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Gaining an Edge with ESG

In this quantitative research study, we investigate the relationship between environmental, social and governance (ESG) factors and subsequent performance. We believe a systematic approach can provide meaningful exposure to companies that deliver strong ESG performance while potentially increasing overall returns.

Creating a Quantitative ESG Factor

In this section we describe the construction of a proprietary ESG metric that is suitable for integration with quantitative investment processes.

We have created a blended ESG rating that combines third-party data and Neuberger Berman's own fundamental research. We analyze companies across granular themes beneath the broader ESG umbrella; for example, environmental themes encompass issues related to climate change and pollution, while social themes include labor practices and product safety. The higher the theme score, the better a company's performance in hitting ESG targets (such as meeting net-zero transition milestones) and in managing ESG-related risks (say, by not discharging hazardous chemicals and avoiding potential fines).

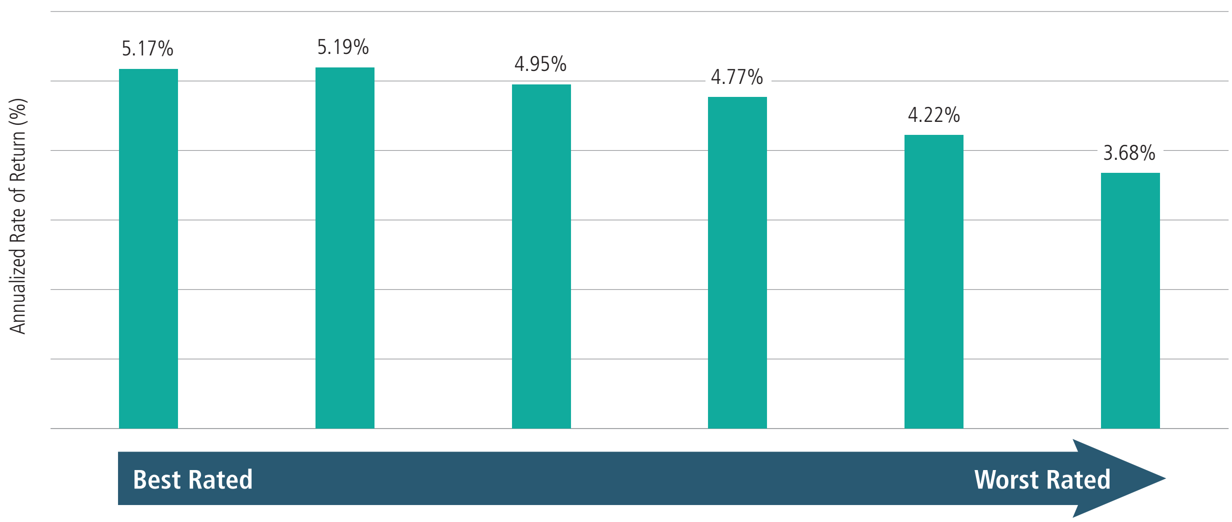
But we don't stop there. While granular ESG scores can be useful, we find that different ESG themes have different sector-specific impacts on expected returns. To capture these nuances, we relate the granular ESG scores with the historical performance of individual stocks to create a sector-by-theme materiality matrix. Using this matrix, we arrive at a blended ESG rating that incorporates a company's most relevant ESG drivers. We believe this approach has potential to deliver higher expected returns driven by ESG.

Returns Analysis

To review the effectiveness of this approach, we used our blended ESG rating to rank the constituents in the MSCI ACWI over a five-year period, from April 2019 to April 2024. The stocks were ranked from best to worst and separated into sixths; each sixth was aggregated across sector and region, then weighted by market capitalization. Sixths were reconstituted at the beginning of each month and returns were calculated over each one-month period.

Annualized returns for the five-year period are shown in the figure below. Result: Higher-rated stocks delivered larger returns than lower-rated ones, while the return spread between the best and worst sixth was 1.49% per year.

ESG FACTOR PROFILE



Source: Neuberger Berman, MSCI ESG Research, S&P Capital IQ.

Conclusion

By combining granular third-party ESG data with fundamental insights from Neuberger Berman's global equity research team, we believe we constructed a robust rating that meaningfully increases a portfolio's ESG exposure while potentially modestly increasing expected returns. Specifically, we find that MSCI ACWI constituents which scored in the top 16.67%, based on our blended ESG rating, tend to outperform the bottom 16.67% by 1.49% a year.

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