Examining the Integration of ESG Factors into Sell-Side Research

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Intro

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“Show me the incentives and I will show you the outcome.“

Warren Buffett on Incentives

- Importance of aligning management incentives with ESG goals to foster responsible corporate behavior.
- ESG integration as a hallmark of high-quality fundamental investment analysis, essential for sustainable long-term returns and better informed decisions.

Defining ESG: ESG Scores

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Environmental factors:

- Climate change impacts, carbon emissions, energy efficiency, waste management, resource use.

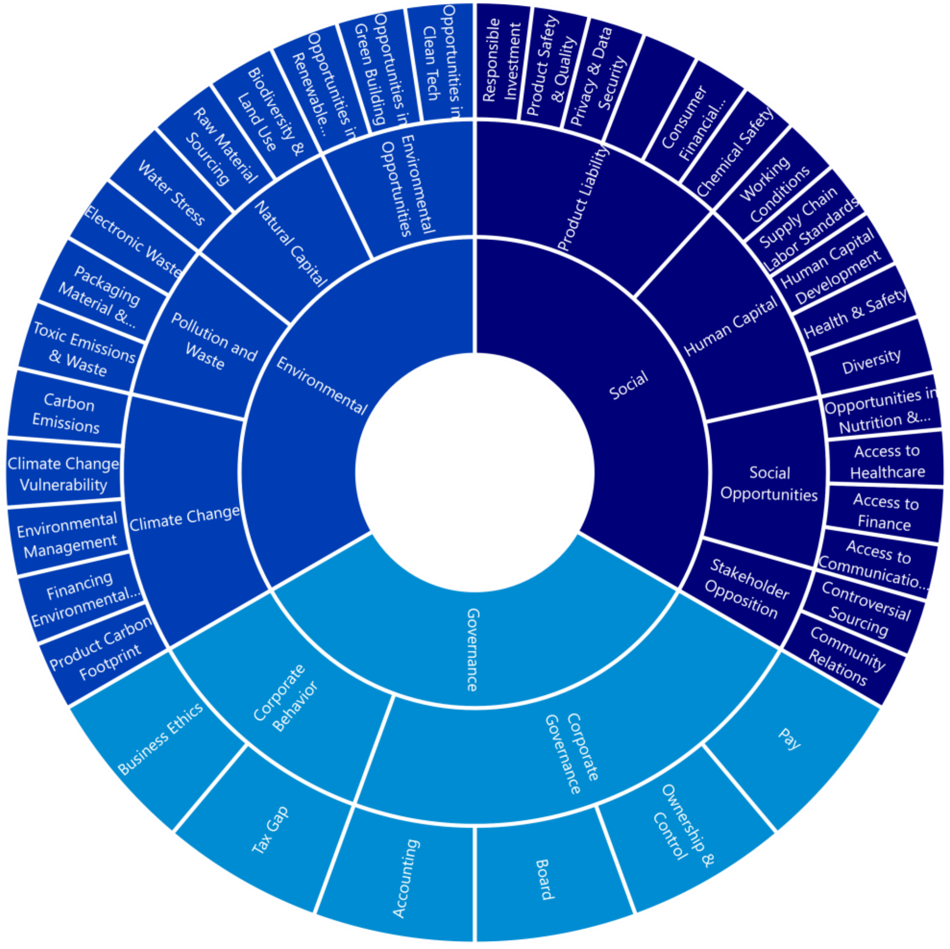
Social factors:

- Labor practices, workplace diversity, community impact, human rights, consumer relations.

Governance factors:

- Transparency, executive compensation structures, board diversity/skills, ethical standards, anti-corruption.

