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Evaluating ESG and Economic Value Added Momentum

FOCUS/THEMES	INDUSTRIES/COMPANIES	COUNTRY/REGION
ESG & EVA Momentum	ALL	Global

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KEY TAKEAWAYS

- ESG Momentum is an important consideration when looking at potential outperformance, and can be a better indicator of alpha than pure ESG Performance.
- Firms with increasing ESG Momentum that are nevertheless rated below 'Prime' offer room for further improvement.
- Combining EVA Momentum and ESG Momentum can generate additional alpha, particularly for small caps.

Incremental Growth

An Environmental, Social, and Governance (ESG) Performance score can be likened to a financial quality indicator. Firms with the strongest ESG Performance often also have high levels of financial risk-adjusted profitability (Quality), as measured through the [Economic Value Added \(EVA\)](#) framework. EVA converts accounting profit into economic profit by reversing accounting distortions and measuring the dollar value profit after *all* costs, including the cost of giving shareholders a fair return on invested capital, have been considered. EVA is what ISS ESG uses to measure financial materiality.

When a market moves away from high-Quality firms, often the most expensive in terms of valuation, the highest-performing ESG firms can come under selling pressure. Companies have followed this pattern through 2022.

This paper examines incremental improvements in [ISS ESG Performance Scores](#) and EVA generation (EVA Momentum). The focus is on firms that are growing EVA, as more EVA is always better. The analysis will show if more ESG is better.

ESG Momentum

The ESG Rating and Performance Score

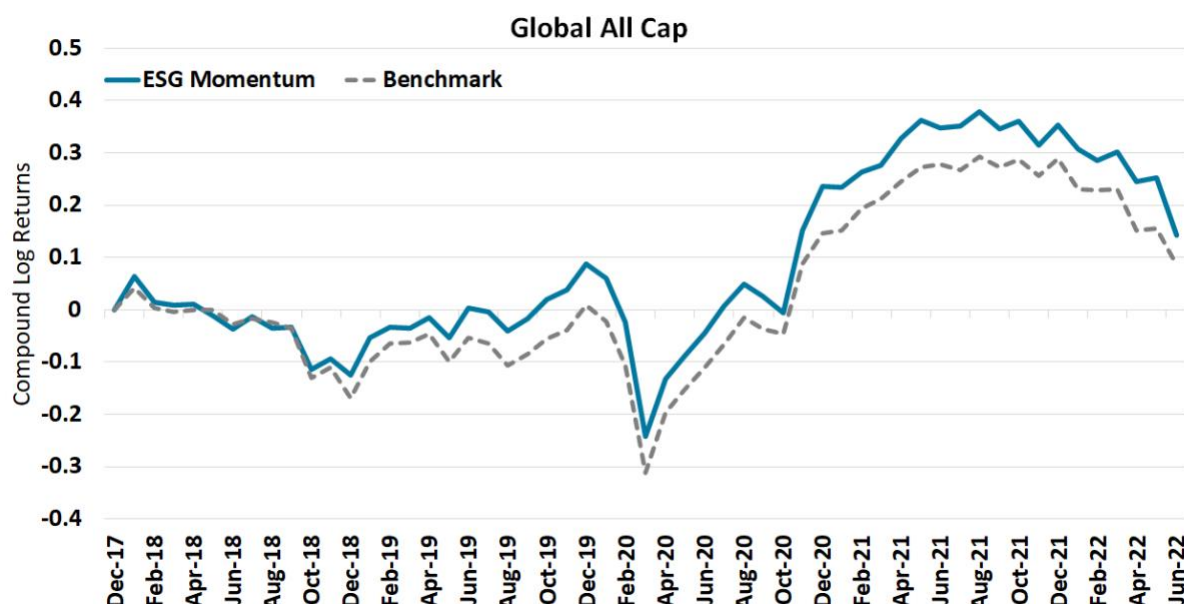
provides a numerical score from 0 to 100. Prime Status is based on the ESG rating and a sector-specific Prime threshold. The ESG Rating and Performance Score, however, is comparable across all rated entities. Rated companies with values greater than or equal to 50 are Prime, companies with values less than 50 are not Prime.

[ISS ESG Corporate rating methodology.](#)

ESG Momentum matters. The chart below shows firms that have seen an improvement in their overall ESG Performance score from 2017 to 2022. This chart also contains a benchmark of large and small cap companies covered in the EVA framework.

