

# ESG AND EARNINGS PERFORMANCE

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## ESG DATA: A NEW QUALITY FACTOR

Given the significant growth in corporate reporting of environmental, social and governance (ESG) factors over the past decade, the material relationship of ESG factors on corporate financial performance has never been more important for investors. Numerous studies have examined the relative returns of Socially Responsible Investment funds, but they have generally proven to be inconclusive given their focus on the relative performance of fund managers rather than the impacts of ESG factors themselves.

A more promising approach pursued by studies focusing on ESG performance of companies more directly has been to over-weight companies with positive ESG scores while under-weighting companies that under-perform on ESG metrics. A 2008 Merrill Lynch study examining ASSET4 ESG scores and equity returns demonstrated a 9.8% relative out-performance over 5 years for low beta US companies with high ASSET4 performance scores compared to high beta companies. A 2009 QSG study demonstrated significant enhancements of its existing quant strategy model by over-weighting companies with high ESG scores and under-weighting those with lower scores. Earlier this year, StarMine published a research piece demonstrating the ability to enhance the StarMine Earnings Quality model by incorporating an additional screening based on the ASSET4 ESG scores.

## ESG AND OUTPERFORMANCE ON EARNINGS

In order to explore one important factor potentially underlying these indications of relative out-performance, we conducted a study correlating U.S. companies' ESG performance scores with their earnings performance relative to analyst estimates. If ESG performance bears a relationship with corporate financial performance, then companies with higher ESG scores should outperform earnings estimates in aggregate. More fundamentally, given the growing recognition of the usefulness of ESG data as a proxy of management quality, one would expect the quality of a company's management also to be reflected in its ability to meet or exceed analyst earnings estimates over time. This outperformance should, in turn, translate into better market returns and therefore potentially explain the signals that ESG data can be used to enhance existing financial models and investment strategies.

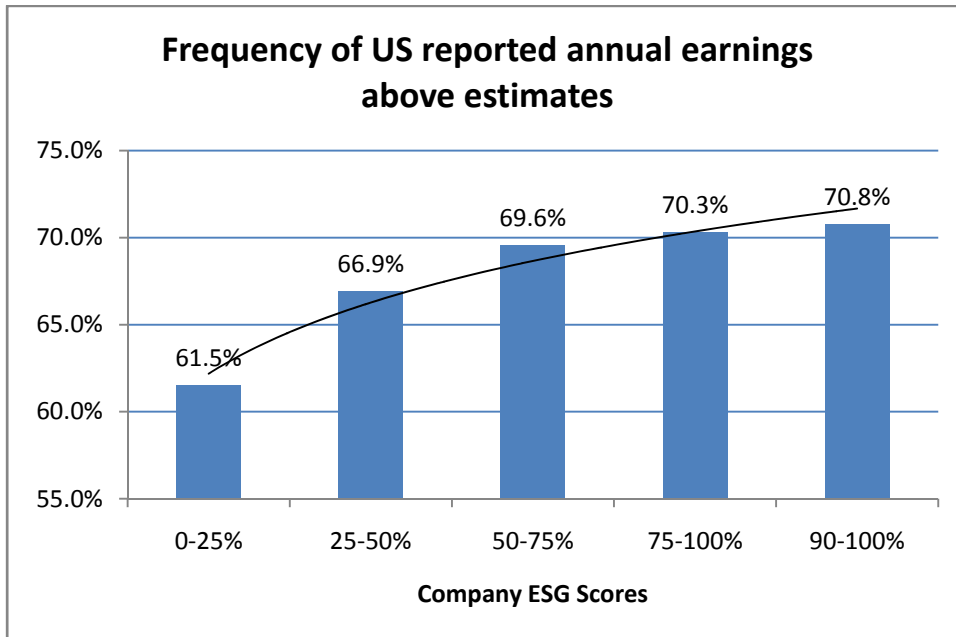
To conduct the study, I/B/E/S Surprise History data was employed to compare company actual reported earnings vs. consensus estimates at the time companies' earnings announcements were released. Historical announcements of earnings were employed for U.S. companies for the period 2004-July 2010 for annual earnings announcement and 2008-July 2010 for quarterly earnings announcements. Company earnings announcements were then matched with the ASSET4 universe and ASSET4 performance scores that would have been published at the time of the announcements. These announcements were then placed into four groupings corresponding to the overall ASSET4 performance scores (0-25%, 25-50%, 50-75%, 75%-100%). A fifth grouping was created including companies with ASSET4 scores between 90-100% in order to focus on the overall leaders in terms of ESG performance. The frequency of earnings announcements above or below the consensus estimates was then compared across the different groupings in order to determine whether and to what extent companies with higher ESG scores tended to beat the consensus estimate more frequently than those companies with lower ESG performance scores.

