The Value of ESG -

Are Environemental, Social and Governance Factors relevant for Asset Pricing?

Topic of the month June 2012

It is nothing new that there has been a revolution in terms of the way in which financial economists see the investment world. However, the fact that there is a growing body of academics and practitioners thinking and writing about the importance of Environmental, Social and Governance (ESG) factors, influencing the risk and value potential of companies is something new. They are arguing that it is the unseen part below the surface, which is not covered by traditional financial analysis, which offers a more accurate and thorough understanding of a company's future. Traditional financial analysis should therefore be extended by an additional dimension *«The Sustainability dimension»,* which should offer a more accurate and thorough understanding of companies future risks and comparative advantages.

However, due to the multi-dimensionality and development of the ESG concept itself, as well as the variety of different methodologies used throughout the years, it is difficult to compare the studies and come up with a general statement. Therefore, more research on the ESG criteria impact is needed to make for a more convincing and viable case.

Sustainable Investing is not an attitude, it's an effective way of doing business.

A newly published working paper by this author (which builds the basis of this article) further investigates the impact of ESG issues on stock prices, while answering the question *"Are environmental, social and governance factors relevant for asset pricing?"*. For this purpose detailed environmental, social and governance (ESG) rating data for the period of January 2005 to December 2009, have been used to examine the pricing ability of environmental, social and governance factors on the US market, following the two-step test procedure described in Cochrane (2005). The long-term multivariate regression analysis used in this paper is based on common empirical asset pricing models, particularly known as the Fama and French 3-factor model (1993) and Carhart 4-factor model (1997), which are extended with an exclusively created ESG factor-mimicking portfolio.

The analysis provides evidence that for specific size and book-to-market sorted portfolios as well as for specific industry portfolios a significant linear relationship with the ESG factor is observable. In sum, however, they do not suffice to substantially increase the models' pricing ability, and hence the ESG factor has currently limited explanatory power. However, in light of several barriers that currently hamper the successful incorporation of ESG issues, this thesis provides further evidence of an increasing importance of ESG aspects and should be seen as a further contribution that helps ESG issues to become more convincing and viable in the future and in consequence attract further attention by mainstream investors and financial professionals.

Autor: Christoph Jochum, MSc.
CSSP-Center for Social and Sustainable Products AG
c.jochum@cssp-ag.com

Free Trial & Further Information

yourSRI does offer a free trial access to its database, no obligations and no fine print - please register at yoursri.com and join now.

If you are interested in further information, please feel free to contact us (info@yoursri.com).

yourSRI
fact sheet

CSSP
Center for Social and
Sustainable Products AG

Herrengasse 11
9490 Vaduz
Liechtenstein

www.cssp-ag.com
www.yoursri.com