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Beyond ESG Rating: The Real Impact of Good Governance

RAM AI Systematic Equity
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ACTIVE INVESTMENTS

Introduction

The Sustainable Finance Disclosure Regulation (SFDR) is a European regulation introduced in 2019[1] and applicable from 10th March 2021 to improve transparency in the market for sustainable investment products, prevent greenwashing and increase transparency around sustainability claims made by financial market participants.[2]

Over the last months, the European Commission has provided additional details, including a more specific definition of governance assessment. In a Q&A published in 2022,[3] it is mentioned that the investee companies held by a fund falling within the scope of Article 8 and Article 9 of the SFDR must follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance.

In this paper, we analyse the impact an SFDR governance framework can have on return and style biases.

Source: AI generated with the Stable Diffusion Model on https://beta.dreamstudio.ai/dream

Our Methodology

Leveraging on an extensive ESG dataset, built from various data sources such as third-party agencies and companies' financial and non-financial reports, we have built a multi-step good governance process that include seven binary metrics (Yes or No) reflecting the SFDR requirements.

Figure 1: RAM AI's Good Governance Metrics. Metric 1 relates to Employee Relations, Metric 2, 3 and 5 relate to Management Structure. Metric 4 and 6 relate to Tax compliance. Metric 7 relates to Remuneration.

→ To perform the assessment, the above-mentioned metrics are combined in different groups and pre-defined criteria apply.

In case some companies lack sufficient data, we apply the following remediation efforts:

- A global governance score (third party or custom) is used as default.
- The investment team is periodically assessing potential additional data sources to improve the coverage.
- Current data vendors will be approached on a yearly basis to increase data coverage where needed.

A firm that fails the good governance test is then automatically excluded from the investable universe. In the next section, we will analyse the impact on those exclusions from both return and style biases perspectives.

Analysing the Impact of a Governance Assessment

To analyse the impact of integrating a governance assessment within our investment process, we start from an All Cap European equity universe, and we split it in two groups:

- → Good governance universe, comprised of stocks that passed the good governance test.
- → Bad governance universe, comprised of stocks that failed the good governance test.

The universes are dynamic, and the governance is reassessed on a monthly basis. The simulation below covers the period following the SFDR introduction, from July 2020 to July 2022.

The purpose of the analysis is to illustrate the characteristics of the two groups and not to present an actual strategy. Therefore, we do not consider any implementation constraint regarding liquidity, market impact, transaction cost and financing cost. Figure 1 shows the portfolio and performance characteristics.

Statistics	Good Governance	Bad Governance
Book Size	1502	79
Return	15.6%	3.3%
Volatility	19.8	25.5
Max Drawdown	-19.8%	-34.3%

Figure 1. Source: Factset, RAM-AI, simulation from July 2020 to July 2022. Past performance is not a reliable indicator of future returns.

Bad governance names, that represent around 5% of the total universe, exhibit lower returns, higher volatility and a higher maximum drawdown over the time period. The cumulative return over the simulation period is displayed in figure 2.