Swisscanto ESG score as the basis for integration



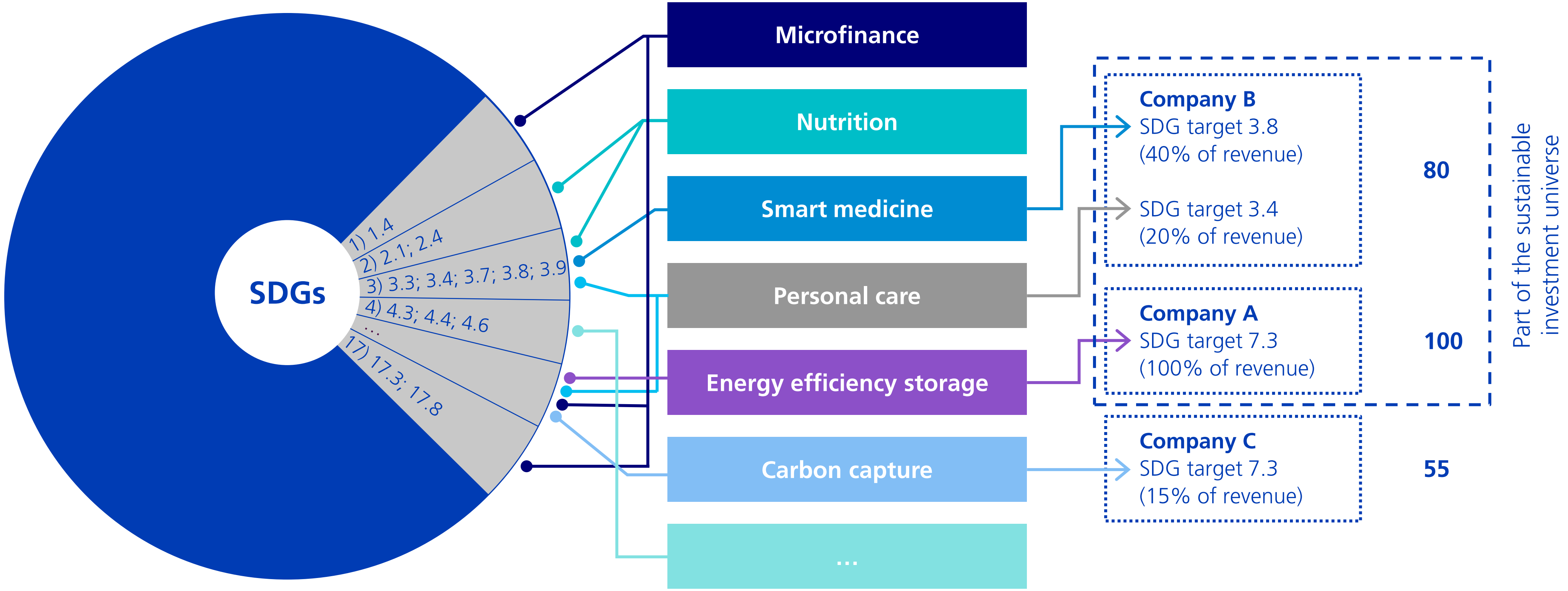
Defining ESG II: SDG-aligned investing - linking corporate solutions with SDG targets

17 SDGs with 169 SDG targets
40 of the 169 SDG targets can be directly assigned to the companies' sustainable solutions (marked in gold), the remaining 129 SDG targets cannot be assigned (marked in red)

Sustainable and non sustainable business solutions in the example areas…
These make a significant contribution to achieving at least one SDG.

