OUTLOOK SPOTLIGHT: ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) – AN INCREASINGLY IMPORTANT SIGNAL FOR INVESTORS

"Environmental, social and governance attributes are a better signal of earnings risk than any other metric we've found. Investors are learning that good companies can make good stocks."

- **Savita Subramanian, head of U.S. Equity and Quantitative Strategy**

Our view

ESG as a driver of financial results: An analysis of S&P 500 stocks from 2005 through 2017 by the BofA Merrill Lynch U.S. equity strategy team found that ESG factors have been strong signals of future return on equity, earnings risk, price volatility and bankruptcies, as well as future alpha in some sectors. Investors who only bought stocks with above-average Thomson Reuters' Environmental and Social scores five years ahead of a company's bankruptcy would have avoided more than 90 percent of the bankruptcies that have occurred in the S&P 500 since 2005.

ESG + Fundamental Investing = Alpha: Over the last market cycle, we've seen a dramatic re-rating of stocks with attractive characteristics on ESG metrics. Our analysis of results from combining ESG with other fundamental factors when making stock selections shows that adding ESG would have consistently outperformed fundamental strategies with less risk. For example, dividend investors who had added ESG to their process would have increased average returns by approximately 2 percent per annum, and investors would have increased alpha by 1 percent per annum had they combined a low price-to-earnings (PE) strategy with ESG factors.

Sectors matter: ESG attributes that historically have been the most effective signals of future return on equity and earnings risk vary by sector. Our analysis found that environmental innovation has been a strong signal of return in the Materials and Energy sectors but generated no alpha in the Consumer sectors. Ethics-related governance factors were among the most alpha-generative factors within Financial and Health Care, but not within Consumer Discretionary.

EFFECTIVENESS OF ESG FACTORS AS A SIGNAL OF FUTURE RETURN ON EQUITY AND EARNINGS RISK

Sector	Return on Equity	Earnings Risk
Consumer Discretionary	Governance	Social
Consumer Staples	Social	Environmental, Social
Energy	Environmental, Social	Environmental
Financials	Social	Governance
Health Care	Governance	Social, Governance
Industrial	Environmental, Social	Environmental, Social
Information Technology	Governance	Social, Governance
Materials	Environmental	Environmental
Real Estate	Environmental, Social	Environmental
Utilities	Environmental, Governance	Environmental, Social

Based on magnitude of difference in future fundamental attributes between above- and below-median companies and consistency of signal in yielding stronger and weaker results over time

Source: BofA Merrill Lynch US Equity and US Quant Strategy

Asset opacity is at a 20-year high: The growth of intangible assets suggest that stock analysis using non-fundamental attributes, including ESG, may be more important than ever. Among S&P 500 companies, intangible assets, such as brand equity and intellectual property, represented as much as 65 percent of book value in 2017, up from 30 percent in 1998.

A wall of money poised to flow into ESG strategies: Our work indicates growing interest in ESG among both institutional and individual investors, corporates, index providers, and regulators. Over the past year, we saw a surge in the use of ESG among institutional investors, with as many as 26 percent now claiming to formally use ESG in their stock selection processes, up from 19 percent in 2017. Assets in U.S. domiciled equity funds tied to ESG strategies have more than tripled over the past 10 years, and we estimate flows into ESG strategies could equate to between $15 trillion and $20 trillion over the next two to three decades.

Women as the X-factor: Our analysis found that companies with high scores on gender/diversity measures, including board diversity, women in management and company policies on diversity/inclusion, generally saw lower subsequent price and EPS volatility and higher subsequent returns on equity than those with low scores. In addition, those with higher scores have generally re-rated in recent years. Among U.S. domiciled actively and passively managed equity funds, assets of funds focused on women, diversity or gender equality have grown by 81 percent over the past three years to $600 million.

Key calls

- We conservatively estimate that inflows into ESG-type strategies over the next few decades could be roughly equivalent to the size of the S&P 500 today.
- ESG is an effective signal of future quality, where we expect quality (earnings stability) will be a rewarded attribute in 2019.
- We recommend using ESG signals in conjunction with fundamental attributes, particularly valuations, to help avoid overpaying for quality.
- A sector-specific framework is recommended for incorporating ESG into the investment process.
- Companies that show a greater focus on gender diversity have seen lower price and earnings risk and better subsequent returns on equity than their peers. Within the S&P 500, the Telecom, Staples and Utilities sectors have the most gender diverse boards, while the Energy, Industrials and Real Estate sectors have the least gender diverse boards.

For more information, please visit https://www.bofaml.com/en-us/content/esg-investing-research-report.html.