Fidelity
White Paper

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Putting sustainability to the test: ESG outperformance amid volatility

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Executive summary

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The first nine months of 2020 were characterised by the Covid-19 crisis, which produced whipsawing markets, big changes in monetary and fiscal policy, and a uniquely austere economic outlook. This period contained the first broad-based market crash, and recovery, of the sustainable investing era, and so provided fertile ground for research into the relationship between sustainability and performance.

We previously focused our research on the crash itself in the first quarter of 2020, testing the effect of this volatility on companies with different environmental, social and governance (ESG) characteristics. Our conclusion then, over a relatively short time frame, was that companies with high sustainability ratings performed better than their peers as markets fell. This bore out our initial hypothesis that companies with good sustainability characteristics have more prudent management and will demonstrate greater resilience in a crisis.

For a fuller picture of the relationship between sustainability and market performance in times of stress, we re-tested our ratings and carried out a research update to include the first three quarters of 2020, taking in the market recovery from April onwards.

Strong correlation between market performance and ESG rating

We carried out a performance comparison across 2,659 companies covered by our equity analysts, and 1,450 in fixed income, using Fidelity International's proprietary ESG rating system. We found that the strong positive correlation between a company's relative market performance and its ESG rating held firm across the longer nine-month time frame.

Issuer numbers by asset class

The companies at the top of our ESG rating scale (A and B) outperformed those with weaker ratings (D and E) in every month from January to September, apart from April. Over the nine months, the A-rated stocks outperformed the MSCI AC World, while the linear relationship across the ESG ratings groups in the earlier research, which saw each one beating its lower rated group from A down to E, also held firm across the longer nine-month time frame.

Overall, we're pleased to observe the relationship between high ESG ratings and returns over the course of a market collapse and recovery, supporting the view that a company's focus on sustainability is fundamentally indicative of its board and management quality.

Fidelity's ESG ratings scale

Equity

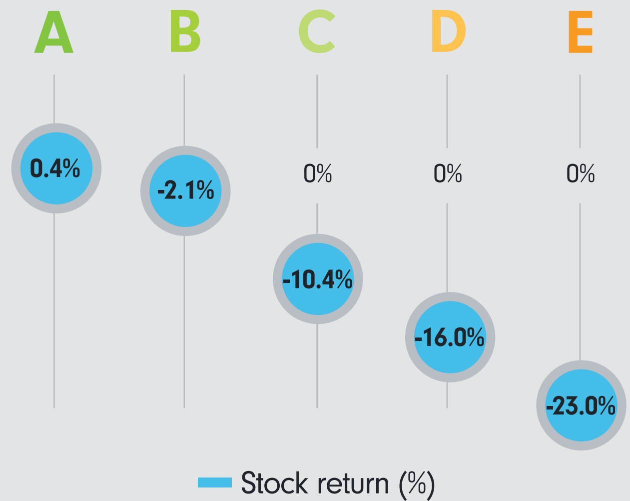
The sudden market drop between February and March was shocking in its severity, affecting markets across the globe. For example, in the US, it took the S&P 500 just 16 sessions to fall 20 per cent from its February peak, marking the quickest bear market in US history.

The recovery has been equally stunning, leaving the MSCI All Country World Index level with where it started the year. During this period, the share prices of companies with a high (A) Fidelity sustainability rating produced a positive equal weighted* stock return of 0.4 per cent, beating the global benchmark, while those rated B to E fell in price.

