BSSF

Bocconi Students for Sustainable Finance

Introduction to Sustainable Finance

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Editorial Board:
Giuseppe Anzalone
Lorenzo Della Rocca
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Pietro Masè
Giovanni Mazzarelli
Pasquale Rizzello
Andrea Rossi
Emanuele Sessa
Zeno Zuliani

Graphics:
Christian Chiaro
Camilla De Bartolomeis

Who are we

Bocconi Students for Sustainable Finance (BSSF) was born thanks to the idea of 12 colleagues, who decided to create the first Bocconi hub where both students and professionals can share information and insights about sustainable and ethical investing.

The goal is to periodically create articles, reports, surveys on present and future sustainable finance practices. In order to develop such a relevant topic, events with representatives and experts in this field cannot be missing.

At BSSF there are two fundamental values: the will to produce high quality and professional content and the desire to enhance the education experience of our members as well as of the entire Bocconi community.

Over the last years investors have become more interested in sustainable investing, by integrating Environmental, Social and Governance (ESG) factors into their valuation analysis. The main goal of this new practice consists in improving the return and the risk profile of a portfolio while generating a positive impact for the society and the environment.

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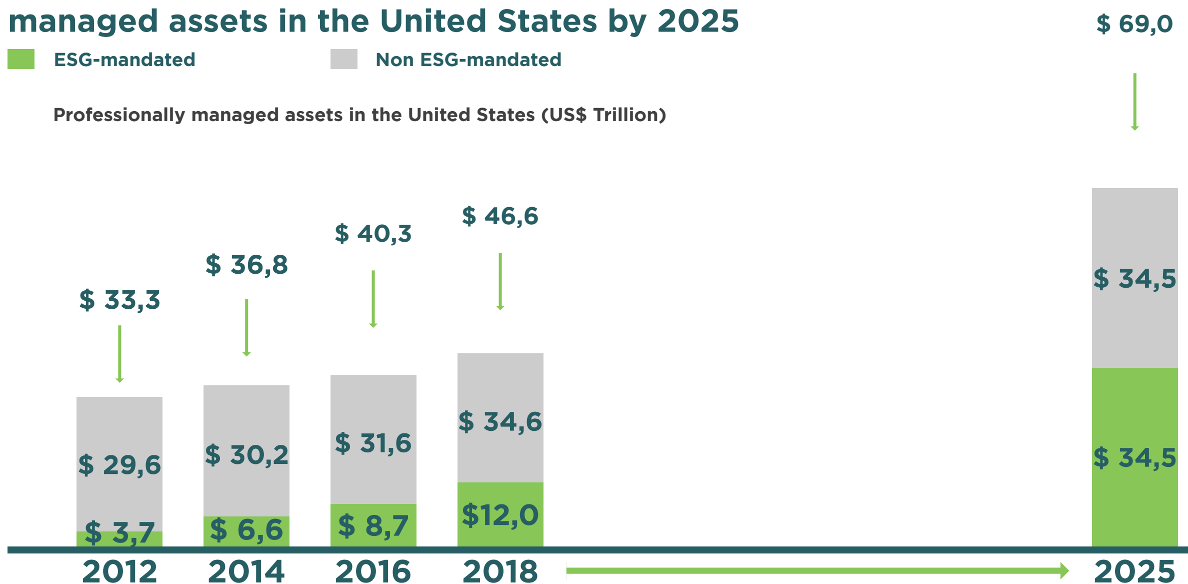
ESG adoption analysis

Globally, the application of environmental, social, and governance principles to at least a quarter of investors' portfolios raised from 48 percent in 2017 to 75 percent in 2019. According to Deloitte Center for Financial Services (DCFS), the main driver of ESG-mandated funds will derive from client demand both retail and institutional, that will lead half of all professionally managed investments to be compliant to ESG standards in the United States by 2025. Furthermore, the emerging technologies (such as AI) that enable better-quality ESG data, together with a clearer regulatory landscape, are playing an important role towards the growing adoption of ESG as well. Consequently, managers are going to respond to this demand by launching up around 200 new ESG funds by 2023.

Figure 1



Even if the US amount of sustainable investing assets is growing quickly, the largest amount is in Europe with a total of US$ 14.1 trillion against the US$ 12 trillion of the US.

Sustainability has increasingly become over the years a pivotal factor in companies' strategies. Since John Elkington's theory of the "Triple bottom line", the attention to the social dimension has risen highlighting the correlation between a particular cluster of non-financial considerations and the value created by a company.

The acronym ESG refers to a set of criteria that allows to evaluate and assess the future performance of a company, addressing both risk and return drivers. Although there is a huge variety of these criteria, they tend to follow this scheme:

1. Environmental concerns: this category mainly includes elements that represent a threat to the environment. More specifically it covers issues related to pollution and resources depletion;

2. Social concerns: this category is divided in four main areas:

- Diversity: represents the level of inclusion of diverse people in the recruitment process;
- Human rights: refers to the impact of unsustainable operation on local communities and on the health and welfare of the employees;
- Consumer protection: level of protection for the consumer;
- Animal welfare: smaller category dedicated to the treatment of animals in the food market and product testing;

3. Corporate Governance concerns:

- Management structure: system of internal procedures and balance between the CEO and the Board of Directors;
- Employee relations: level of participation in decision-making processes among employees;
- Executive and Employee compensation: transparency and equitableness in compensation.

