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Building ESG momentum in US equities

Why investors should care about ESG trend in US equities

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US ESG (Environmental, Social and Governance) investors are increasingly likely to benefit as the country's companies close the gap with best-in-class global companies on ESG disclosure and performance. The trend towards ESG in the United States is being driven by asset owners demanding ESG integration into corporate business strategies, investors using it as a source of alpha[1], and regulators looking to formalise ESG into its rules and protocols. A growing body of empirical evidence suggests that companies with improving ESG momentum have been correlated with positive risk-adjusted returns. These ESG improvers are companies with solid business fundamentals that are demonstrating positive momentum in addressing ESG risks and opportunities. **We believe that an investment focus on firms, combined with an emphasis on sustainable, high-quality business models, can potentially uncover unique sources of alpha and deliver consistent outperformance for active equity investors.**

Key observations:

- Through the first half of 2020, the United States lagged other countries and regions in ESG, based on ESG ratings by major ratings providers.
- Momentum has been building in US firms closing the gap with the best-in-class ESG firms globally.
- There is increasing evidence to suggest that improving ESG momentum at US companies can drive positive risk-adjusted returns, thus, all else equal, providing key support to an investment case for being ahead of the curve by investing in ESG improvers.
- If Joe Biden wins in November and the Democrats sweep Congress, we expect a sharp acceleration in US ESG leaders and improvers relative to global peers.
- We believe that integrating ESG criteria into an investment strategy and a focus on sustainable, high-quality business models will be advantaged by an improving ESG landscape, as there is a close relationship between ESG and earnings quality.

"An investment focus on firms, combined with an emphasis on sustainable, high-quality business models, can potentially uncover unique sources of alpha and deliver consistent outperformance for active equity investors".

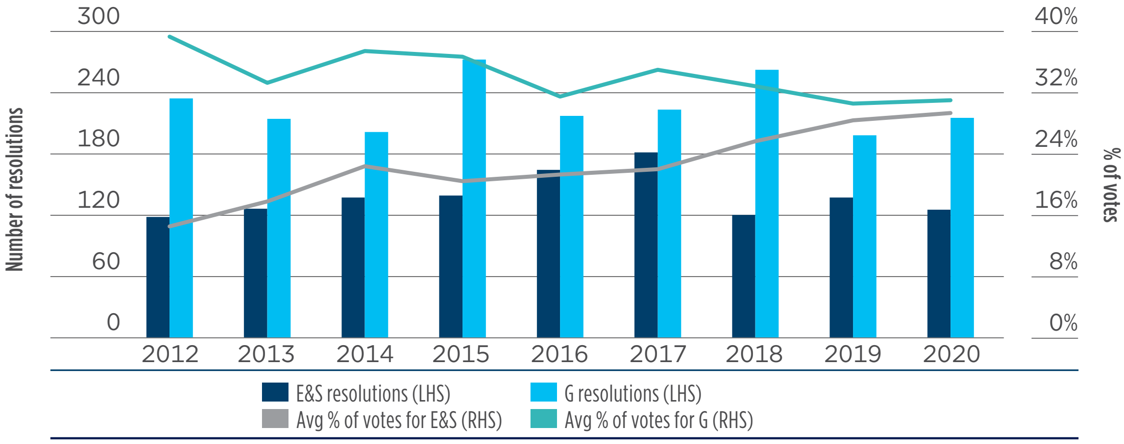
US closing the ESG data gap

Even without new federal regulations, improvements in ESG data and disclosures are gaining momentum among US companies. The lack of disclosure is a meaningful reason for the ESG scoring gap between US companies and what we consider to be global best-in-class ESG:

- Environmental and social shareholder resolutions are gaining traction in corporate proxies. Goldman Sachs observed that the average support for environmental and social shareholder resolutions from the recent proxy season was just over 29% among S&P 500 companies, very close to the average support levels of governance-oriented resolutions for the first time ever.
- Levels of support this past proxy season were about twice what they were seven years ago.
- The bulk of environmental and social resolutions called for greater transparency and improved disclosure; thus the United States should continue to close the gap in investor-relevant ESG data versus other regions.

[1]Alpha is the excess return of an investment over a benchmark.