As of June 2022, a total of 1,895 firms have seen their ESG Momentum improve since 2017. In aggregate, these firms have consistently outperformed the benchmark since the fourth quarter of 2018. These firms have also maintained their outperformance through the aggressive market sell off in 2022. This performance is consistent with the notion that ESG Momentum can work in varying market conditions. ESG Momentum applies not just when high financial quality is outperforming, but also when cheap value is outperforming, which is when ESG Performance may start to struggle.

Figure 1: Global All Cap ESG Momentum



Source: ISS ESG & ISS EVA Data

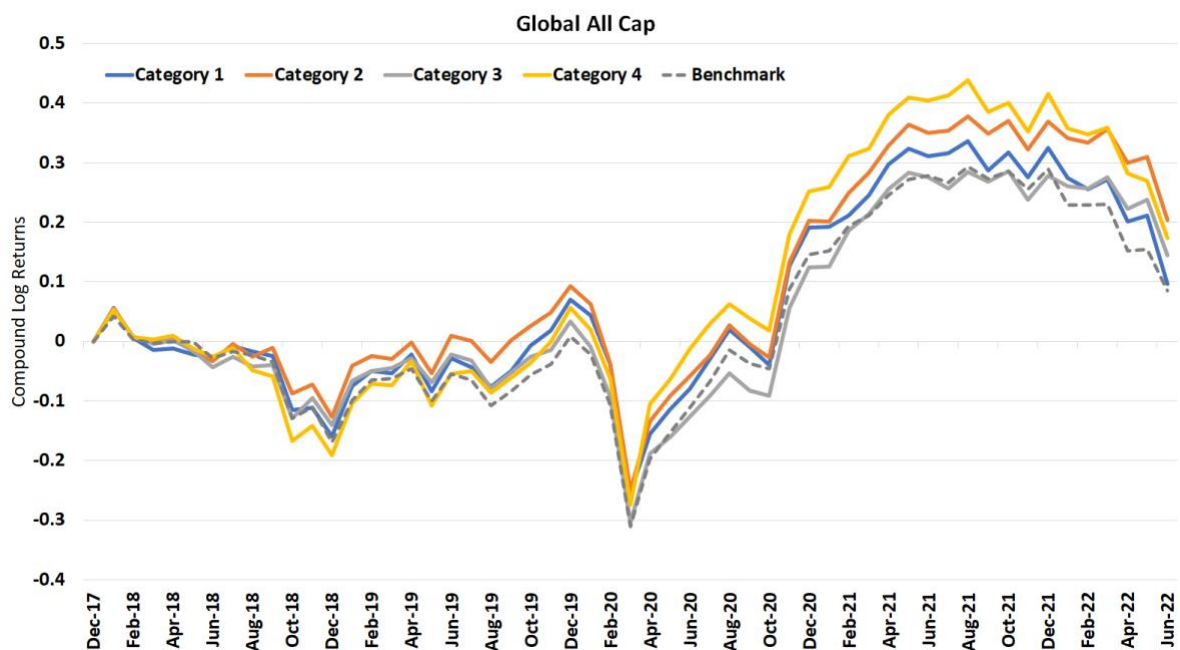
ESG Momentum Categories

To further understand ESG Momentum, the ESG-improving firms can be grouped into four ESG Momentum categories. The returns of these four categories are graphed in Figure 2 below:

- ESG Momentum Category 1 (blue line) for firms that have moved to Prime status (***ESG ≥ 50 , companies had score of < 50 four years ago***);
- Category 2 (orange line) for firms that have improved to above 30 but remain below Prime (***ESG > 30 , < 50 [companies had at least three improvements in score over the last five years]***);
- Category 3 (grey line) for companies that have improved but score below 30 (***ESG < 30 [companies' total improvement > 10]***); and
- Category 4 (yellow line) for firms that have seen a less consistent improvement (***ESG > 30 , < 50 [companies had negative or less than three positive changes, total improvement > 15]***).

The equal-weighted average returns of the benchmark are represented by the dotted line. An important consideration is whether a firm that has moved to a Prime rating status has less potential for improvement once it has crossed that ESG rating threshold. Such a condition suggests that ESG Momentum is less cyclical through market cycles.

