Marketing communication for professional investors only.

GENERALI INSURANCE ASSET MANAGEMENT

How so-called "ESG laggards" can drive alpha

October 2022

GIAM ESG, Macro & Market Research

Companies that have a poor ESG score but are on track to improve tend to drive outperformance over companies with static ESG records, explain the Investment, ESG and Research teams at Generali Insurance Asset Management S.p.A. Società di gestione del risparmio (GIAM).

- **We believe there is value, both financially and in social and environmental terms, in engaging with so-called ESG laggards to help them improve.**
- **Companies with a low but improving ESG profile tend to outperform the market and their industries.**
- **A broad, experienced, collaborative ESG team that is integrated across the investment process is crucial for identifying the ESG laggards on the verge of improving, while avoiding the ones that will not.**

ESG analysis is at the heart of our sustainable investment strategy. We aim to deepen our understanding of companies by going beyond ESG scores, using a broad and detailed framework to find buying opportunities even among so-called "ESG laggards".

Our view, informed by our proprietary analysis, is that a combination of financial as well as ESG analysis can enable active managers to identify companies set to improve their ESG score and outperform the market.

We continually add ESG analysts to our team to strengthen our analysis and active ownership capabilities, and provide our clients with a robust investment process that meets their ESG targets while sourcing excess returns.

ESG momentum: Why improving ESG laggards are important

ESG momentum refers to how a company's ESG characteristics change over time. Those with positive momentum are improving their ESG practices. Examples could include setting more competitive carbon reduction targets or improving gender diversity on the board of directors. Our research shows that improvement in ESG characteristics is not only reflected in a company's share price but also its underlying financials, leading to greater long-term value for investors.

ESG laggards that want to improve their ESG standing can understandably face skepticism from investors. Many investors prefer to invest in companies that already have a strong ESG track record, in order to lower potential risks. This means there can be an opportunity to enhance returns by investing when a company focuses on improving its ESG approach before the rest of the market catches up. This is why, at GIAM, we believe there is value, both financially and in social and environmental terms, in engaging with ESG laggards to help them improve.

Does the ESG score or the ESG momentum drive outperformance?

Does the ESG score or the ESG momentum of a single company drive outperformance, or a combination of both?

To answer this question, our Insurance & Asset Management Research team analysed companies

included in the MSCI Europe in the last 10 years, dividing them into quintiles based ontheir Eikon Refinitiv ESG Score.

The first quintile represents the lowest 20% of companies by ESG score, with fourth quintile being the top 20%. Improvers, firms moving up from one quintile to the next, are not excessively rare. On average, around 16% of companies in the first quintile (c. 90, showing the lowest score) reported an improvement every year: 13.5% had a one-notch upgrade (from first to second quintile) and 2.5% had a two-notch upgrade (from first to third quintile).

For each company, we calculated the total return performance over a one-year horizon from the score publication in absolute terms, as well as relative vs. the MSCI Europe and relative to the specific sector. This approach should limit any potential outperformance related to the economic cycle and sector bias. Finally, we also controlled the outcomes for the effect of a change in 12-month forward earnings.

We found that combining current the ESG level with momentum could be a promising strategy. Identifying laggards set to improve their ESG score could capture higher performance than the overall market and sector, even when corrected for the respective relative earnings revision momentum. An increase of one notch from the first quintile (lowest total ESG scores) lead to a higher total return than the same increase from the fourth quintile (second highest ESG scores) relative to each company's own sector over a period of one year. The higher the starting point (quintile) of the ESG-improver, the lower the outperformance.

Similar results have been found also relative to the whole market, even after controlling for the earnings momentum the outperformance related to a one notch increase from the bottom quintile is higher than the relative positive EPS revision (median vs market: 11.3% TR vs 5.7% EPS change).

This result can be useful in building portfolios, by including a basket of companies that are left behind by standard ESG scoring but, crucially, are deemed by the specialist analyst or fund manager to be on the right path to improve.

QUINTILE CHANGE IN ESG SCORE

MEDIAN	Rel. vs. Market		Rel. vs. Sector	
	1Y TR	EPS	1Y TR	EPS
1st → 2nd	11.3%	5.7%	12.6%	6.4%
2nd → 3rd → 4th	5.9%	5.2%	5.5%	4.5%
4th → 5th	-1.2%	3.2%	-0.3%	2.2%
1st → 3rd	22.7%	24.5%	23.2%	19.7%
AVERAGE	1Y TR	EPS	1Y TR	EPS
1st → 2nd	10.2%	21.7%	11.0%	21.1%
2nd → 3rd → 4th	7.2%	6.3%	6.3%	2.8%
4th → 5th	0.4%	-0.8%	0.5%	-3.7%
1st → 3rd	23.7%	22.8%	23.1%	21.8%

Note: 1st quintile = worst 20% companies by score
Source: Refinitiv, GIAM calculation

Pay attention to activist investor campaigns

Moreover, stock screening to identify potential targets for activist investor campaigns may generate outperformance, should such campaigns be successful. Activist campaigns with a focus on environmental and social issues have gained momentum in the past years, doubling in proportion of total campaigns (from 10% to 20%) in the past 5 years. An activist investment approach towards ESG laggards – among other ESG strategies – may contribute to a tangible reduction in their negative ecological and social footprint, while also generating financial outperformance for investors.