## RESULTS

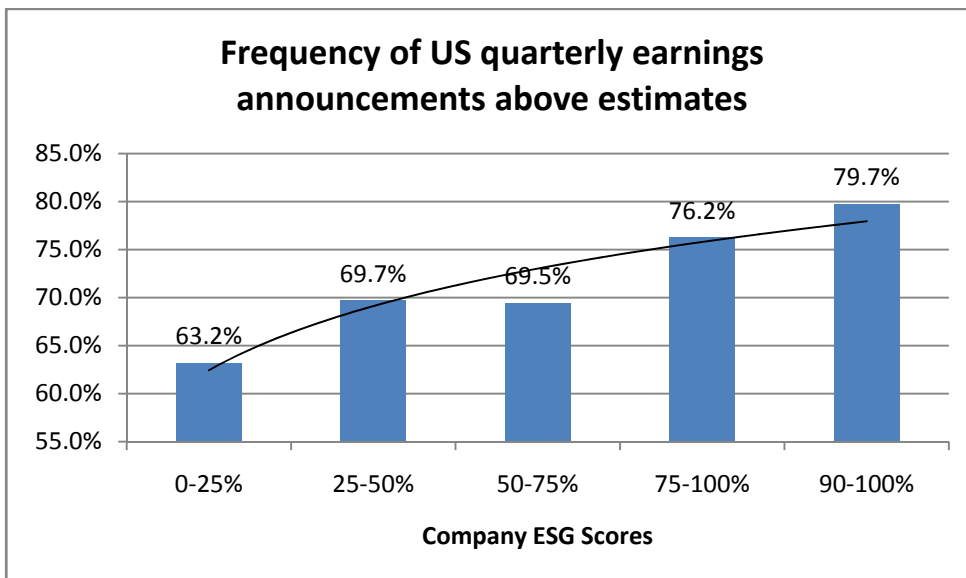
The data revealed that U.S. companies with stronger ESG scores consistently beat earnings estimates more frequently than those with lower scores. U.S. companies with ASSET4 ESG scores in the lowest quartile issued annual earnings announcements that exceeded estimates 61.5% of the time, while companies with ESG scores above 75% and 90% exceeded estimates 70.3% and 70.8% of the time respectively. This gap in outperformance



between ESG leaders and laggards persisted consistently across time as well. Between 2005-2009, U.S. companies with ASSET4 ESG scores above 90% issued annual earnings announcements above analyst estimates between 9.3-13.9% more frequently than companies with ESG scores below 25%



For U.S. quarterly earnings announcements, the gap in earnings performance between ESG leaders and laggards was even more significant. U.S. companies with ESG scores below 25% issued earnings that beat the estimates 63.2% of the time, while companies with ESG scores above 90% issued earnings estimates in excess of the estimates 79.7% of the time. In terms of earnings misses, the ESG leaders missed estimates 19.8% of the time while the laggards missed 35.6%, a difference in the absolute frequency of earnings misses of over 50%.



In addition to outperforming in relation to the overall score, the difference between ESG leaders and laggards in terms of earnings performance also existed when segmenting earnings results in relation to the Environmental, Social and Corporate Governance Pillar scores. The performance differential between companies with scores above 90% and below 25% was 12.9% on the basis of the Social pillar, 10.9% on the basis of the environmental pillar and 16.4% for the corporate governance pillar.

Interestingly the gap between ESG leaders and laggards for quarterly announcements widened during the 2008-2010 time period, suggesting that companies with higher ESG performance were able to emerge more quickly from the recession in terms of their earnings performance. Similarly, the outperformance gap between ESG leaders and laggards for annual announcements was widest for the 2007 fiscal year as the U.S. was entering recession. These results suggest that companies with strong ESG performance saw their earnings deteriorate more slowly going into the recession, but were more quickly able to beat earnings estimates after the recession ended.

## CONCLUSION

The earnings outperformance of companies with strong ESG scores not only provides an important piece of evidence that can explain some of the positive outperformance suggested by long-short strategies employing ESG data, but it also illustrates the usefulness of ESG data a proxy for measuring management quality. There are several important aspects of management quality in relation to earnings performance that can help explain the positive correlation between ESG performance scores and companies' ability to exceed earnings estimates. First, companies with strong ESG performance disclose more information concerning management policies, practices and performance on extra-financial metrics, and this transparency on extra-financial likely correlates with a more general transparency of management on its financial performance as well. Greater transparency by management on financial prospects and results leads to better and more accurate earnings estimates, which companies should be able to exceed more consistently. As a result, ESG performance serves as an important measure for the general openness of management toward investors, which leads analysts to formulate better earnings estimates over time.

Second, companies with strong ESG performance have comprehensive and timely data on their global operations concerning many details of the company's extra-financial performance, from global energy use, to employee turnover rates, healthy and safety statistics, etc. Managers with such strong data sets on extra-financial factors likely have access to more timely and more detailed data on their financial and overall business performance as well. As a result, management is better able to make more timely adjustments to its business planning, and it is better able to know and proactively communicate necessary changes in its forecasts with analysts. This advantage leads analysts' estimates to be more accurate and realistic and it allows management to have more precise information in order to manage their results to meet or exceed market expectations on a regular basis.

Third and perhaps most fundamentally, companies with strong ESG performance generally have a strong understanding of the long-term strategic issues in their industries, and managers at these companies are better able to manage in accordance with long-term goals. Such companies make the necessary long-term decisions to ensure the success of their business over longer time periods. As a result, these companies in the aggregate are less likely to be met with unanticipated earnings surprises resulting from poor long-term planning, and they therefore they are more likely to have more stable and predictable earnings results over time.

In short, the positive correlation between companies' ESG performance scores and their ability to meet or exceed earnings estimates provides an important piece of evidence that ESG data can serve as a very useful quantitative metric for measuring the quality of a company's management. ESG data provides an important qualitative window into the management practices of companies, which underlie top-line financials, and which determine how effectively managers are able to manage and control their top-line financial results over time. Those companies that are able to manage effectively their relations with customers, employees, suppliers and corporate governance issues and environmental challenges tend to be those companies that are able to manage all aspects of their business more effectively. And although management quality is one of the most difficult factors to determine on the basis of financial statements alone, the market conditions of the last several years have served to underscore that management quality is perhaps the most important factor in determining a company's long term valuation.