Figure 2: Global All Cap ESG Momentum Returns



Source: ISS ESG & ISS EVA Data

Category 1 firms, those that have moved from below Prime to above Prime, have tended to outperform, but less so than the Category 2 firms. Category 2 includes companies that have seen incremental gains in ESG Performance over at least three time points over the prior five years and have a score above 30, but are still rated below Prime. Category 4 firms, which have made less progress towards improvement, tended to underperform prior to the COVID-19 lows, and have outperformed since the March 2020 dip. This tendency likely reflects investors moving lower in the quality curve as economic activity started to recover.

Coverage

Table 1: Companies with Improved ESG Performance, by Category

Category	Firms
1	347
2	1114
3	376
4	58
Total	1895

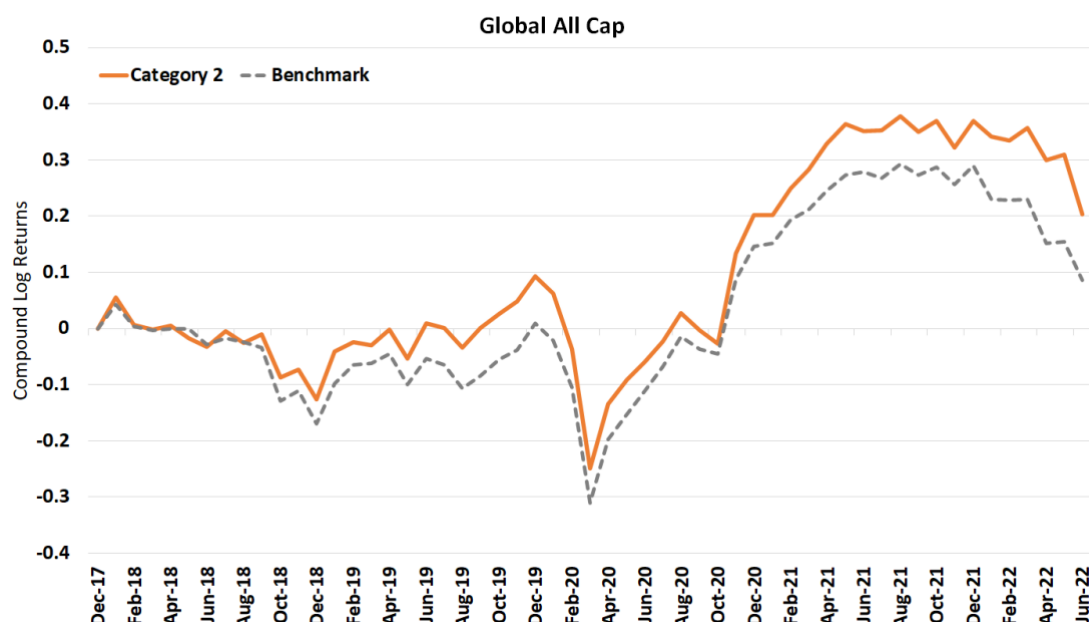
1,895 firms have seen an improvement to their ESG Performance scores since 2017. Category 2 has the largest count, followed by Categories 3 and 1.

Source: ISS ESG Data

Picking from the ESG Momentum Categories

Figure 3 below shows that focusing on the right type of ESG Momentum opens up additional outperformance opportunities. The Category 2 companies, which score below 'Prime' (that is, they score < 50), but are above 30 and have had at least three ESG performance improvements over the prior 5 years, may interest investors who want to avoid financial value traps. Focusing on companies that have a score of above 30 means avoiding the companies with the worst ESG scores. That these companies also have scores below 50 means that they offer room for further improvement.