ESG Investing can manifest itself through various forms that range from the investment in companies that meet the required ESG criteria, to forms of “activism” by the shareholders of a company. The benefits if ESG investing can be summarized in two main options.

- Higher returns: this option relies on the hypothesis that the market does not thoroughly recognize the value of the ESG intangibles at the time of the investment but that will later adjust to the real value of the company.
- Risk reduction: this option has much stronger evidence as an antithesis of the so called “sin stocks”. In fact, these stocks have shown much lower returns and additional risk factors due to environmental or social negative externalities. On the contrary, sustainable companies are much more reliable and consistent over the years and maintain their value more permanently;

When we talk about sustainable investing it is essential to answer the following question: is there empirical evidence on the thesis that ESG compliant portfolios deliver better performance over the ordinary ones?

In order to give an answer, we took into consideration a research promoted by MSCI (Morgan Stanley Capital Investing).

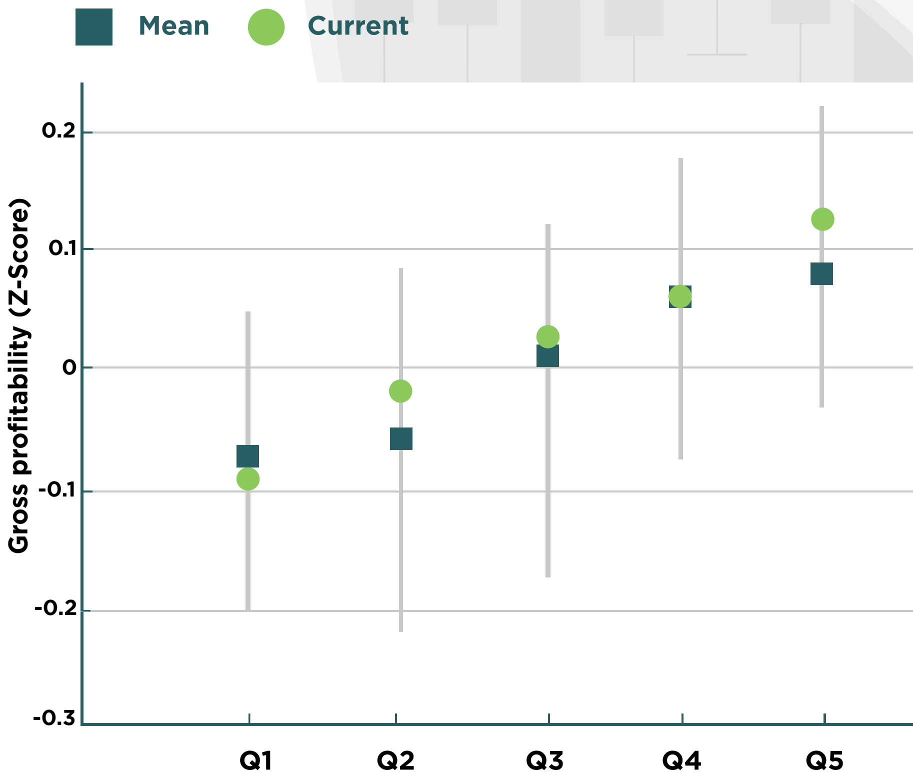
The data bank used is the MSCI World Index universe for the January 2007 to May 2017 time period, which contains over 1,600 stocks. It is sufficiently diversified for the statistical analysis performed and adjusted on the basis of the MSCI ESG Ratings. All risk and factor calculations are performed using the Barra Long-Term Global Equity Model (GEMLT).

The results are distributed across five size-adjusted ESG score quintiles (Q1 to Q5), with Q1 indicating the companies with the lowest ESG rating and Q5 the highest-rated companies.

The research generated data supporting the assertion that high ESG-rated companies (Q5) were more profitable and paid higher dividends, especially when compared to bottom quintile (Q1) companies (less sustainable companies), as can be seen in Exhibits 1 and 2.

All the results shown are neutralized for industry exposure (through the use of industry adjusted ESG scores) and size.

Exhibit 1



Notes: Gross profitability (Z-score) of size-adjusted ESG quintiles is computed as most recently reported sales less cost of goods sold, divided by most recently reported company total assets. Data from January 2007 to May 2017. Average value over the period is represented by square dots; current exposure by round dots. The vertical bars represent the 5% to 95% range of observed values.

Source: MSCI

Exhibit 2

Notes: Trailing dividend yield (Z-score) of size-adjusted ESG quintiles is computed by dividing the trailing 12-month dividend per share by the price at the last month end. Data from January 2007 to May 2017. Average value over the period is represented by square dots; current exposure by round dots. The vertical bars represent the 5% to 95% range of observed values.

