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"Help wanted" - Seeking effective ESG integration that puts alpha over ratings

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An Empirical Illustration of Delivering "Value Through Values"

Responsible investing is typically associated with excluding investment opportunities based on third-party ratings or the nature of the underlying business, leaving investors with the false choice between "value or values" when considering Environmental, Social, and Governance (ESG) investments. There are also concerns around overreliance on rating agencies, leading many investors to develop a proprietary approach to evaluating companies through an ESG-tinted lens. Effective and authentic ESG integration puts alpha over ratings and is consistent with the existing investment philosophy. While ESG factors present relevant non-financial information that should be considered in any investment analysis, materiality is inherently contextual and may be industry or even company specific. As we will illustrate, ESG touches all aspects of a company's operations -- tangible examples are everywhere.

ESG & Performance

ESG factors are non-financial metrics that relate to a company's "social license to operate." When environmental (E) and social (S) externalities are not managed, market forces and public policy debate may render some enterprises obsolete. The governance (G) of companies is how they enact these principles and negotiate their interactions within the context of their respective businesses. ESG factors have a material influence on company performance because businesses operate within and part of society, serving different stakeholders. As society evolves, previously accepted business practices may become controversial and unsustainable or immoral over time.

ESG factors that uncover risks in a company's business model are inherently material and should be taken into consideration in the investment process. Conversely, successfully navigating these challenges may offer both a better foundation and new opportunities for growth. For example, using a hypothetical energy company, goodwill from being a good corporate citizen and employer may ease regulatory obstacles and help it recruit the talent to facilitate a necessary pivot to green technology. It is no surprise that the Business Roundtable in 2019 redefined the purpose of a corporation to benefit all stakeholders rather than solely focus on shareholders: it's simply good business.

The Role of ESG Ratings

Given the growing focus of investors and asset owners on ESG issues, the role of ESG ratings issued by agencies such as MSCI and Sustainalytics is increasingly important. Despite a few research papers reporting promising findings, there is no obvious consensus in academic literature on alpha resulting from ESG ratings. Rather, the primary use for such ratings has been risk management. Moreover, even if the idea of alpha from public ESG ratings was to gain traction, it would rapidly get arbitraged away. In fact, setting aside this risk of crowding, some have argued that conscientious investors ought to be willing to pay a premium for highly rated ESG stocks, even after accounting for their likely better prospects.

[1] For example, Berg et al. (2019) report on the divergence of ESG ratings from major providers, expanded on by Edmans (2019).

A further challenge with adopting ESG ratings in an investment process is that there is meaningful disagreement among the main rating agencies.[1] Research has shown that about half of this discrepancy results from weighting differences in ESG attributes, and half from differences in how to measure those attributes. In other words, how to weigh poor G's against strong E's, or whether an event represents a poor G or a poor S. For example, the extent to which Tesla's poor corporate governance (G) in failing to balance its strong executive is offset by its prospective contributions to sustainable transportation (E) is an entirely subjective question. The same is true for whether the "fake accounts" scandal at Wells Fargo was predominantly a failure of corporate governance (G) or more about hurting its clients and the communities it operates in (S). Because of the large degree of subjectivity around ESG, discussions are inherently philosophical and have failed to resolve such ambiguity and conflicting indicators.

ESG in Practice

To highlight some of the questions related to ESG investing, let's consider an energy company with an attractive and stable dividend yield. Given the environmental impact of energy, these companies may be off-limits to some investors. Financially speaking, it may also be a poor investment idea due to "stranded assets" impairing book value.[2] It seems clear that these companies should be avoided for asset owners concerned with ESG. However, let's muddy the water a bit and assume the same company is investing heavily in renewable energy to weather the energy transition or better yet, to capitalize by helping to accelerate it. Should the company still be excluded? Setting aside moral ambiguity, the risk, reward, and investment opportunity related to ESG issues in this example are material.

Taking this line of thinking a bit further, let us dig deeper into the "Social" pillar of ESG considerations, which is less readily defined than "Governance" and "Environmental." The primary social functions of a company include creating and providing useful services or products to customers and gainful employment in the communities in which it operates. A topical example of the former is pharmaceutical companies setting everything aside to develop a COVID-19 vaccine, a goal that is beneficial to their clients, the economy, and society as a whole. To evaluate the latter, one can look at companies' annual reports for changes in the number of people employed. A more direct and real-time measure of pick-ups in hiring activity can be gleaned from "help wanted" postings, now predominantly online. The level thereof relative to current employee count may reflect natural employee turnover. However, the trend in hiring activity is an indication of anticipated business expansion. It reflects the type of growth that actually creates local jobs, earning goodwill from communities and governments that may result in tax breaks to further benefit the bottom line. Through an ESG lens, there is a clear contrast with growth from cost cutting through outsourcing jobs to locales with potentially weaker worker rights, predatory pricing, or anti-competitive practices.