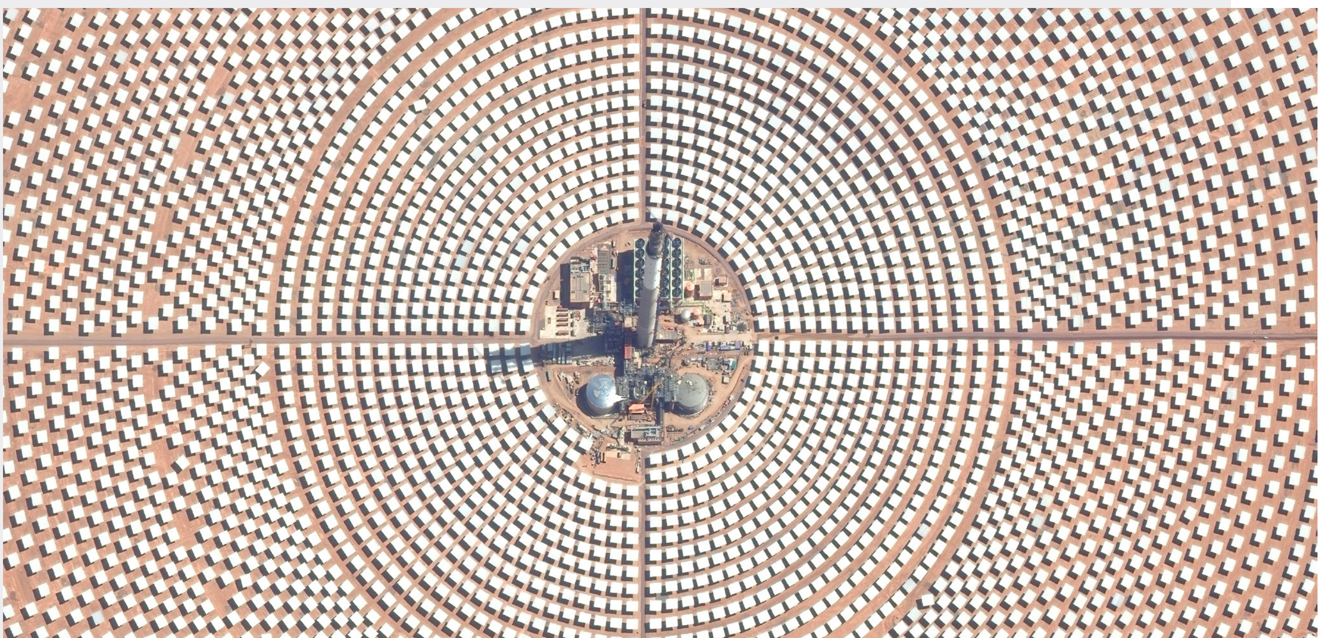
While each ESG grouping outperformed the one beneath it in the ratings, it is important to note that most rating groups underperformed the MSCI index due to the huge gains in the tech sector over the course of 2020. Tech stocks are dispersed throughout our ESG ratings, from A to E, hence all five categories have not been able to keep up with the benchmark.