Source: MSCI

It is useful to recall the work of Gregory, Tharyan, and Whittaker (2014) who try to elaborate the economic rationale at the basis of these results:

Companies with a strong ESG profile are more competitive than their peers. For instance, this competitive advantage can be due to the more efficient use of resources, better human capital development, or better innovation management. In addition to this, high ESG-rated companies are typically better at developing long-term business plans and long-term incentive plans for senior management. Higher profitability results in higher dividends.

High-dividend yields play an essential role in the analysis because sustainability investors typically have a long-time investment horizon (Eccles and Kastrapeli 2017).

Therefore, the apparent tilt of high ESG-rated strategies such as the ESG Universal Index toward high dividend-paying companies may have helped enhance medium- to long-term improvement of risk-adjusted returns.

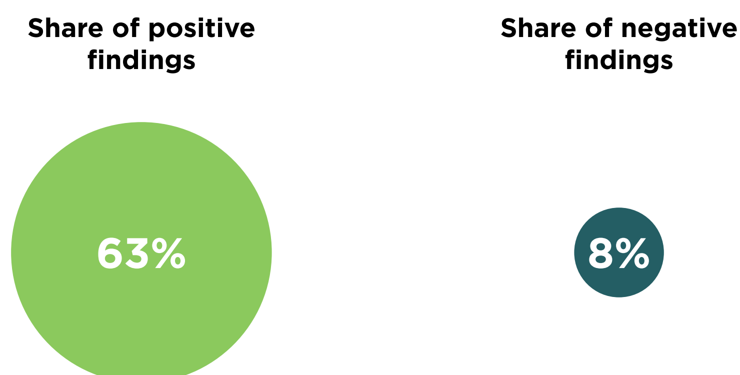
Value creation Through ESG (McKinsey)

It is important to understand the multiple ways ESG factors relates to value creation. Nowadays Environmental, Social and Governance criteria are a fundamental part of businesses. If we analyze this concept in depth, we realize that they are also interlinked.

Nowadays, since there is a growing concern about the social impact of business operations, a fast-paced movement towards responsible investments is emerging in order to preserve a company's long-term success.
As McKinsey reports, companies that pay attention to ESG will experience a strong growth in value creation.

Figure 2

Paying attention to environmental, social and governance (ESG) concerns does not compromise returns - rather, the opposite



Results of > 2.000 studies on the impact of ESG propositions on equity returns
Source: McKinsey

Furthermore, a very solid ESG proposition is associated to higher equity returns and lower risks as demonstrated by lower loan and credit default swap spreads and higher credit ratings.

"How exactly does a strong ESG proposition make financial sense?"

Recent studies found out that sustainable investing is linked to four important factors:

1. Top-line growth

ESG proposition allows companies to explore new markets while expanding into the existing ones. Sustainable companies have two main advantages. The first one is represented by the trust given to them by government authorities, which allow them to obtain concessions, approvals, and licenses to expand their businesses. The second main advantage is the capability of driving the consumer preference. As McKinsey research has shown that 70% of customers by multiple industries (such as automotive, building, electronics...) are willing to buy green products even if it means paying an additional 5% over the ordinary price tag.

2. Cost reductions

ESG practices can also allow substantial cost reduction. In a report published by McKinsey, analysts found out a correlation between sustainable asset investment and financial performance: ESG can help minimizing expenses due to legal disputes, renovation of machinery, employees turnover cost.

3. Reduced regulatory and legal interventions

McKinsey analysis stated that, on average, one third of corporate profits are at risk from state intervention because of the environmental and social impact of the firm's operation. This implies that, without a long-term sustainable strategy, there is a high risk of adverse government action.

4. Employee productivity uplift

It has been observed that to have an effective company it is also necessary to motivate and reward employees. In order to do that, companies can use a strong ESG proposition to attract and retain quality employees by making them sense the positive impact of their work. Furthermore, an encouraging environment with great values helps employees in their daily tasks by increasing their productivity.

An example of employee productivity uplift can be proved by an initiative of an Australian bank, which had given bonuses to employees in form of local charities. The one who received this type of bonus reported a greater job satisfaction than the other colleagues.

On the other hand, a weak ESG proposition not only can drag productivity down, but it can also bring a lower job satisfaction, with the consequence of strikes and worker slowdowns.

Conclusion

With this first report we want to present ourselves as a new Association which is interested in analyzing from a qualitative and quantitative point of view the issue of sustainability of investments, which in this historical moment is gaining an increasingly central role.

In support of our reports we will mainly make use of the Bloomberg database for analyzing the new trends related to sustainable finance with constantly updated and reliable data.

Articles and reports will be made available to raise awareness on the subject;

Experts from the sector will be invited to tell their experiences in terms of sustainability. Moreover, we will try to start a collaboration with an analogous student association from the London School of Economics (thanks to an analyst from our association who will have the opportunity to study in London).

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