ESG ratings can be useful in identifying leaders and laggards based on ESG fundamentals. They may provide an additional service by forcing companies with the worst ESG credentials to recognize and remediate their ESG shortcomings. We believe this improvement may relate positively to stock price performance.

At Pzena, integration of ESG into the investment process means focusing on the financially material ESG issues that influence the investment case and, through their remediation, could be reflected in better stock price outcomes. As fundamental investors, we rely on various sources of information to inform our decisions about the companies in which we invest. This includes third-party ESG scores despite their notable shortcomings, such as consideration of issues we believe may be immaterial to company performance. Nevertheless, ESG scores can be a helpful proxy in determining relative ESG performance. Our preliminary empirical research has revealed a possible link between ESG score improvement and better company performance (see ESG Scores whitepaper). This research has contributed to our emphasis on engagement with companies we own to achieve these better outcomes (see Opportunity List piece), while always maintaining focus on our fiduciary duty of maximizing long-term risk-adjusted returns.

As a supplement to our initial research linking performance with ESG improvement, we theorized that the most significant laggards might recognize the need to improve their ESG standing more so than ESG leaders and, therefore, take corrective action. This could benefit not only the companies themselves, but their broader stakeholders as well. To test this, we looked at the three-year ESG score change of companies in the top quintile and bottom quintile of ESG score performance. To avoid unfair comparisons as a result of differences in industry structures, the analysis was undertaken on a sector-neutral basis.

Our observations for the three-year forward score change rolling monthly (2014–2019) were as follows:

Change in ESG score - 3-year Average[1]

Russell 1000	
Top Quintile	Bottom Quintile
-0.22	+1.15

MSCI EAFE	
Top Quintile	Bottom Quintile
-0.24	+1.03

MSCI EM	
Top Quintile	Bottom Quintile
-0.37	+1.01

[1] Based on MSCI's Industry Adjusted Scores
Source: MSCI, Pzena Analysis, FactSet
Data table displays forward 3-year rolling monthly averages from December 31, 2013 - December 31, 2019.
Past performance is not indicative of future returns

The findings indicate that, on average, across all markets, companies with the lowest ESG scores saw noticeable improvements in their overall ESG scores. In contrast, on average, those in the top quintile saw a slight deterioration in their ESG scores. To further examine this relationship, we looked at the percentage of companies in the top and bottom quintiles that saw changes in their respective quintiles in subsequent periods:

Change in Score Quintile - Percentage of Companies[2]

Russell 1000	
Top Quintile	Bottom Quintile
34%	47%

MSCI EAFE	
Top Quintile	Bottom Quintile
34%	34%

MSCI EM	
Top Quintile	Bottom Quintile
31%	51%

[2] Percentage of companies that moved our of the relevant quintile based on 3-year forward ESG score.
Source: MSCI, Pzena Analysis, FactSet
Data table displays forward 3-year rolling monthly averages from December 31, 2013 - December 31, 2019.
Past performance is not indicative of future returns.

Our results show that, on average and regardless of geography, roughly two-thirds of top quintile ESG performers remain in the top cohort. This indicates a tendency for these companies to maintain their status as ESG leaders. In contrast, the bottom quintile demonstrates much more variance across geographies.

In the US and emerging markets, there was a noticeable churn in the bottom-scoring quintile of companies on a three-year forward basis. Roughly 50% of companies, on average, improved their scores on a sector-relative basis and moved out of the bottom quintile. However, in EAFE, the results were much lower, with only 34% improving over the same period.

From both analyses, we can see that top-quintile ESG scorers remain best-in-class relative to their peers, despite a slight negative trend in overall ESG scores. Meanwhile, the biggest laggards across all markets see more significant absolute score improvement but show less progress in graduating from the bottom quintile. The performance advantage we have observed for companies that improve their ESG scores may be a result of the market rewarding these companies accordingly.

As fundamental investors, we pride ourselves on our deep understanding of the companies in which we invest and the underlying factors that drive their performance. We use multiple sources of information, including ESG scores, to inform our understanding while recognizing there are flaws in how these scores are currently assessed and rated. However, our research indicates that ESG scores can play an important role in driving engagement. They help identify areas for improvement in ESG laggards and allow the market to pressure these companies to improve.

The ability to distinguish leaders from laggards may encourage a more focused effort to improve material ESG issues within companies lagging behind their closest peers. As active investors, we believe we have a role to play in this identification process. We aim to extract value while the necessary improvement takes shape.

FURTHER INFORMATION

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