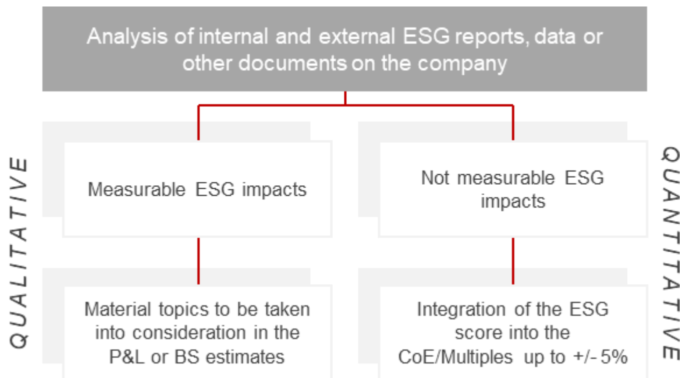
We found evidence in broker research and especially in academic literature – see Dimson et al. (2015), Barko et al. (2021) and Naaraayanan et al. (2021) among others – validating our findings. There is direct evidence that ethical investing and strong performance can go hand-in-hand, say Barko et Al. in their study. Engagement from activist investors seems most beneficial – both in terms of ESG performance

and financial performance – for firms with ex-ante low ESG performance, suggesting that these investors play an important role in helping firms understand how they can improve outcomes for all their stakeholders.

How does GIAM integrate ESG criteria?

At GIAM we have developed skills in active ownership and engagement that aim to seize the best investment opportunities and build more resilient portfolios with better long-term risk-adjusted returns. Our investment solutions, however, remain tailored to the risk profile and sustainability requirements of our clients, ensuring that ESG is always integrated into the investment process.

We believe that integration of ESG analysis unveils risks that traditional financial analysis might not capture. We have developed a proprietary equity ESG integration model that aims to improve our stock selection process and spot potential investment opportunities, including companies currently at the tail end of ESG rankings but that have taken a virtuous path to improve their ESG performance.



Potential to apply additional premium/discount to the target price by including further elements (eg. company's very low performance in some topics or other more recent news).

When analysing an equity holding, investors can adjust financial forecasts (such as revenue, operating cost, asset book value and capital expenditure) and/or valuation model parameters, to reflect expected impact of ESG factors.

The materiality of the ESG impacts can vary according to the industry – for example, an oil company will be more exposed to environmental issues, while a retail company to social ones. Beyond the identification of industry relevant ESG metrics, the past and future strategy of any investee company can influence its extra-financial behavior. It is therefore important to have a thorough idea of ESG materiality at a sector and company level.

Our two-step ESG integration process

GIAM's ESG equity integration process takes a two-step approach to assess, first, the relevant ESG factors impacts that can be embedded into the company's P&L and balance sheet, and next how to adjust the valuation model's parameters take into account the overall ESG rating of the investee.

The first step is qualitative analysis. In this phase, the equity portfolio manager uses internal and external research to gather and identify material factors likely to have a financial and quantifiable impact. The company's balance sheet or P&L are adjusted accordingly.

Examples of material factors are: reputational damages affecting sales, pending legal proceedings, heavy reliance on raw materials that are in short supply.

If there are no material issues to be included directly in the financial forecasts at industry or at company level, the portfolio manager implements only the second part of the process. This is more quantitative and takes into consideration the company's ESG rating. This second step is an adjustment of valuation-model parameters (like the cost of equity or multiples) by applying premiums/discounts according to the ESG rating. The portfolio manager can apply higher or lower premiums or discounts in case of particular severity of one or more topics (i.e. the same rating average but extremely poor result in one category flags a possible higher risk) or in case the application of the defined

premiums/discounts results in a market inconsistent model adjustments (too low cost of equity or a too high PE ratio for example).

The maximum cost of equity discount/premium given to a highly ESG rated company is 5%, which would imply a final target price on average of about 10% higher compared to the traditional financial approach. Empirical evidence shows that such an impact is considered to be consistent with equity market implied ESG valuation.

Conclusion

In summary, specialist asset managers should take care not to ignore companies that have a lower ESG score if, and only if, they are on track to improve. We believe that accurate ESG analysis and effective engagement is of paramount importance to spot investment opportunities in companies adequately equipped to improve their environmental and social characteristics while generating financial outperformance for investors.

GENERALI INSURANCE ASSET MANAGEMENT

LDI solutions and multi-asset portfolio management

Generali Insurance Asset Management (GIAM) is specialized in Liability Driven (LDI) solutions, leveraging a track record of solid performance in Generali Group insurance companies' portfolios and pension funds mandates.

GIAM offers LDI capabilities and solutions, Strategic Asset Allocation (SAA) and Capital Management, and benefit from extensive proprietary research and ESG analysis resources.

GIAM is part of Generali Investments' ecosystem of asset management firms.

The information contained in this document provides general guidance on the products and services offered by Generali Insurance Asset Management S.p.A Società di gestione del risparmio. Under no circumstances does it constitute an offer, recommendation or solicitation to (i) invest in shares and units of Undertakings for Collective Investments or (ii) request an offer for investment services. This document is not related to, or is the basis of, a contract or commitment. This document may not be considered as an explicit or implicit recommendation for an investment strategy or investment advice. Before entering into an investment service agreement, each potential customer will receive the documents as laid down by law from time to time, with the customer being required to read such documents carefully before making any investment decision. No part of this document may be (i) copied, photocopied or duplicated in any way or (ii) re-distributed without the prior consent of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio shall not be held responsible for any damages or losses related to the inappropriate use of the information contained herein. Generali Investments is a trademark of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A. Certain information in this publication has been obtained from sources outside of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio. While such information is believed to be reliable for the purposes used herein, no representations are made as to the accuracy or completeness thereof.