Figure 1. S&P 500 2020 shareholder resolution statistics



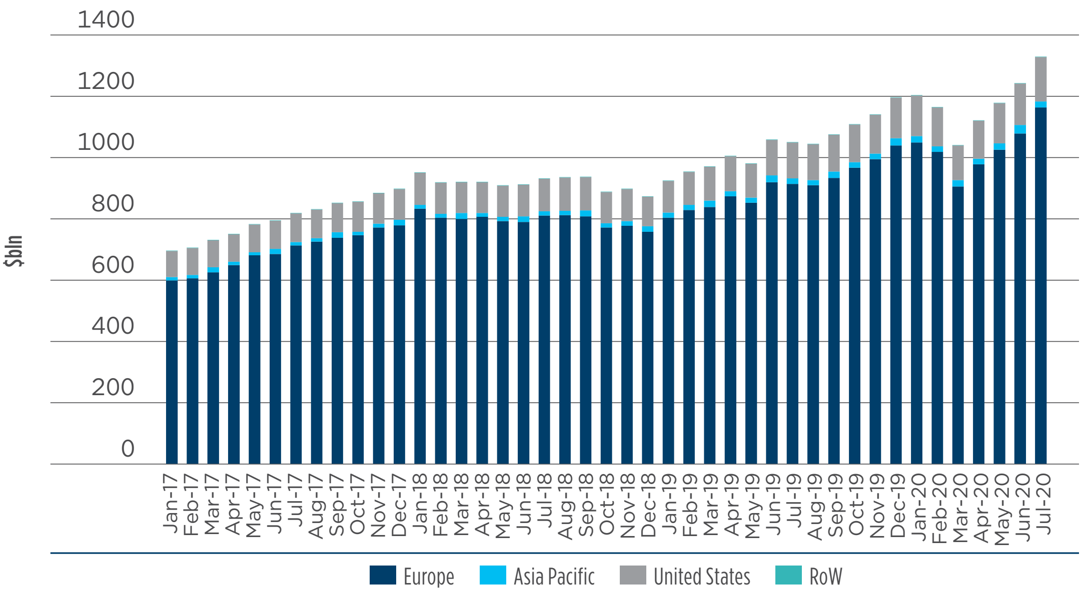
Source: Goldman Sachs. Data as of 30 September 2020.

"Sustainable fund flows in the United States continued at a record pace in the second quarter, with estimated net flows of $10.4 billion, according to Morningstar".

Investor flows are a key driver of increased ESG disclosure

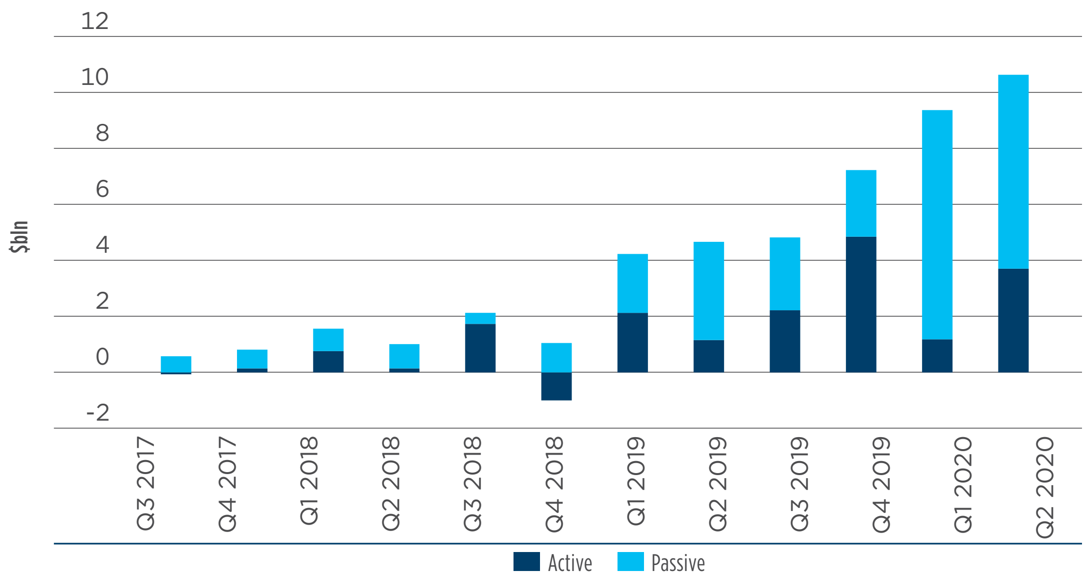
- While Europe accounts for about 75% of ESG mutual funds globally, growth is building in both US retail and institutional channels in the United States. Specifically, in the United States, ESG AuM has increased from $96 billion at the beginning of 2017 to $145 billion as of July 2020. We would expect this growing support to drive the emerging theme of ESG Improvers in the United States.
- There has been a huge spike in flows into ESG retail strategies in 2020, according to Morningstar data. Sustainable fund flows in the United States continued at a record pace in the second quarter, with estimated net flows of $10.4 billion, according to Morningstar. That nearly matched the record set in the first quarter and brought the total for the first half of 2020 to $20.9 billion, just shy of the annual record of $21.4 billion in sustainable fund net flows set in 2019. This is unambiguous support that has been driving the emerging theme of ESG improvers in the United States.

