Here's Proof That ESG Can Improve Returns — If It's Done Right

According to a new study from MIT, investors can combine different ESG rating systems to mitigate the noise of each individual ESG index provider.

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The inconsistent standards adopted by the various environmental, social, and governance index providers have frustrated many investors in the ESG space. However, a recent study conducted by MIT's Sloan School of Management suggests a possible solution. By combining different ESG indices, investors may be able to mitigate the noise of each index provider and generate better ESG returns.

From 2014 to 2020, individual ESG indices generated average annual excess returns of 4.8 percent, 2.9 percent, and 9 percent in the United States, Europe, and Japan, respectively, according to the paper. Six index providers were studied in the paper: MSCI, S&P Global, ISS, Moody's ESG Solutions, Reprisk, and TruValue Labs.

However, the MIT researchers found that merging the ESG indices using different aggregation methods can generate significantly higher returns. When combined, the six indices achieved excess returns of 6 percent in the U.S. and Europe and 9.6 percent in Japan, according to the paper.

As one example, the simplest aggregation method — which assigns equal weight to the various ESG indices —generated an excess return of 7.7 percent in the U.S. when applied to a portfolio that is long the stocks in the top quartile of ESG ratings and short the stocks in the bottom quartile.

The debate over whether good environmental, social, and governance practices are associated with positive financial returns has been intensifying amid the rise of the anti-woke movement. In the existing body of research, the empirical evidence on the excess returns created by ESG investing has been mixed, with some papers indicating a positive relationship and others claiming the opposite. Nevertheless, the MIT study shows that ESG investing does generate excess returns over the market, although the returns vary widely across different index providers.

For example, based on the rating system used by MSCI, the most popular index provider, a portfolio that goes long the stocks in the top quartile of ESG ratings and short those in the bottom quartile achieved an annual excess return of 3.8 percent between 2014 and 2020. But a similar portfolio based on the S&P Global rating system only produced an annual excess return of 0.31 percent.

“The choice of different data methodologies and sources can lead to a substantial divergence between rating providers,” the paper said. “This raises the question [of] whether ESG ratings are in fact useful for portfolio construction, and if so, how to optimally exploit the signal in ESG ratings, despite their noisy nature.”

The paper explains that by combining ESG ratings from different providers, investors can reduce the noise level of each provider. That’s why ESG returns are much higher when aggregation methods are used.

Diversifying the source of ESG ratings is very helpful,” Florian Berg, research scientist at MIT Sloan School of Management and one of the paper’s five authors, told II in an interview. “Having more than one source...[helps] you get rid of some noise.”