Figure 3: Focusing on Category 2



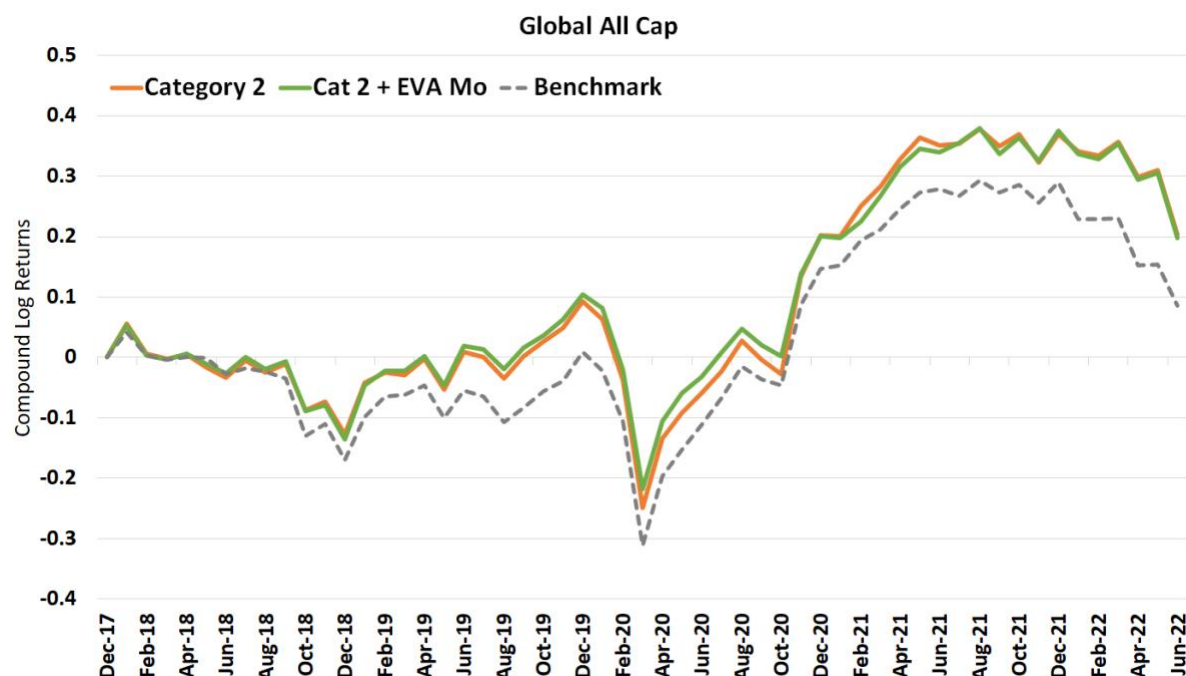
Source: ISS ESG & ISS EVA Data

Adding EVA Momentum

Adding the EVA growth measure, EVA Momentum, to the Category 2 firms (Figure 4) serves to incorporate financial materiality. EVA Momentum captures the change in EVA and can be thought of as measuring ‘business model momentum.’ It is the ideal summary measure of incremental value creation.

The ability to sustain and extend periods of EVA Momentum is often key to share price performance. Directional changes in EVA Momentum, known as inflection points, can highlight turning points in stock performance. EVA Momentum has usually added alpha, although it has struggled somewhat during the first half of 2022. The latest [PRVIt Factor Report for the Global universe](#) provides historical backtest results for all of [ISS EVA](#)’s Profitability, Risk, and Valuation metrics.

Figure 4: Focusing on Category 2, plus EVA Momentum



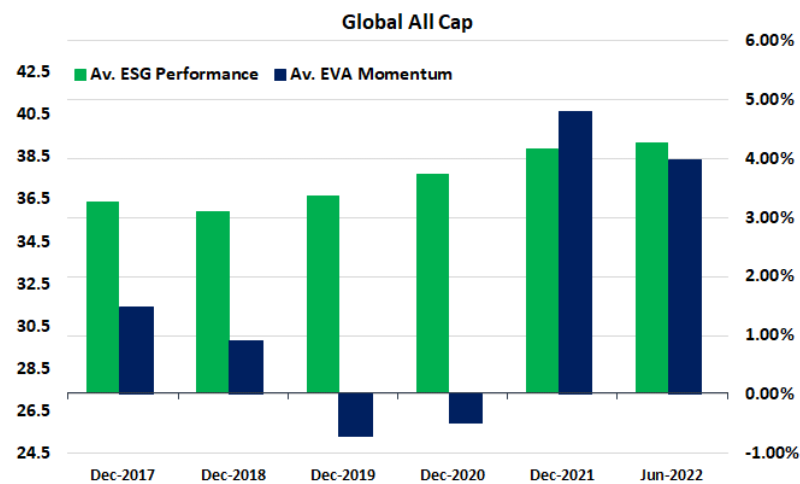
Source: ISS ESG & ISS EVA Data

Average Momentum Trend

Figure 5 shows the aggregate average ESG Performance score (green bars) and aggregate average EVA Momentum (blue bars) for the companies with ESG Momentum that broadly improved each year from the end of 2017. ESG Performance scores initially dipped slightly in 2018 and saw strong expansion from 2018 to 2021, before slowing while maintaining a higher absolute score level overall. EVA Momentum generally fell through 2019, but had rebounded strongly by 2021 and has remained at a high level.

