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ESG News and Market Reaction

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News is well known to move financial markets, but what about ESG news? Given that data on ESG corporate performance is not provided by corporations as frequently as the one reporting on operational and financial performance, it is reasonable to expect that investors would turn to the media to integrate their assessment of a stock's ESG profile. Furthermore, scandals like BP, Volkswagen, or Wells Fargo, were widely covered by the media and tarnished the firm's reputation. What do we know about the reaction of investors to this news?

In a previous note, we mentioned a study that showed that climate concerns in the media explain up to 17% of the variance in what they call the green factor driving stock returns. Another study explored the impact of a single event, the "Fridays for Future" global climate strike started by Greta Thunberg. The study showed that the success of this event on Mar. 15, 2019, affected the market valuation of carbon-intensive firms (a one-standard-deviation increase in carbon intensity was associated with a 19 bps reduction in the 5-day cumulative abnormal returns).

Other studies looked at the impact of positive and negative ESG news at the individual stock level. There is evidence that media coverage of these negative events, as measured in the RepRisk database, translates into higher financial risk and more specifically, higher credit risk. This effect is stronger when the media coverage and reach are higher. Negative ESG news, not surprisingly, lead to negative market reactions. News on the evolving regulatory space also affects stocks differently. One study showed that the announcement of the ESG disclosure mandate in April 2014, had less negative market reactions for firms with higher ESG disclosure (as investors reassessed the risk of firms who were disclosing less). Finally, the disclosure of positive eco-friendly initiatives was shown to lead to positive market reaction.

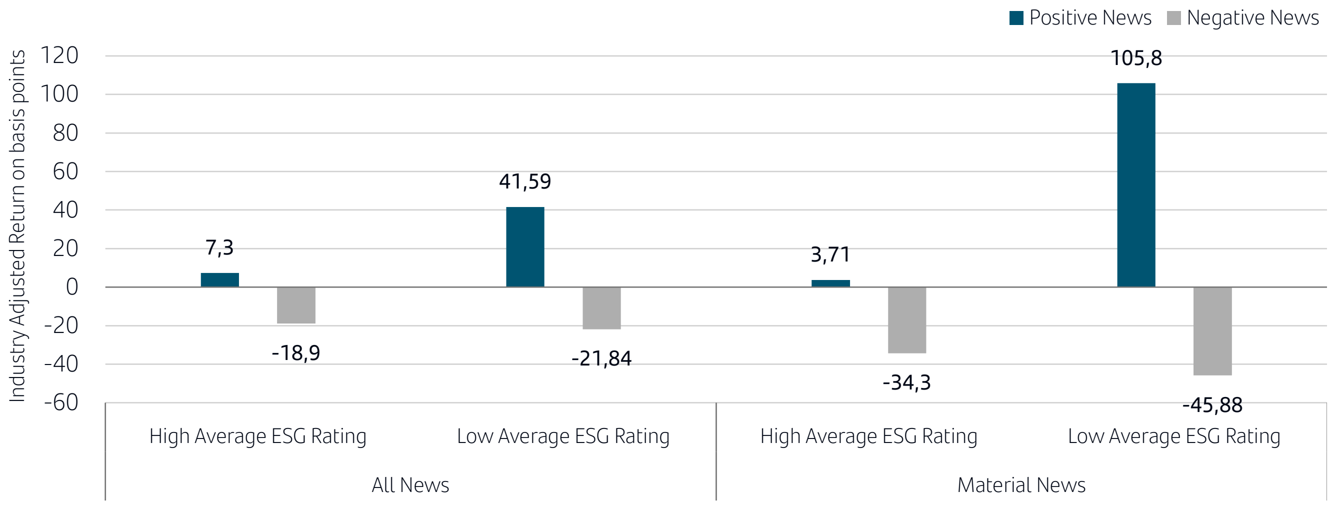
ESG news might not necessarily reflect good or bad ESG performance, and it is important to understand what relationship there is, if any, between ESG news, ESG performance, and market outcomes. Two studies have addressed this question.

In a study of US stocks from 2009 until 2018, the author used a measure of ESG news sentiment developed by TruValue labs using Natural Language Processing (NLP) analysis of 100,000 news sources in English. These sentiment scores capture whether ESG news are positive or negative on a 0-100 scale, and as these scores change daily, it is possible to construct a measure of their momentum (how much they change over time). The study shows that the market valuation (market-to-book ratio) of corporate ESG performance increases as a function of public sentiment. That is, an increase in ESG Performance (2 points on a scale of 0-10) for companies with positive sentiment momentum is associated with a 6.1% higher market valuation for the 2009-2018 period. This means that in the presence of negative public sentiment, company sustainability activities are valued less. Yet, firms with good ESG performance and low ESG news momentum are associated with positive abnormal returns in the future. This finding suggests that while negative ESG news depresses stock valuations of good ESG stocks, they also create opportunities for abnormal returns (4%-5% alpha annually). This would suggest an exciting ESG "value investing" opportunity for investors.