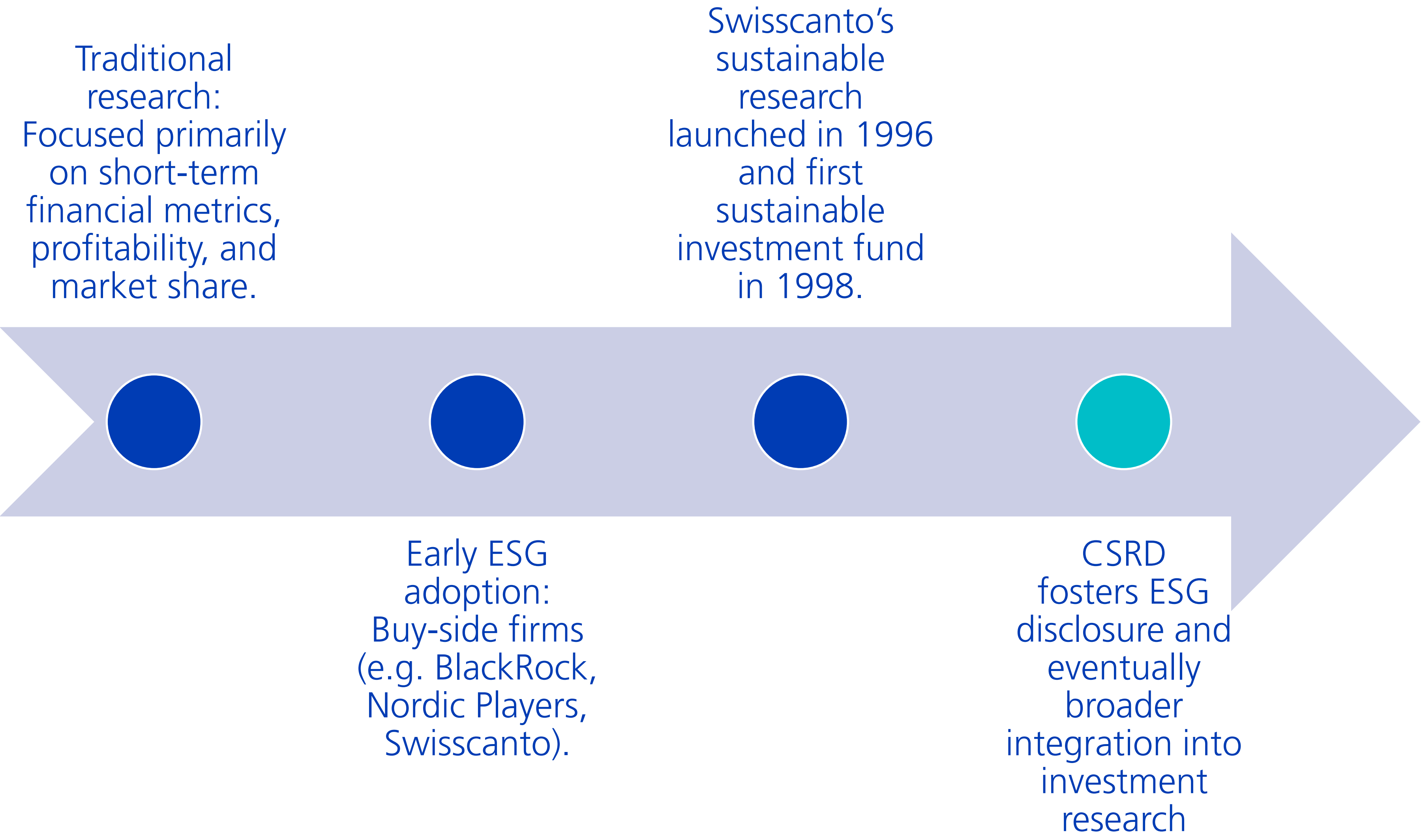
Company level
Share of revenue from sustainable solutions in relation to UN SDG targets

Swisscanto SDG score
Requirement for SDG leaders:
≥ 60 for thematic funds
≥ 66 for other Sustainable Funds



Source: Zürcher Kantonalbank

Evolution of ESG in Investment Research



Sustainability has been our conviction for 29 years

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1996
- Signing the UNEP-FI Declaration (UNEP FINANCE INITIATIVE)
- Sustainability research

1998
- First sustainable investment fund

2003
- Launch of sustainable mixed investment funds

2007
- Edition sustainable Thematic funds
  – Water
  – Climate

2009
- Signature of the PRI (PRI Principles for Responsible Investment)

2011
- Sustainability indicator for All funds

A B C D E F G

2018
- Expansion of sustainable product range with focus on Swiss equities and portfolio funds

2020
- Standardised alignment with the Paris Climate Agreement [1]

-CO_2e

2022
- Launch of Private Equity Carbon Solutions

2024
- Launch sustainable Thematic funds
  - Circular Economy
  - Digital Economy
  - Healthy Longevity

2025
- Launch sustainable ETFs ESGeneration

[1] Standard for actively managed responsible and sustainable investment funds in traditional asset classes (exceptions possible) and in selected indexed products.

Drivers of ESG Integration
Events

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Environmental: BP Deepwater Horizon oil spill (2010) - ecological and financial impacts.

Social: Rana Plaza collapse (2013) highlighting corporate responsibility for labor practices.

Governance: Volkswagen emissions scandal (2015), Wirecard fraud (2020) - transparency and accountability.

Integrated Financial Analysis & Stewardship Activities (Engagement & Proxy Voting)

Drivers of ESG Integration

Why ESG and Financial Performance are connected

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Risk Mitigation: ESG-conscious companies are often better at identifying and mitigating long-term risks, such as regulatory changes, environmental disasters, or social unrest. This allows them to avoid costly surprises and maintain stable financial performance.

Operational Efficiency: By implementing sustainable practices, companies can reduce waste, lower resource consumption, and cut costs, which improves profit margins.

Brand Loyalty and Reputation: Companies with strong ESG reputations tend to attract more loyal customers, partners, and employees. Consumers increasingly favor brands that align with their values, leading to higher sales and market share.

Access to Capital: Companies with strong ESG ratings tend to attract more investment from institutional investors who prioritize sustainability. This can lead to lower financing costs and better access to capital.