The [EVA Matters II paper](#) written by Dr Kevin Spellman explains how improving profitability and growth relates to positive change in ESG Performance. Higher EVA Margin (a profitability measure), EVA Spread, and return on invested capital are all associated with higher changes in ESG Performance.

Figure 5: ESG Performance and EVA Momentum among All Companies with Improved ESG Momentum

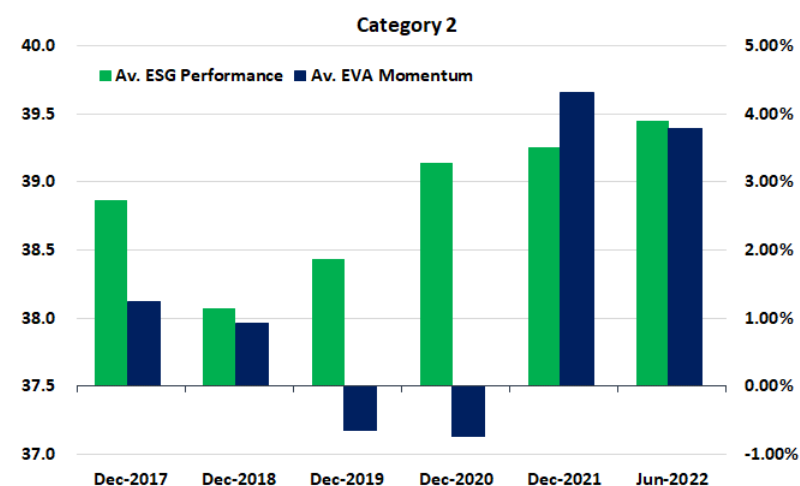


Source: ISS ESG & ISS EVA Data

Category 2 Firms' ESG Performance and EVA Momentum Trends

The aggregate average ESG Performance and aggregate average EVA Momentum score for the Category 2 ESG Momentum firms is shown below. ESG Performance scores initially dipped in 2018 before seeing sequential improvements after that. EVA Momentum turned negative in 2019 and 2020 but rebounded strongly. Category 2 firms may be interesting to investors due to the room for additional improvements in ESG Performance which the market could react favorably to.

Figure 6: ESG Performance and EVA Momentum among Category 2 Companies



Source: ISS ESG & ISS EVA Data

Category 2 Sector Contribution

Table 2: Category 2 Companies, by Sector

Sector	Category 2
Industrials	190
Financials	175
Consumer Discretionary	119
Health Care	109
Information Technology	98
Materials	98
Real Estate	80
Consumer Staples	74
Utilities	61
Energy	58
Communication Services	52
Total Companies	1114

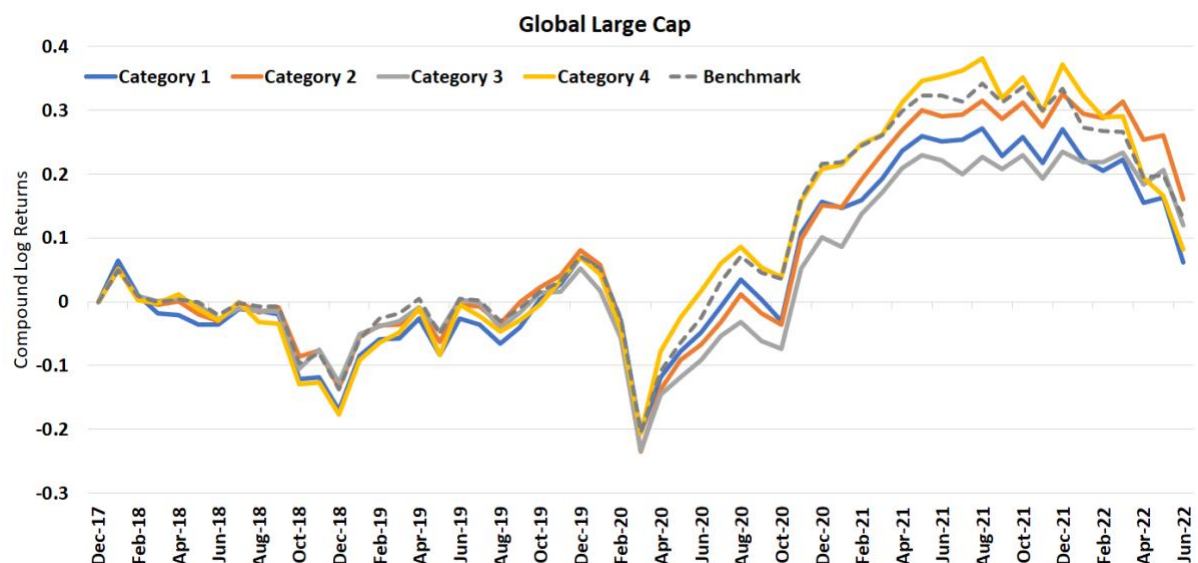
The Industrials and Financials sectors account for the largest number of firms in Category 2. Consumer Discretionary has the third-highest contribution and rounds out the top three sectors, which are all economically cyclical.