Attention to ESG earns rewards

FIL ESG ratings and stock performance



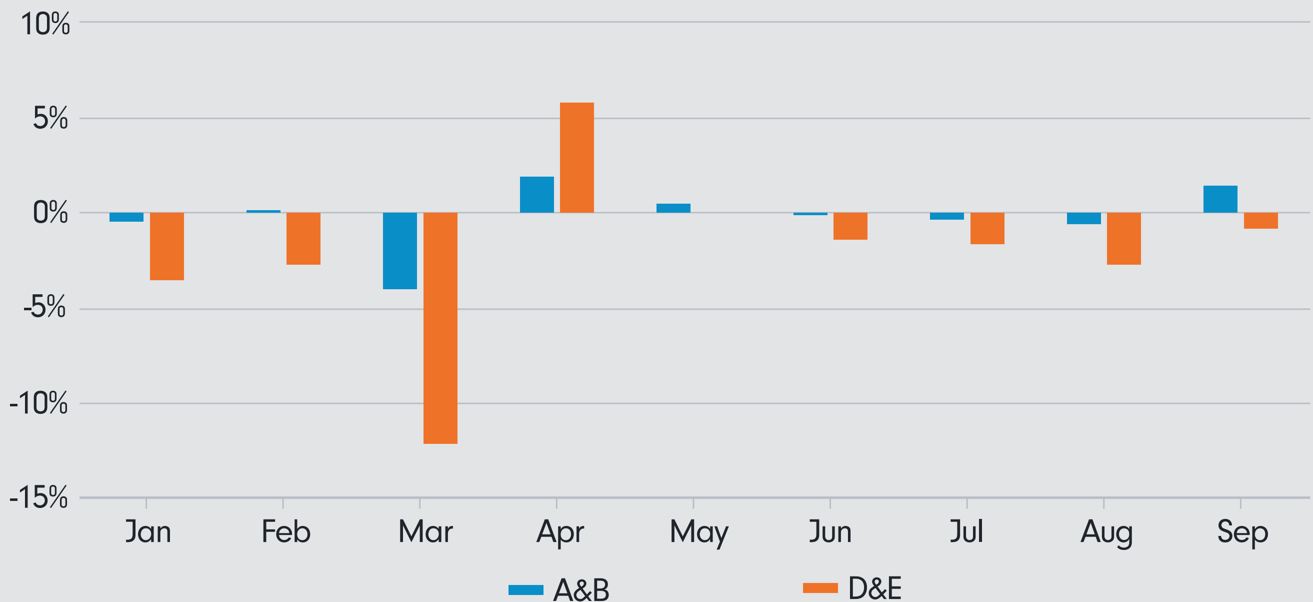
Source: Fidelity International, October 2020. Note: Chart displays equal weighted USD stock returns of A-E rated stocks vs MSCI AC World USD returns, from 1 January to 30 September 2020. Data from 2,659 company ratings.



Satellite image of the Ouarzazate Solar Power Station. (Credit: DigitalGlobe/ScapeWare3d, Getty Images)

Stocks with higher ESG ratings had better returns in almost every month

FIL ESG ratings and stock performance



Source: Fidelity International, October 2020. Note: Time period is 1 January to 30 September 2020

April breaks the winning streak of sustainable stocks

We performed a monthly returns analysis for the first nine months of 2020, relative to the MSCI AC World index. We observed that better ESG-rated stocks, the As and Bs, had higher returns than poorly rated stocks in all months, apart from April.

The groups with higher ratings fell less as the markets collapsed and rose less when they recovered sharply in April than those with lower ESG ratings.

The groups with higher ratings fell less as the markets collapsed and rose less when they recovered sharply in April than those with lower ESG ratings. This suggests that those stocks with higher ESG ratings also have a low beta, high quality factor and are less prone to volatility in the broader market.

Adjusting for quality

As well as the dispersion of returns mapping to ESG rating categories, we observed a similar correlation with return on equity (RoE). This indicates those stocks with a higher sustainability rating also have a bias towards being higher quality stocks, raising the prospect of drawing conclusions about ESG from the quality of a company's business.

With that in mind, we took a five-year average of our companies' RoE, sorted the universe in descending order, split them into five averaged buckets, and then analysed the stock performance to better pinpoint ESG as a factor in assessing market returns.

On an overall basis, the dispersion noted before holds up under this new analysis. The A and B ESG-rated stocks still managed to outperform those in the lower D and E categories across all five levels of average RoE, indicating that the

sustainability rating holds as a performance factor regardless of this definition of quality.

> The securities of higher rated ESG companies performed better on average than their lower rated peers from 2 January to 30 September, on an unadjusted basis.

Also, we found that the performance of poorly rated companies (D and E) in a high RoE bucket was, in many cases, worse than A and B-rated stocks of companies with a relatively lower return on equity. This suggests that the market has generally prized a company's sustainability characteristics over straight return on equity in 2020.