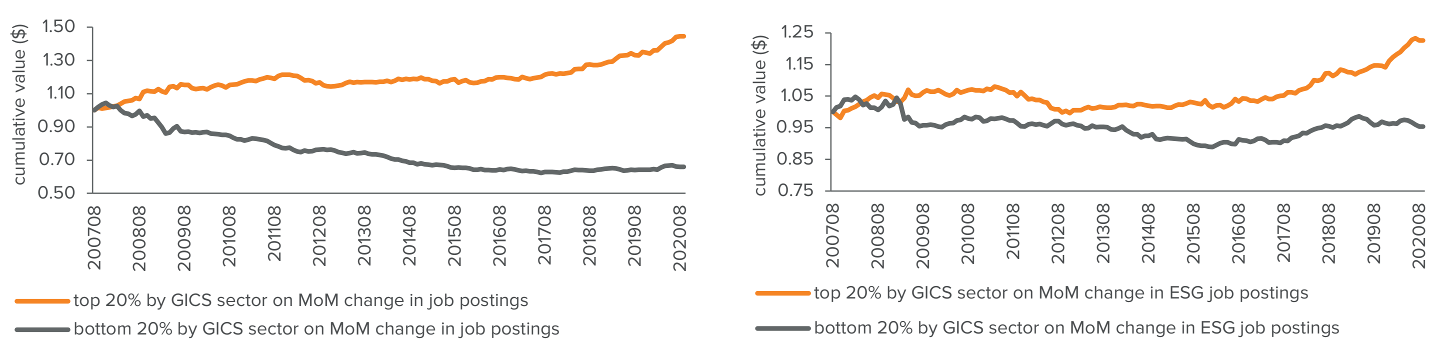
Job postings are a rich data source that may complement, and at times dispute, the self-reported data that often underlie ESG ratings. For example, we created a supervised learning algorithm that flags ESG-related positions based on the job description through use of Natural Language Processing (NLP).[3] This told us something about the centrality of Corporate and Social Responsibility (CSR) to the company's management and its intent to purposefully and successfully navigate the ESG landscape. Additional company focus areas of potential interest were increased hiring of sales representatives or researchers, the latter category being particularly relevant for Pharma companies

Figure 1. What Can Job Postings Tell Us About A Company's Stock?

Cumulative value of $1 invested in hypothetical simulated strategy that holds the top or bottom 20% of stocks in each GICS sector by month-over-month change in job postings

Job postings of any type

ESG-related job postings



Source: Factset, LinkUp, Two Centuries Investments, Voya IM. Hypothetical investment strategy for which simulated performance is shown may not actually have been investable. Analysis is provided for illustration purposes only. Voya IM does not necessarily have ongoing access to online job postings data nor necessarily use any such data for investment purposes. Past performance is not indicative of future returns. Investing inherently risks loss of capital. This hypothetical performance reported gross of any fees or transaction costs, which would have reduced returns.

[2] In this example, "stranded assets" are reserves of fossil fuels the company won't be able to sell now that the world has united behind combating climate change.

[3] See our prior blog "Using AI, Words Can Speak Louder Than You Think" for additional use cases for NLP for investment purposes, gauging management sentiment from company financial filings.

aiming to successfully develop new drugs. Extensions like this offer ample opportunities for future research into ESG related investment signals.

