in ESG scores can offer any excess return (Exhibit 4).

Exhibit 4: Average three-month excess return by notch change

	ESG	E	S	G
2	98	-598	-480	337
1	-287	69	108	-76
0	-104	-61	-64	-64
-1	-143	-116	-157	-101
-2	-338	252	-505	-26

Source: Bloomberg and AXA IM Research, January 2023

Overall, around 20 companies have their ESG ratings upgraded each month. We observed that over a three-month period, only the companies that have been upgraded by two notches have delivered a positive performance of 98bps with a positive excess return in 64% of cases. We would add some caveats to this finding; a small number of companies – on average two per month – had their ESG score upgraded by two places. However, companies whose scores were downgraded were sanctioned in all cases.

For the environment pillar nearly 35 companies had their score raised by one notch each month. On average, firms in this case outperform the European stock market by 69bps over the three months.

In addition, more than 60% of companies are ranked below single-A in the Social rating. On average, 21 companies have improved their score by at least one notch each month. We found that only the companies whose social score increased by one place have outperformed by 108bps in the three months following the increase.

On the other hand, companies with an environmental score lowered by one notch tend to undershoot the market. An exception is companies that have been downgraded by two notches, largely made up of companies from the Energy sector. The robust performance of the sector since the beginning of the fourth quarter in 2021 largely helped improve this average.

We also found that the wide gap in excess return of the two-notch upgrade for both the environmental and social pillars is mainly explained by a one-off period in July 2021 when Energy and Consumer Discretionary (the largest sector of the bucket) underperformed the market.

Thereafter, about 30 companies had their governance score upgraded by at least one position each month. Only the companies whose score was increased by two outperformed the market (+337bps) while the other upgrades did not outperform the STOXX 600 index over a three-month horizon.

Overall, we did not observe any three-month performance patterns among companies with improved ESG ratings. We believe that the three-month investment horizon is rather short to observe the benefit of a structural factor such as the one studied. Nevertheless, we note that companies reduced by one notch consistently underperformed the market, regardless of which pillar was impacted by the downgrade. Furthermore, companies where social and environment pillars have been downgraded by one notch are the most impacted, which can also be observed over a longer investment horizon[6].

[6] Glïck, M., Hüble, B. and Scholz, H., "ESG rating events and stock market reactions", SSRN, 31 March 2022

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