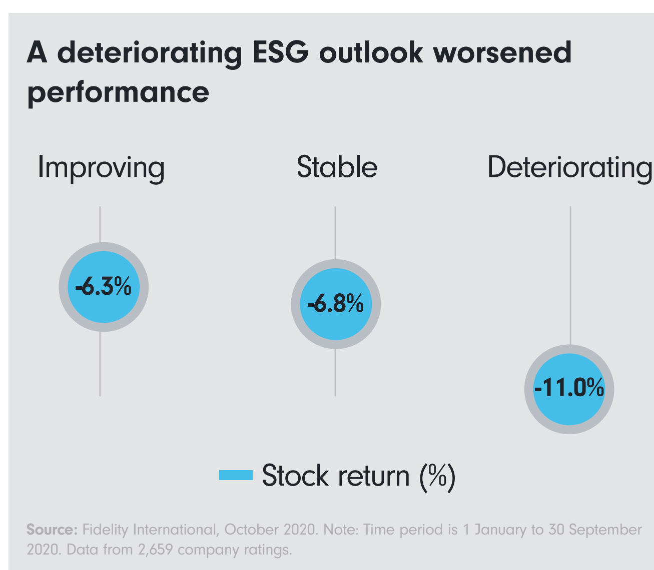
Rating direction: Companies with deteriorating ESG outlook underperform

In assigning the companies an ESG rating, our analysts also indicate whether they think a company ESG's performance is improving, deteriorating or stable. A full 31 per cent of companies have an improving outlook, with only 4 per cent seen to be in decline, which shows how seriously ESG is being taken at the highest levels of company boardrooms.

Looking at returns, those companies with a deteriorating outlook underperformed stable and improving peers for most rating levels.

Taken as a group, their stocks fell an average of 11 per cent over the first nine months of 2020, compared with a 6.8 per cent loss for companies with a stable outlook and 6.3 per cent for improving names. Again, this supports our hypothesis that companies with management teams who are engaged in ESG issues, enjoy better market performance. Again, the same tech sector effect as before is in evidence here.

A deteriorating ESG outlook worsened performance



Source: Fidelity International, October 2020. Note: Time period is 1 January to 30 September 2020. Data from 2,659 company ratings.

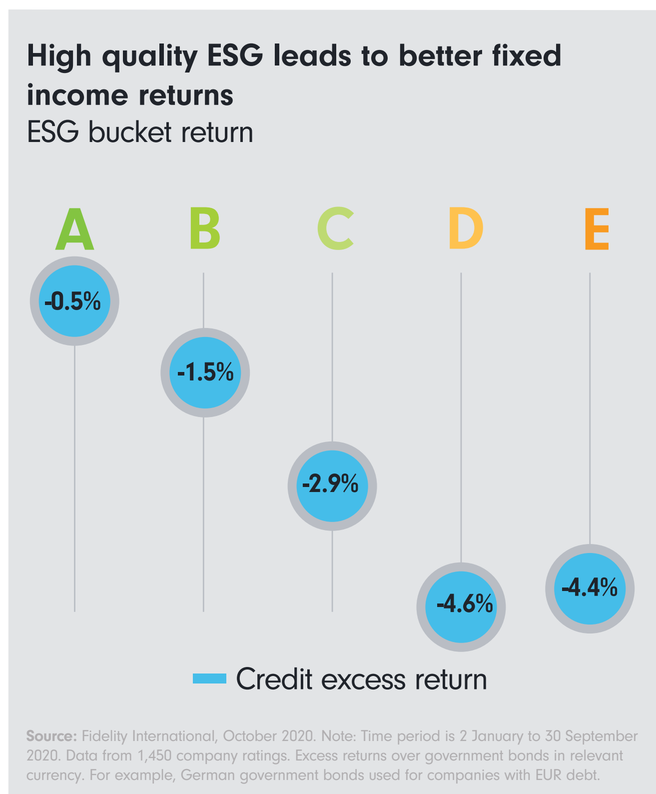
Fixed Income

The findings in fixed income are similar to those in equity. The securities of higher rated ESG companies performed better on average than their lower rated peers from 2 January to 30 September, on an unadjusted basis.