Figure 2. Global monthly ESG AuM by region, $bln



Source: Morningstar, annual data, plus YTD through 31 July 2020. Includes open-end active and passive mutual funds, not including money market funds. RoW: Rest of world.

Figure 3. US ESG Flows



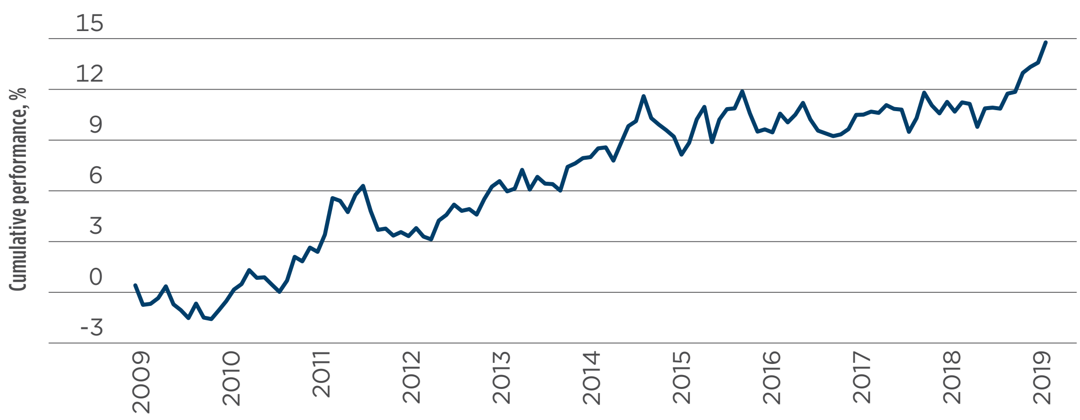
Source: Morningstar. Data as of 30 June 2020. Includes active and passive open-end funds, not including money market funds.

"Companies on an improving ESG trajectory can potentially provide a financial re-rating opportunity, which can impact their stock positively".

ESG momentum (i.e., ESG improvers) has generated alpha

Companies on an improving ESG trajectory can potentially provide a financial re-rating opportunity, which can impact their stock positively. Research from MSCI and the UN Principles for Responsible Investment (PRI) finds that ESG momentum, defined as year-over-year improving ESG scores, boosted risk-adjusted returns between 2009 and 2018. Specifically, the PRI study concluded that companies in the United States stand to benefit from an upward trend in ESG scores, based on an analysis of a hypothetical portfolio measuring the performance of companies with improving ESG scores over a ten-year period ending in June 2017.

Figure 4. Developed markets ESG momentum, top quintile vs. bottom quintile



Source: UN Principles of Responsible Investment. Data as of 30 September 2020. ESG momentum refers to year-over-year improvements in ESG scores. Backtest is top versus bottom ESG momentum quintiles as measured by UN PRI.

Further, the UN PRI's US ESG momentum portfolio had better risk-adjusted returns relative to portfolios with static ESG ratings. This was based on the finding that the US component of the UN PRI portfolio had the highest information ratio, which indicates whether a portfolio is achieving a higher return in excess of the benchmark given the

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amount of risk taken, relative to other major global regions. If US companies improve their ESG profiles via best-in-class ESG practices and better disclosure relative to the rest of the world, we would expect a meaningful alpha opportunity, all else equal.