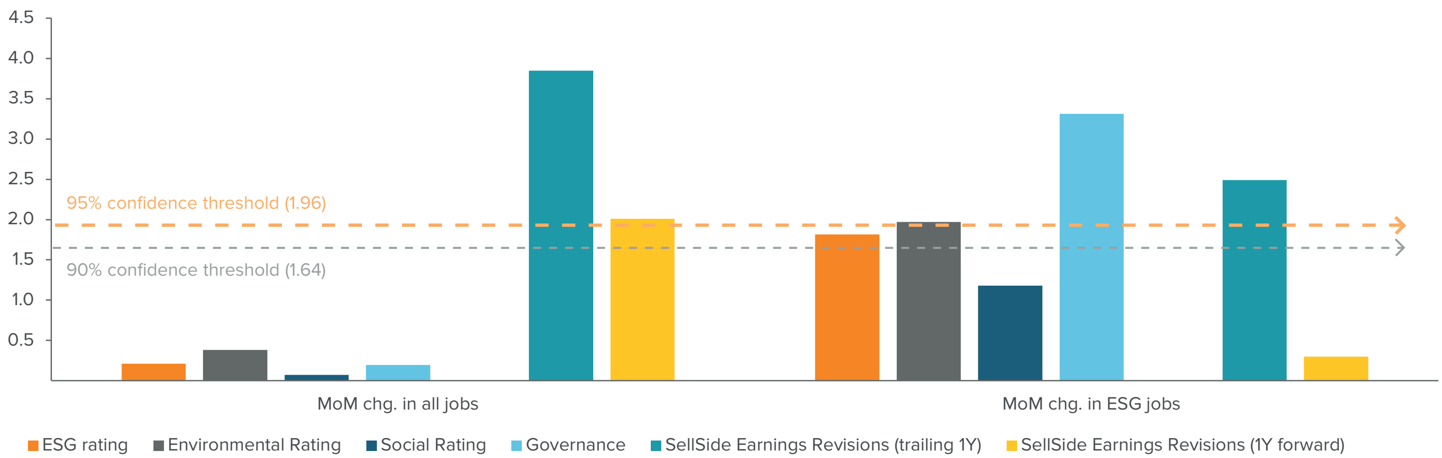
To measure the usefulness of these insights for investment purposes, we evaluated the performance differential between companies with the strongest pick-up in hiring activity[4] versus those with the biggest drop, likely indicating a head-count reduction. The simulated performance of these hypothetical investment strategies is shown in Figure 1 (left chart), which shows the change in overall job postings has been highly predictive of future returns.[5] We then repeated this test for the change in ESG-related positions (Figure 1B), which also differentiated relative performance. The correlation in monthly spreads between companies with a pick-up and reduction in hiring activity based on overall job postings and ESG positions was 0.33. This is positive as they stem from the same data source but nonetheless indicative that they measure different aspects of the company's hiring practices.

Figure 2 aims to corroborate the fundamental intuition behind this ESG-related strategy. Clearly both overall hiring and ESG-related hiring pick up when the company's business prospects are looking positive, as indicated by strong upward revisions of its estimated earnings by sell-side analysts. However, only total hiring is a good predictor of continued growth (future EPS revisions) while only ESG-related hiring is a good proxy for the company's ESG performance as evaluated by MSCI.

Figure 2. Job Postings and Fundamentals: Analyzing the Connection

T-stat of monthly cross-sectional correlation of month-over-month change in job postings (all, and ESG specific) to MSCI ESG ratings and sell-side sentiment (recent and future) on company earnings prospects

(Sept 2007 - Aug 2020, US large-cap stocks)



Source: Factset, LinkUp, Two Centuries Investments, Voya IM

Putting it all together

While labor practices are a common component of ESG ratings, we are not aware of "hiring" or derived indicators of "CSR centrality" to be a prominent part thereof. Taking a holistic approach to ESG investing and using a comprehensive range of data sets (traditional, alternative, and proprietary) allows investors to go well beyond headline ratings to deliver AI-driven ESG integration. The result is a proprietary ESG methodology targeting risk-adjusted alpha as well as visibility on ESG-related material risks and opportunities. All else equal (valuation, business prospects, etc.) between two investment opportunities, a fundamental analyst should prefer that with the best ESG profile. In fact, differences in ESG related risks and opportunities may well justify paying a premium. To complement this discretionary approach, systematic investors can target those ESG-related factors, often intangible in nature and therefore difficult to fully discern, that have historically been mispriced by the market, offering opportunity for alpha generation.

In summary, when it comes to ESG investing, we believe "value or values?" is the wrong question. Rather, Voya's approach to ESG focuses on generating "value through values," both as a public asset management company as well as through our investments. While much of the debate around ESG is inherently "fuzzy," a holistic ESG lens can create tangible alpha opportunities for those who understand the intrinsic materiality of such issues for any investment thesis.

[4] Specifically, we measure the change in job postings scaled by number of existing employees. The resultant portfolio goes long the top 20% of US large-cap stocks by this measure and short the bottom 20%, all positions are equally weighted, and the portfolio is rebalanced monthly. Posting data is lagged by 10 days to mitigate the risk of look-ahead bias.

[5] See Gutiérrez et al. (2020) for an academic study corroborating this finding.

References:

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