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The Value of ESG Information in Financial Markets

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What makes for an efficient financial market? Any market participant could probably list ten things without burning a calorie, but one thing that would probably make everyone's list is information. Financial markets need information in order to work efficiently. We should know: we tried it the other way, and found that conjecture and inference were not good foundations for financial markets in the 1929 stock market crash. Ever since, the U.S. and most other nations with financial markets have required substantive reporting from companies with securities listed on financial markets.

Most of that reporting focuses on the financial parameters that define companies' recent past and future prospects. But increasing amounts of it concern companies' points of tangency and friction with indicators of sustainability: environmental impact, worker safety, labor-management relations, human rights, product safety and integrity, and so on. In past decades, many mainstream investors wrote these off as "non-financial" and generally regarded them as marginally or occasionally useful, at best, for investors. That is changing rapidly.

Bloomberg, for example, reports that the number of customers using its ESG data increased eightfold between 2009 and 2015.[1] Credit ratings agencies are increasingly incorporating ESG information into ratings.[2] Thomson Reuters recently introduced a substantial data service focusing on ESG data. And the SEC's Regulation S-K makes it clear that information on sustainability can be material and if so, should be reported to investors. In its concept release last

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KEY TAKEAWAYS

- » Financial markets need information in order to work efficiently.
- » Financial analysts can do a demonstrably better job when they have information on sustainability.
- » Requiring sustainability disclosures from companies as a listing standard would help investors, companies, and financial markets—and help reinforce the foundations of civil society.

[1] Bloomberg, "Customers using ESG data," 2015. https://www.bloomberg.com/bcause/customers-using-esg-data
[2] Ceres, "Moody's Incorporate ESG into Ratings," 2014.

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year, the SEC specifically asked investors to weigh in on whether Reg S-K should be amended to expand disclosure of sustainability matters.[3]

There is abundant research, both from academia and from major financial institutions, showing that there is a positive and significant correlation between sustainability and financial performance for both companies and funds.[4] Moreover, financial analysts can do a demonstrably better job when they have information on sustainability.

Information on sustainability is valuable to investors when evaluating companies' future financial performance and management quality. Yet it is not yet consistently reported by companies, and enforcement of existing statutes requiring such disclosure has not been robust.

A 2012 paper noted that having information on strengths and weaknesses in corporate social responsibility significantly reduced both the absolute analyst forecast error in earnings per share and its standard deviation.[5] A 2013 paper showed that more information on ESG factors helped to reduce errors in forecast expected earnings, and that as markets incorporated more of this information, the potential for mispricing was reduced.[6]

Efficient markets need accurate information, and they need it on all the factors that affect companies' future risks and opportunities, and their effects on security prices. This is well accepted: it's called the Efficient Market Hypothesis, and this has been taught in financial curricula for decades. It comes in several variants, including the strong form, which says that markets incorporate all information from both public and private sources, to the semi-strong form, to the weak form, which states that current stock prices reflect all security market information.

If the strong form was a better descriptor of the current state of financial markets, there would not be anywhere near as much substantive, authoritative literature providing evidence that there are attractive returns to be had for investors that do incorporate ESG information. If there weren't, the companies that performed better on ESG metrics would already trade at premiums, compared with less sustainable peers.

It is time that financial markets accepted and embraced that reality. Requiring at least basic sustainability disclosures from companies as a listing standard, or at least providing guidance on such disclosure, as the London Stock Exchange recently did, and as 58 stock exchanges have publicly committed to do, is something that would help investors, companies, and financial markets—and help reinforce the foundations of civil society.

[3] U.S. Securities & Exchange Commission, "SEC Solicits Public Comment on Business and Financial Disclosure Requirements in Regulation S-K" April 15, 2016.

[4] See Pax World's Sustainable Investing page for a collection of studies on the impact of ESG on corporate performance: http://paxworld.com/about/sustainable-investing

[5] Leonardo Becchetti, Rocco Ciciretti and Alessandro Giovannelli, "Corporate Social Responsibility and Stock Market Efficiency," November 8, 2012.

[6] Borgers, Arian C.T. and Derwall, Jeroen and Koedijk, Kees C. G. and ter Horst, Jenke, Stakeholder Relations and Stock Returns: On Errors in Expectations and Learning, March 1, 2013. UCD & CalPERS Sustainability & Finance Symposium 2013.

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