Source: ISS ESG & ISS EVA Data

ESG Momentum Categories Even More Important in Large Cap

This analysis also takes into account the difference between large cap and small cap firms. Large cap firms have seen ESG Momentum struggle, except for Category 4 firms, which have performed the best from the March 2020 lows (Figure 7). Category 2, the focus category, has generally been the next-best performing. Category 1 firms that have reached Prime status have struggled. These Category 1 struggles may be the result of any potential improvement already having been priced in by the time the firm reached the Prime standard.

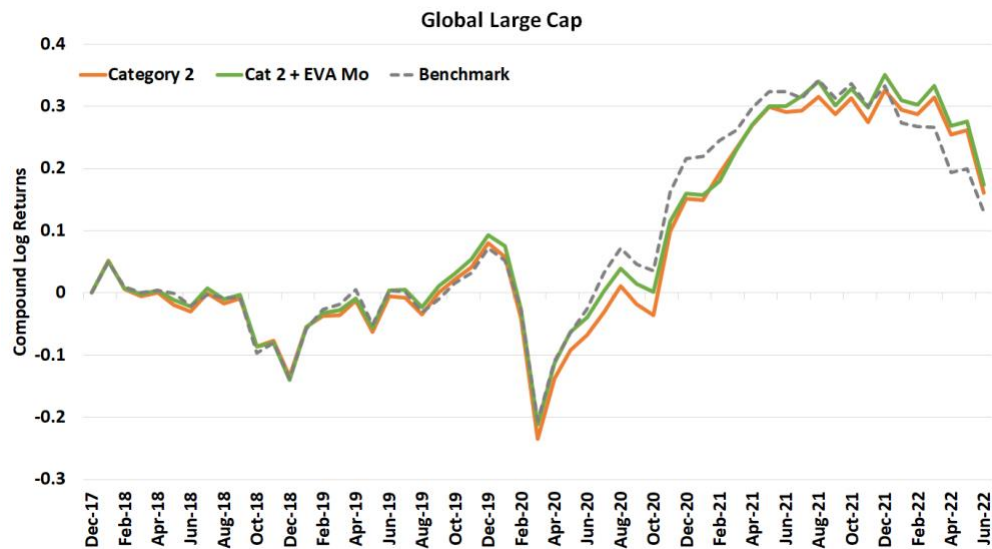
Figure 7: Global Large Cap ESG Momentum Returns



Source: ISS ESG & ISS EVA Data

Adding EVA Momentum (Figure 8 overleaf) generates additional performance.