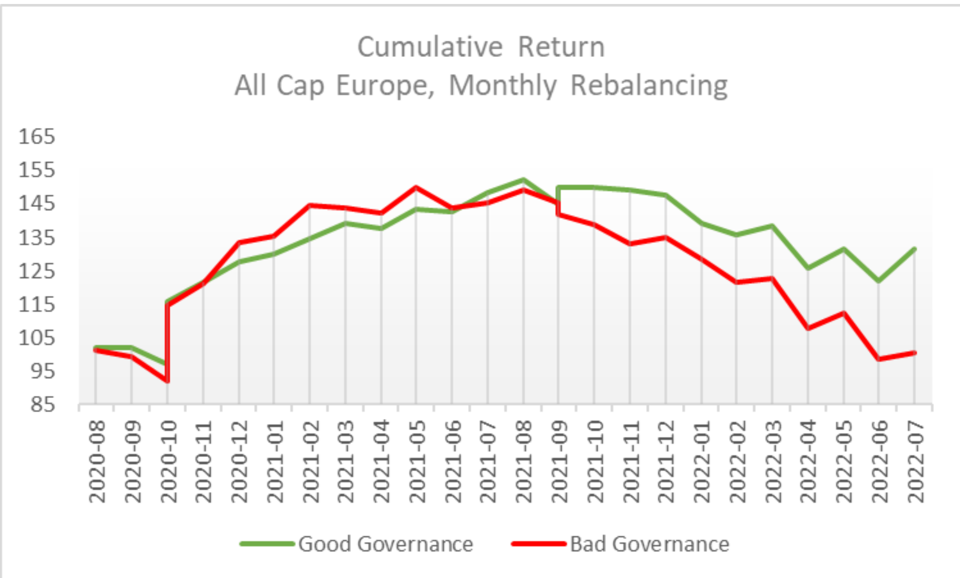

Figure 2: Source: Factset, RAM-AI, simulation from July 2020 to July 2022. Past performance is not a reliable indicator of future returns.

Next, we analyse the fundamental profile of the bad governance universe. Figure 3 shows the average factor percentiles over the simulation period. An average percentile of 0.5 represents no specific bias. A negative/positive factor bias will translate into an average percentile below/above 0.5.

The bad governance universe (in red) exhibits a fundamental profile much less attractive than the good governance universe (in green). It demonstrates low quality, low profitability and low income characteristics. Analyst Revision, Value and Price Momentum biases are slightly negative while no specific bias can be observed on Growth.

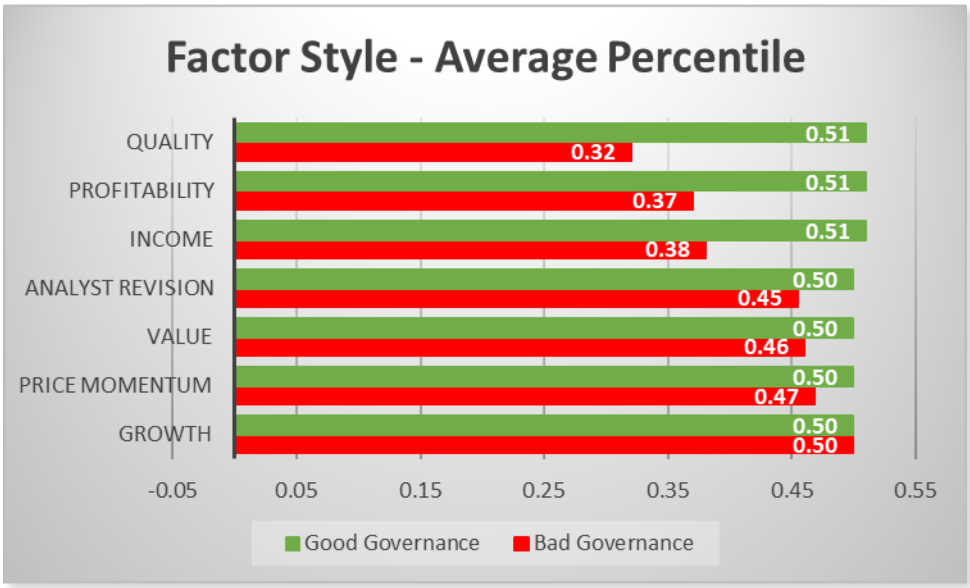

Figure 3: Source: Factset, RAM-AI, simulation from July 2020 to July 2022

Conclusion

Following the introduction of SFDR regulations, the investee companies held by Article 8 and 9 funds must follow good governance practices, in particular with respect to sound management structures, employee relations, remuneration of staff and tax compliance. We are proposing a multi-step quantitative process to systematically integrate a good governance test into an investment process. The firms that fail the assessment exhibit on average low return, high volatility, and a weak fundamental profile. On top of improving the ESG profile of a stock selection, the exclusion of such companies from an investable universe should over the long term be financially beneficial.

References

1. Regulation (EU) 2019/2088, https://eur-lex.europa.eu/eli/reg/2019/2088/oj
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3. Questions related to Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability‐related disclosures in the financial services sector (SFDR) https://www.esma.europa.eu/sites/default/files/library/c_2022_3051_f1_annex_en_v3_p1_1930070.pdf

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