Table 1. Risk-adjusted returns, US ESG improvers vs. world and major regions

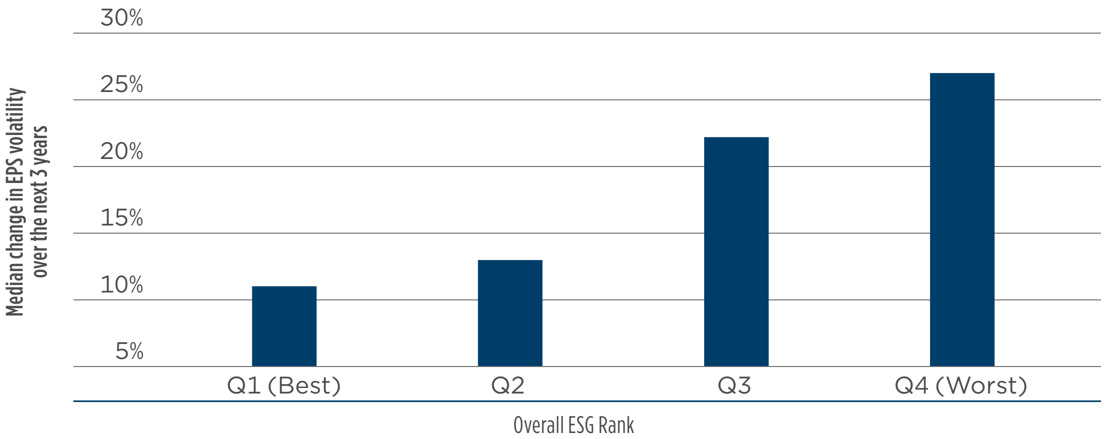
ESG Momentum *(ESG Improvers)*	
World	0.72
United States	0.69
Europe	0.44
Japan	0.65

Source: UN Principles of Responsible Investment, "The PRI's ESG and alpha study", March 2018. Information ratio measures risk-adjusted return by calculating whether a portfolio is achieving a higher return in excess of the benchmark compared to the volatility of the benchmark. The higher the number, the better the risk-adjusted performance.

ESG as a predictor of earnings quality

ESG is a predictor of earnings quality. A recent BofA study observed that ESG ranking was the best measure signaling future earnings risk, and was superior to leverage or other risk and quality. The study covered the period between 2005 and 2018.

Figure 5. Best signal of future earnings risk: worse ESG ranks signaled more earnings deterioration

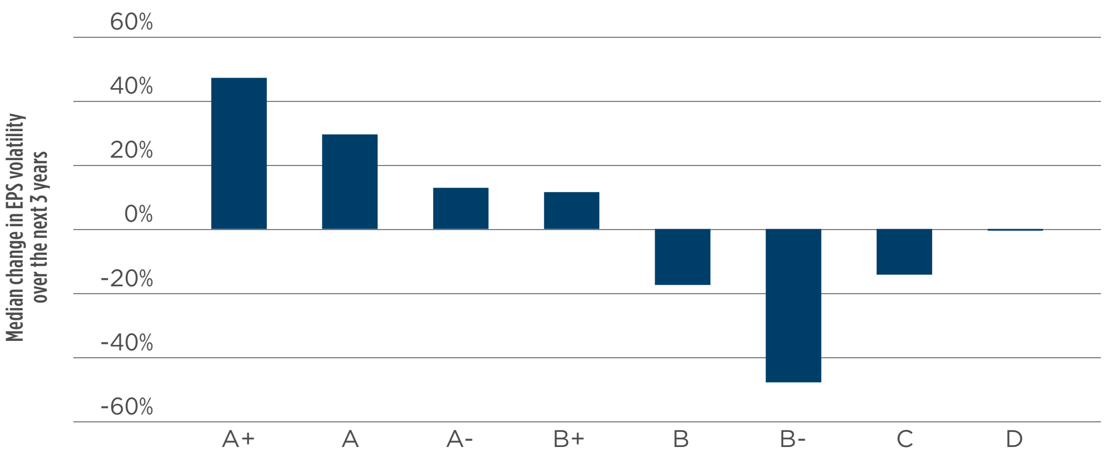


Source: Refinitiv, BofA US Equity & Quant Strategy. Reprinted by permission. Copyright © 2020 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information. Median change in 3y EPS volatility of S&P 500 companies over subsequent three years, based on Refinitiv overall ESG score from December 2005 to December 2016, with volatility through December 2019.

"Given the post-Covid level of diminished earnings visibility, improvements in a company's ESG profile should be a significant factor in future earnings quality".

Given the post-Covid level of diminished earnings visibility, improvements in a company's ESG profile should be a significant factor in future earnings quality. The aforementioned acceleration of US ESG data and disclosures should provide earnings quality support when it is needed most.

Figure 6. S&P quality ranks have no apparent predictive power over future changes in US earnings quality



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A Biden presidency and a democratic Congress are likely to accelerate ESG momentum:

"Under a Biden presidency and a democratic Congress, ESG regulations that follow Europe's lead on data and disclosure would accelerate further the shrinking of the ESG profile gap that exists for the US market".