Another study showed interesting relationships between ESG news, ESG ratings, and market reactions. Using data on US stocks from 2010 until 2018, the study shows that positive ESG news is associated with positive stock price reactions (measured as industry-adjusted returns during the three days around the news item). However, this reaction will be stronger in firms with low ESG ratings, as investors likely expected positive news. When the news relates to a financially material issue, the price reaction to positive ESG news is much larger in firms with low ESG ratings.

Market Reaction to ESG News (Average ESG Rating)

Source: Author, based on Serafeim and Yoon (2021).



As ESG ratings do not often converge and there is often disagreement across various ESG data providers, the study also explored whether market reaction varies depending on the degree of disagreement in the ESG ratings provided by MSCI, Sustainalytics, and Refinitiv. The results of their analysis suggest that:

1. The stock price reaction to positive ESG news is more positive than that on negative news.

2. Positive news is associated with 75 basis points higher stock returns than negative news but this spread is only 34 basis points for firms with high ratings.

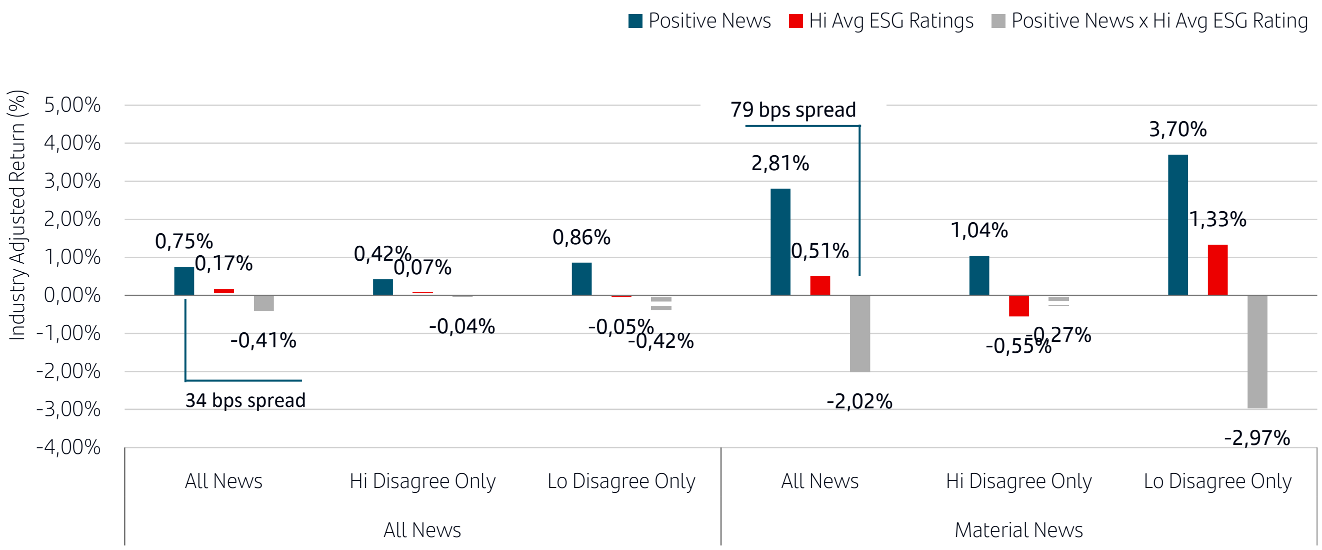
3. The relationship between ESG news and market reaction is moderated by the degree of disagreement in ESG ratings: the stock reaction spread between positive and negative news increases to 2,81% for firms with high disagreement ESG ratings, and the spread is 79 basis points for firms with low disagreement ESG ratings.

4. These results are much stronger for material ESG news

Market Reaction to ESG News (Average ESG Rating)

Source: Author, based on Serafeim and Yoon (2021).

