

Why ESG Is Too Critical to Ignore

Understanding how companies and investors are positioned for ESG

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Savita Subramanian
Head of U.S. Equity and Quantitative
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WHY COMPANIES THAT DO GOOD MAY BE THE BEST PERFORMERS

More and more, research suggests that if you want to know which companies are built for long-term prosperity, first check out what kind of corporate citizens they are.

It stands to reason that forward-looking policies on improving the environment, helping the communities they serve, treating employees fairly, and maintaining strong governance practices can all help companies promote a more sustainable world. Historically, adopting such policies was primarily a means for companies to demonstrate good corporate citizenship. Yet as an increasing number of businesses formally weave environmental, social and governance (ESG) issues into their operations, strong evidence is emerging that such practices also improve their financial performance—and make those companies healthier and more attractive to investors.

KEY TAKEAWAYS

ESG practices may improve a company’s financial performance.

ESG ratings can help signal future earnings volatility.

The benefits of ESG take time and rarely materialize overnight.

"When you buy a stock you're buying the earnings power of a company along with what you hope is some safety and predictability that those earnings will continue to grow," says Savita Subramanian, head of U.S. Equity and Quantitative Strategy at BofA Merrill Lynch Global Research. "I've been a quantitative analyst for 20 years, and I've never seen anything as effective as ESG characteristics when it comes to anticipating future earnings and volatility of U.S. corporations."¹

In their research report ["ESG Part II: A Deeper Dive,"](#) Subramanian and her colleagues suggest that progressive ESG practices make companies less likely to suffer large price declines, and signal significantly better three- to five-year returns on equity than their counterparts and a greater chance of long-term success. As one example, an investor who factored ESG into long-term investment decisions starting in 2008 would have avoided 90% of the U.S. corporate bankruptcies that have taken place within the universe of companies they analyzed since then, Subramanian says.

Based on historical data from recent years, Subramanian's research found that companies in the top fifth in terms of ESG ratings in 2005-2010 experienced the lowest (32%) volatility in earnings per share in the subsequent five year period. By contrast, companies with the worst environmental, social and governance records averaged 92% volatility.²

Yet ESG benefits rarely materialize overnight, Subramanian notes. A strong record on environmental or governance issues, like a reputation, may take years to develop, and U.S. companies are just beginning to understand the impact on their bottom lines. "As a society we can be very short-term in our focus," she says. "But ESG doesn't necessarily work over the next month or quarter. You start to see results over the next year, or three years, or five years."

Still, for companies and investors willing to be patient, Subramanian adds, "It's a great thing when you find something that's good for the world, and also good for your wallet."

READ OUR RESEARCH ON ESG

For a more in-depth look into ESG and how companies, regulators and investors are positioned for it, read our report [ESG Part II: A Deeper Dive](#).

DATA SOURCES

¹ "ESG Part II: A Deeper Dive." BofA Merrill Lynch Global Research report. 6-1-17

² Ibid

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