ESG may drive financial success

ESG Ratings:
High Divergence among ratings

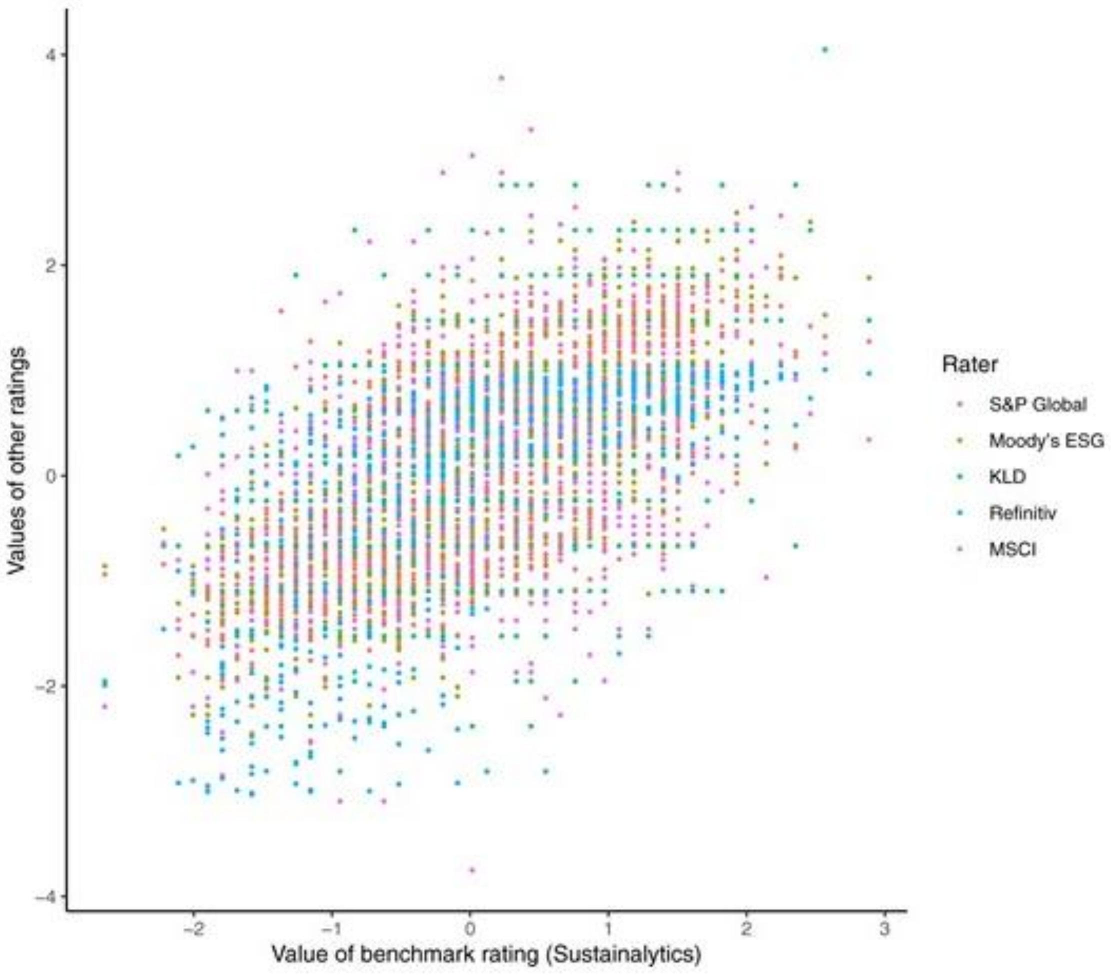
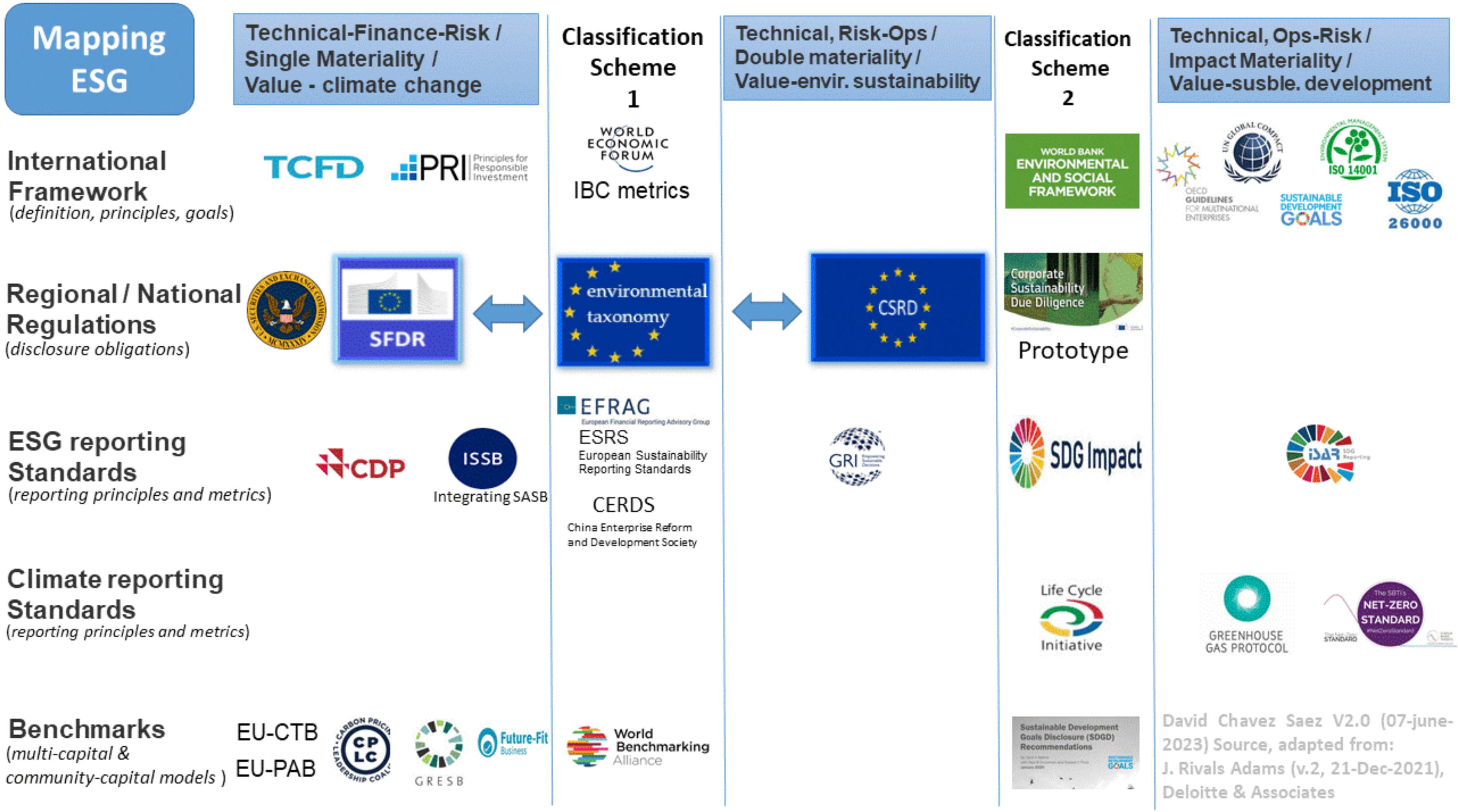