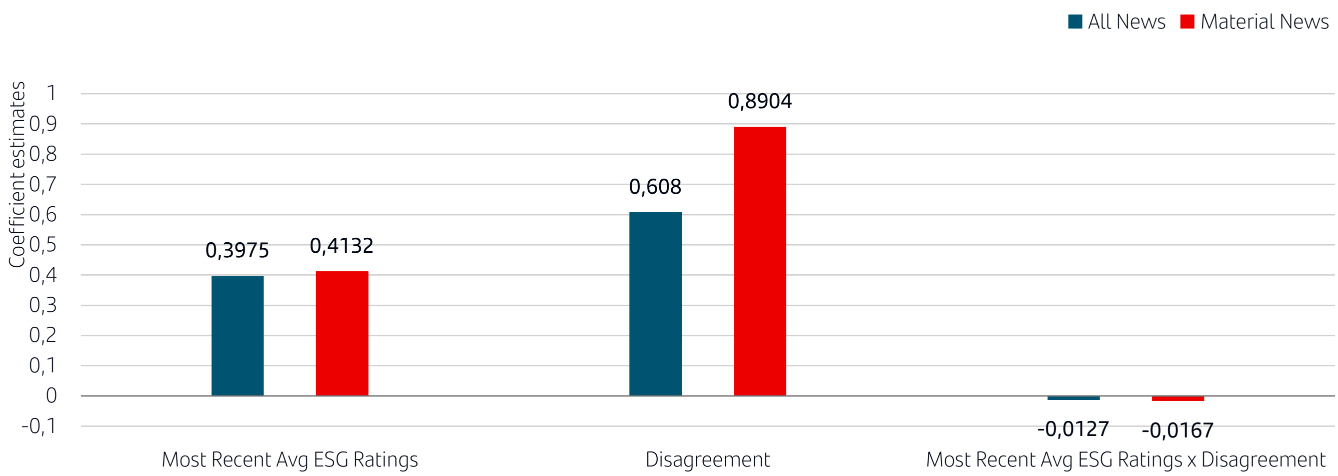
*Pattern bars show non-statistically significant results.



Given how much ESG investing rely on ESG ratings, it is also interesting to explore the extent to which these ratings can predict future ESG news. Their findings suggest that the most recent ESG rating predicts ESG news, but this predictive power disappears when there is substantial disagreement. Finally, when comparing the three providers, the study shows that MSCI offers the highest predictive capability, followed closely by Sustainalytics, and with Refinitive a distant third.

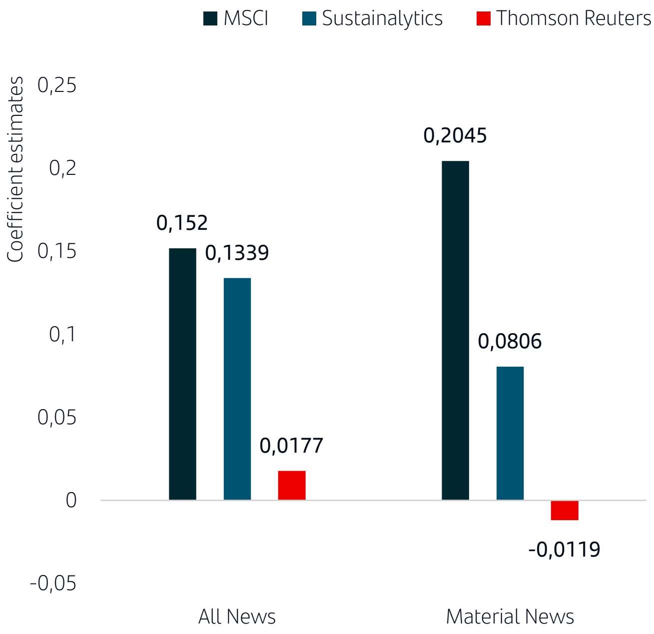
Predictive News Power of the Most Recent Average ESG Rating

Source: Author, based on Serafeim and Yoon (2021)



Predictive Power of News Based on ESG Rating Provider

Source: Author, based on Serafeim and Yoon (2021).



As we learn more about the relationship between news, ratings, and market reaction, one key question that will warrant attention is the extent to which the concept of ESG itself and the relative weight of different ESG issues is shaped by media. Climate change dominated any other ESG issue in the past decade. Most social issues, including human rights, were trailing environmental ones. Also, ESG investors generally did not integrate geopolitical issues in their ESG investment process to avoid the perception of making political investment decisions by underweighting their exposure to specific countries. Will this change after the Russian invasion of Ukraine? Will human rights (and their status in different countries) become a key ESG issue? Also, some commentators suggested we should reconsider the pariah status of defense stocks. Also, while investors were increasingly shunning fossil fuel stocks, especially coal-related, would the new European energy independence direction justify reconsidering this position? Or will we see an even faster acceleration of decarbonization, which ultimately would also help reduce dependence on fossil fuels? These are difficult questions, but the way the public discourse evolves on them will have to be considered by ESG investors.

To Learn More

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