> The quality-adjusted data shows that the bonds of higher rated companies outperformed their lower rated peers both during March's collapse and April's recovery.

The bonds of the 154 A-rated companies returned around -0.5 per cent on average, compared with -1.5 per cent for the 557 B-rated companies and -4.6 per cent for the 225 D-rated companies.

There is some bunching between D and E-rated companies, which may be explained by the latter's low sample size of only 24 companies.



High quality ESG leads to better fixed income returns
ESG bucket return

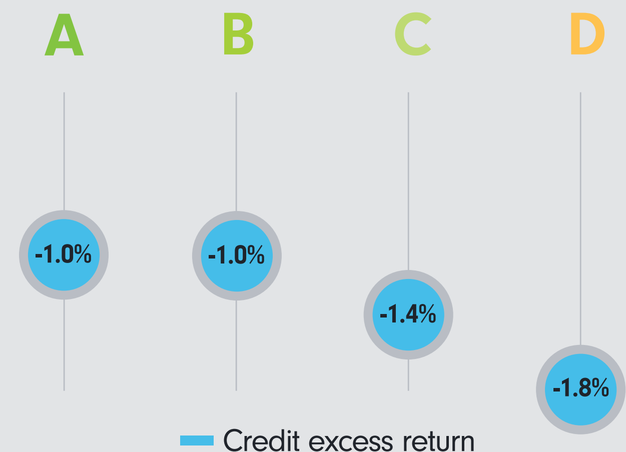
Source: Fidelity International, October 2020. Note: Time period is 2 January to 30 September 2020. Data from 1,450 company ratings. Excess returns over government bonds in relevant currency. For example, German government bonds used for companies with EUR debt.

Adjusting for credit quality

Not all bonds are created equal. We observed that companies with a high ESG rating also had a lower average credit spread (option adjusted spread) to start with, indicating that they are high quality names and would be expected to outperform lower rated peers in volatile markets.

When we control for the starting level of credit beta of each issuer, performance across the Fidelity ESG rating grades is persistent and bonds from higher rated companies still fared better than their lower rated counterparts.

Adjusting for starting spread gives similar dispersion pattern
ESG bucket quality-adjusted return



Source: Fidelity International, October 2020. Note: Time period is 2 January to 30 September 2020. Excess returns over government bonds in relevant currency. For example, German government bonds used for companies with EUR debt.

For this calculation, we separated the tickers by their starting credit spread into quintiles and calculated the average return for each combination of quintile and ESG rating, averaging again by the credit spread buckets to get a single number for each A-E rating.

We removed all E-rated tickers and all tickers in the lowest credit quality quintile from the analysis, due to low numbers of both.

Month-by-month breakdown

In our final piece of analysis, we split the headline figures out by month for more detail on how the securities behaved during the different periods of a volatile 2020. The quality-adjusted data shows that the bonds of higher rated companies outperformed their lower rated peers both during March's collapse and April's recovery.

May was the only month where the Cs and Ds did better than their more sustainable counterparts, but, even then, only on a marginal basis.