Figure 8: Global Large Cap EVA & ESG Momentum Returns, Category 2

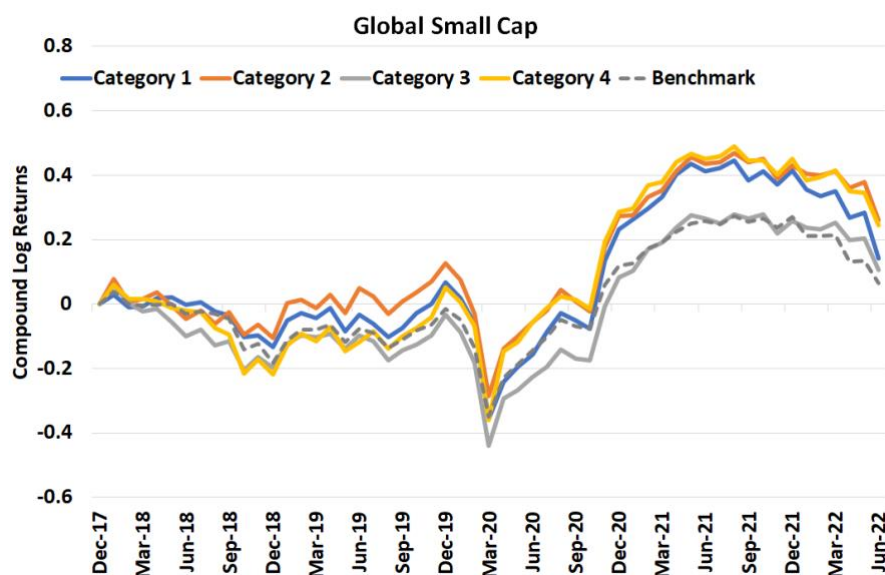


Source: ISS ESG & ISS EVA Data

Small Caps See Higher ESG Momentum Performance

Small Cap firms have seen stronger performance from the ESG Momentum categories, with only Category 3 having struggled to outperform the benchmark. Category 3, which includes firms that still have an ESG Performance score below 30, could be likened to a 'value trap,' as the firms have improved but are still in the lower ESG Performance quality bracket.

Figure 9: Global Small Cap ESG Momentum Returns

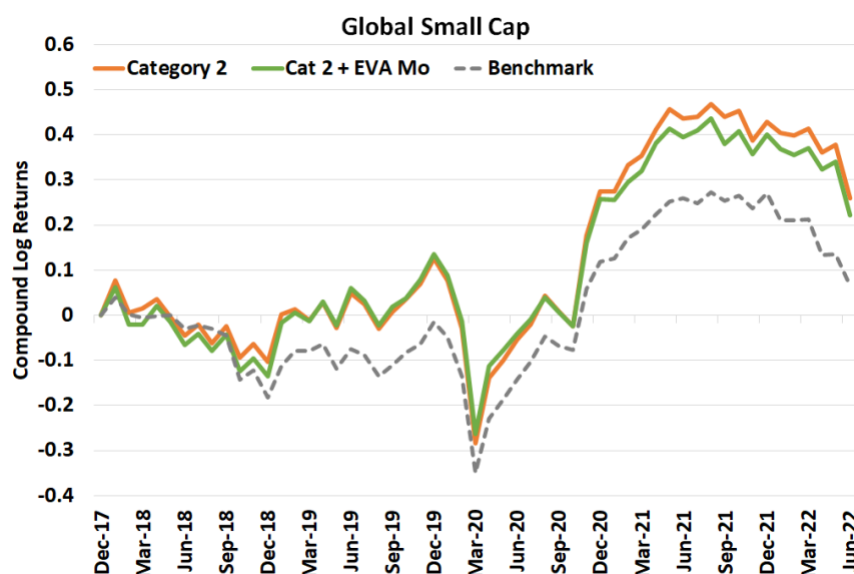


Source: ISS ESG & ISS EVA Data

Category 2 has been among the strongest-performing categories for small caps. Adding EVA Momentum (Figure 10) shows that heading into and out of the March 2020 lows, additional performance was generated above Category 2. Since the end of 2020, EVA Momentum has been a

drag, perhaps due to the greater focus through the recovery on firms with a cheap valuation rather than those with higher trend levels of Profitability in the small cap space.

Figure 10: Global Small Cap EVA & ESG Momentum Returns, Category 2



Source: ISS ESG & ISS EVA Data

Conclusion

The use of ESG factors in the investment process is still often thought of largely as a matter of risk mitigation. ISS ESG goes beyond this approach, working with clients to help integrate ESG into their investment framework and find alpha-generating opportunities.

ESG Momentum matters and should be a key consideration in investment decisions. When considering ESG Momentum, it is important to identify a firm's starting point and its relative progress in terms of improving or deteriorating ESG Performance.

Firms that reach Prime status have improved their ESG Performance more than those that have not. As a firm may be re-rated due to improving earnings, reaching Prime may lead to a firm's ESG re-rating. Firms that have been incrementally improving their ESG Performance yet still score below Prime can perhaps achieve further improvements. Identifying such firms may offer an opportunity to investors—hence this paper's focus on Category 2 firms.

ESG Momentum can also help to identify engagement opportunities. By using the highly detailed and transparent [ISS ESG Corporate Rating](#) data, investors can learn about an investee or potential investment candidate's ESG Performance and where to look for further Performance improvements. EVA Momentum may also prove a powerful tool to use in conjunction with ESG Momentum, particularly for the large cap firms where obvious additional performance has been generated. For investor's seeking to use this tool, [ISS EVA's work](#) can be valuable resource.

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