Finding the benefits of ESG integration

Mark Jeavons of Aon says the many benefits to schemes of ESG considerations mean that they will play an important role in setting scheme strategies

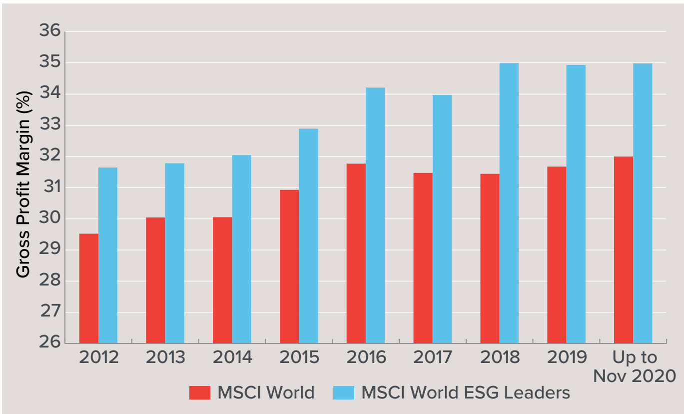
ACCELERATING macro-economic trends, including climate change, transforming technology and changing socio-demographics, are driving us towards a future that will look significantly different to today. As the global economy and society transform, these trends will pose new risks – and offer new opportunities – for investors in the years ahead.

Evidence is mounting to show that businesses which address non-financial Environmental, Social and Governance (ESG) risks such as work conditions (including modern slavery) and climate change, and which focus on good governance, also perform better in the long term.

In one of the largest studies in this area, Deutsche Bank and the University of Hamburg examined more than 2,000 empirical studies relating to ESG integration and corporate financial performance. They found that ESG integration did not adversely affect investment returns in 90% of the analysed studies – and, in most cases, it added value.

Similarly, MSCI ESG data demonstrates that companies with higher ESG ratings, on average, deliver gross profit margins which are higher than the broad market. [*See Figure above right*] A recent study by MSCI goes further still, finding that companies rated higher for ESG tended to demonstrate higher corporate financial performance.* Furthermore,

Annual gross profit margin for MSCI World and MSCI ESG Leaders Indices



Source: Bloomberg

the return gap between the best and worst ESG-rated companies appears to have widened in more recent years, with it being just over 2.9% over the past five years (2015 to 2019).

Correspondingly, pension scheme demand for investments in companies with strong ESG profiles is growing fast. To meet this demand, trustees, consultants and asset managers want to have a better understanding of the ESG factors which are most likely to affect the financial outcomes of a given investment.

ESG integration seeks to support this. Defined by the Principles for Responsible Investment (PRI) as "the explicit and systematic inclusion of ESG issues in investment analysis and investment decisions", it supports investors by identifying and managing ESG risks, alongside other financial information, to better quantify the purpose, strategy and management quality of companies. All of this will influence corporate performance and correlate with equity return.

The benefits of ESG integration can be summarised as:

- **Improving corporate performance.** The long-term financial benefit of ESG integration at the company level is that better ESG practices can enhance corporate financial performance and financial value.
- **Strengthening long-term future investment returns** ESG information and metrics better inform portfolio construction and stock selection decisions. This can help create additional long-term value and mitigate ESG risks.
- **Progress on ESG integration enhances valuations and investment returns.** Investment in companies that have stronger momentum in ESG ratings tend to see stronger improvements in their financial performance, leading to improved valuations and stronger investment returns.
- **Greater resilience to severe risk incidents and lower return volatility.** Real-world examples highlight that neglecting financial risks from ESG issues can severely impact a company's performance and adversely impact shareholder value.

These benefits mean that ESG considerations are set to play an increasingly important, and demonstrably integrated, role in setting strategy for asset allocation, portfolio construction and manager selection. It will also become imperative in supporting schemes' long-term outlook and augmenting traditional financial analysis as part of investment decision-making.

ESG integration is discussed in more detail in Aon's Guide to ESG Investing – The Benefits of ESG Integration. For a copy, email talktous@aon.com

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* Controlling for other factors, such as quality, size and industry.