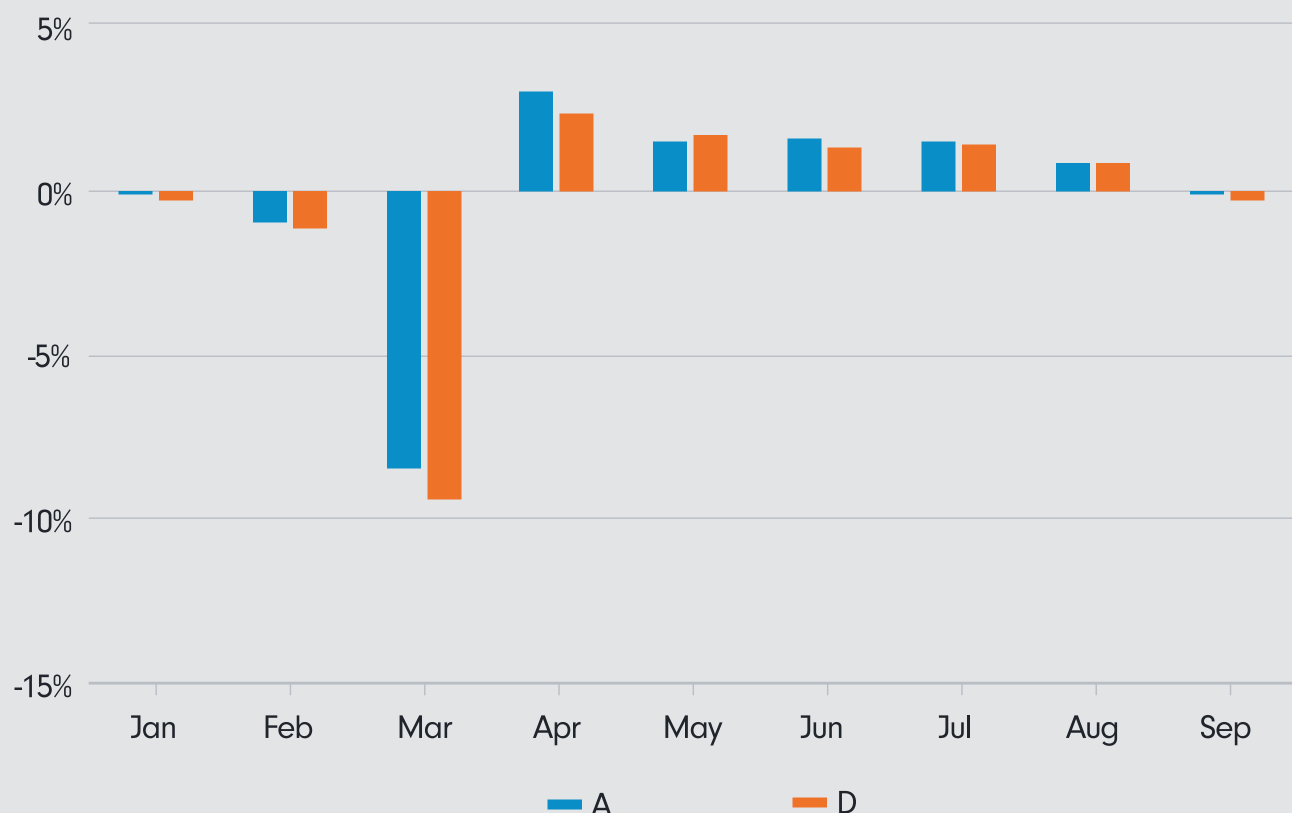
Conclusion

The market volatility of 2020 echoes that of 2008, despite the difference in circumstances. It would be natural to shorten investing horizons in a time of uncertainty and put longer-term concerns about environmental sustainability, stakeholder welfare and corporate governance on the back burner.

But our research suggests that the market does, in fact, discriminate between companies based on their attention to sustainability matters, both in crashes and recoveries, demonstrating why sustainability is at the heart of active portfolio management.

Sustainability is an indicator of better performance in rough bond markets

FIL ESG rating monthly quality-adjusted return



Source: Fidelity International, October 2020. Note: Time period is 2 January to 30 September 2020

Equity methodology note

We decided to equal weight issuers within our ESG categories for two reasons. First, equal weighting avoids the potential for the performance of an ESG group to be skewed by a stock with a particularly large or small market capitalisation.

Second, at Fidelity International, we consider companies of all sizes and market capitalisations for potential alpha opportunities, and so felt that equal weighting was an appropriate step to take when evaluating the results.

To give the research a defined context within the broader equity world, we compared it to the market-weighted MSCI World Index. As a widely used, standardised measure, we think it provides the easiest to comprehend and most recognisable benchmark for our system.

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