Figure 1. ESG rating disagreement.

Source:
Aggregate Confusion: The Divergence of ESG Ratings* (2022)
Florian Berg, Julian F Kölbel, Roberto Rigobon

ESG Regulation remains dynamic



ESG Impact on Investment Research
Pros & Cons

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- Broader analytical scope:
  ESG data (carbon footprint, climate risks, labor conditions).
- Innovative methodologies: Satellite imagery for environmental claims, social media sentiment for reputation risk.
- Data inconsistency: Diverse rating methodologies causing comparative analysis issues.
- Balancing short-term financial pressures with ESG's long-term value; effective stakeholder communication needed.
- ESG integration may lead to better informed decisions

Regional ESG Dynamics

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USA:

Backlash, political pushback (Ensuring Sound Guidance Act), "greenhushing."

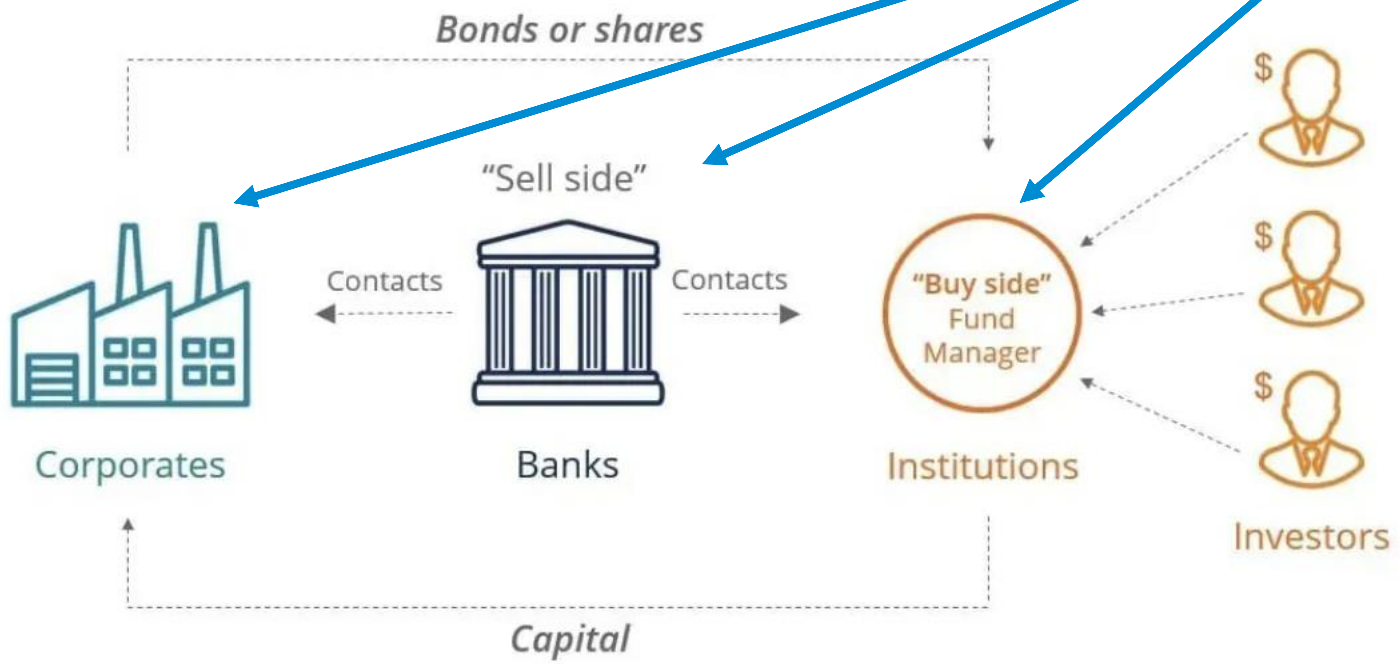
Europe:

Proactive regulations (CSRD), Omnibus Simplification Package aiming streamlined reporting while maintaining ESG commitment.

- ESG as competitive differentiator in Europe due to regulatory frameworks.
- Potential for greener and more ESG-focused European capital markets vs. other markets.

What matters for researchers?
…on capital markets

Standardized, reliable and audited **financial and relevant and material non-financial information** is need to make informed investment decisions.



 Source: CFI

What matters for researchers?
…in their daily activities.

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Industry Experience:
"Managers with industry experience outperform in industry-relevant stocks." (Cici et al., 2018)

Connectedness:
"Managers who are well-connected with peers and company representatives show superior performance (Cohen et al., 2008; Rossi et al., 2018)."

Proprietary Research:
"Funds that rely on 'research-based' investment decisions outperform, particularly in recessions." (Abis, 2024)

Active Share:
"Managers with a conviction-based stock selection strategy deliver outperformance." (Cremers & Petajisto, 2009)

Education:
"Well-educated Managers are outperforming." (Chaudhuri et al., 2020)

Standardized, reliable and audited **financial and relevant and material non-financial information** is need to make informed investment decisions.

Some empirical evidence* supports the business case for ESG investing and related integration into research.

 Source: *University of Oxford and Arabesque Partners (2015); Friede, Busch, and Bassen (2015), Morningstar (2020); NYU Stern Center for Sustainable Business (2021).

Future Outlook

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- Advocating **ESG reporting standardization** and transparency for consistent and reliable **disclosures** while limiting the regulatory burden.

- Tracking **relevant and material ESG KPIs** for clarity, transparency, and actionable insights.

- «**Double materiality** principle»: Financial impacts and broader societal/environmental influences.

➢ ESG's role in risk management and strategic investment decisions, reinforcing long-term strategy.

Conclusion: Top-notch investment research now focuses on spotting resilience in non-financial data, not just forecasting earnings.

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ESG may lead to better informed investment decisions!

- ESG is reshaping sell-side research, aligning financial analysis with sustainability goals.
- Analysts driving corporate responsibility and ethical governance, fostering global economic health especially through their stewardship activities.
- Commitment to ESG integration as central element to long-term investment analysis.

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