ESG regulations that follow Europe's lead on data and disclosure would accelerate further the shrinking of the ESG profile gap that exists for the US market. We think this will create opportunities for US ESG strategies versus the rest of the market. However, should Trump be reelected, the ESG theme is still underway, because of the aforementioned evidence of investor pressure for increased disclosure and better environmental and social practices, and supported by accelerating ESG equity flows, albeit not at the same level should there be a democratic sweep.

A swing to Democratic leadership would accelerate ESG trends significantly, including the initiatives below that are now underway in Congress:

- In September 2019, the democratic-controlled House of Representatives Financial Services Committee passed the ESG Disclosure Simplification Act, which would require the SEC to define material ESG metrics and require companies to disclose in proxy materials a discussion of the link between these metrics and their business strategy, and the process used to determine that connection.
- The bill would also create a Sustainable Finance Advisory committee, which would make recommendations on ESG metrics companies should be required to disclose, and recommend policy changes encouraging the flow of capital to sustainable finance.
- Such a proposal is consistent with the priorities within financial services and capital market policymaking of the Sanders/Warren/AOC Green New Deal wing of the democratic party.
- ESG proposals like this are joined at the hip with democratic climate change and environmental policies that candidate Biden has supported.

"Democrats are likely to push for greater environmental regulations related to materials, water and sourcing."

Many Biden priorities reward those firms with strong or improving ESG profiles:

- **Environmental** laws and regulations.
- Biden has made climate change a major theme of his campaign. A democratic sweep should move the United States away from fossil fuels by raising the cost of fossil fuel production through regulation and higher taxes, while lowering the cost of renewable energy through subsidies for wind, solar, electric vehicles, and biofuels. For firms with any level of asset intensity, management of carbon emissions and use of carbon define the '*E*' profile.

- **Democrats are likely to push for greater environmental regulations related to materials, water and sourcing.** These are all critical ESG considerations.

A Biden presidency could boost social policies.

- In a Biden administration, the Consumer Financial Protection Bureau would be a primary regulatory winner, thus financial institutions that treat customers fairly should be relative winners.
- We expect enhanced data security and privacy laws to be an increasingly important theme for financials, consumer, and technology companies. These are already important ESG differentiators when material.
- Democrats are united in the desire for robust labour reforms to increase worker bargaining power, pay, job security, and flexibility. **Labour reform is a core plank of Biden's agenda to curb inequality, and is highly likely to be pursued early in a Biden administration.** There is broad Democratic consensus on labour policies. Thus, firms that already prioritise workers, particularly with pay above the likely federal $15/hour minimum wage or are unionised, would be better equipped to manage. **Companies that prioritise workers typically define a better ESG profile.**
- Biden and the democrats have pledged to target companies that do not pay their fair share of taxes, particularly for foreign-sourced income. This is another key ESG penalty for firms, especially for the technology sector.

Conclusion

"Proper integration of ESG into an investment process, with an emphasis on ESG momentum to identify 'ESG improvers', will be increasingly important to drive compelling risk-adjusted returns and outperformance versus traditional benchmarks."

Best-in-class ESG is an emerging theme in the US equity market, which is starting to close the gap with Europe as the long-time leader in ESG investing. The United States is seeing improvements in ESG disclosure, experiencing increased flows into ESG strategies by a broad range of US investors, and accelerating an increased focus by US companies on improving their performance with respect to key ESG considerations, particularly around the environment and social components. The prospect of a Biden Presidency and a democratic Congress are likely to accelerate the importance of ESG in US equities. **We believe that proper integration of ESG into an investment process, with an emphasis on ESG momentum to identify 'ESG improvers', will be increasingly important to drive compelling risk-adjusted returns and outperformance versus traditional benchmarks.** Further, we believe large asset managers players with a strong ESG footprint and experience are well positioned to offer investors compelling investment opportunities, as they developed methodologies, process, research capabilities able not only to detect the companies making strong progress on ESG, but also identify tomorrow's ESG leaders.

Definitions

- **Alpha:** The additional return above the expected return of the beta-adjusted market return; a positive alpha suggests risk-adjusted value is added by the money manager compared with the index.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Beta:** Beta is a risk measure related to market volatility, with 1 being equal to market volatility and less than 1 being less volatile than the market.
- **Information ratio:** A measure of portfolio management's performance against risk and return relative to a benchmark or alternative measure.
- **Open-ended funds:** In these funds, investors have the choice of whether to partially or completely redeem their subscription on each redemption day, subject to the redemption terms specified in the fund's offering document.

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