Zuger Kantonalbank

ESG at Zuger Kantonalbank

ESG performance

As the leading bank in the Zug economic region, we are aware of our responsibilities. We think and act in a future-oriented way, and incorporate environmental and social aspects into our ambitious commercial objectives. By doing so we create added value – for our stakeholder groups and for the environment.

This document is based on a research paper[1] drawn up by MSCI ESG Research LLC.

The main points at a glance
- Companies with higher MSCI ESG ratings have a better performance over the long term than companies with lower ratings. This applies both to regions and increasingly also to sectors.
- These companies also have higher earnings growth as well as higher and slightly increasing dividend yields.
- However, it must be remembered that market phases can always occur in which external factors push the performance in the opposite direction.

Introduction

One of the most frequently asked questions in connection with ESG concerns its influence on a portfolio's performance. When investing responsibly, do investors have to take lower overall returns into account or can it even pay off to consider ESG factors when putting together a portfolio?

This document provides an overview of the various factors involved. A consideration of the fundamental trend on the one hand and the market price trend on the other is key, as major differences exist between MSCI ESG ratings and traditional market risk factors. While the latter represent a direct valuation of the market risk of a share, the MSCI ESG ratings involve a valuation of the company risk.

A performance analysis shows to what extent the differences observed in terms of market risk and performance between companies with high and those with low MSCI ESG ratings are due to differences in the company's management, e.g. the company's ability to increase earnings or to protect it from business risks. In this publication, both the fundamental company performance and the market performance of the companies in the MSCI ACWI Index are therefore considered.

Procedure

MSCI ESG scores are used as the basis for the calculations. In contrast to the approach of many other ESG valuation systems, the MSCI ESG rating method or MSCI ESG score (see also the separate publication on our website at www.zugerkb.ch/en/esg) focuses exclusively on measuring a company's dependency and resilience in terms of long-term ESG risks of relevance to its sector. Whereas the leading companies have their ESG risks and ESG opportunities under control and are therefore less exposed to potential risks, those languishing at the bottom of the rankings do not have management processes in place for controlling these risks. This can therefore potentially affect their earnings and consequently their share or bond price.

Quantile analysis is an approach frequently used to check the impact of an indicator on the market price trend. For this purpose, MSCI ESG Research LLC divided the companies in the MSCI ACWI universe (All Country World Index, industrial and emerging countries combined) – based on their sector-adjusted ESG scores – into five equal-sized groups, known as quintiles. In order to avoid distortions, these sector-adjusted values were additionally adjusted for company size and the region concerned (North America, Europe, Pacific and emerging-market countries). The quintiles therefore reflect the companies in line with their sector-, size- and region-adjusted ESG ratings. The analysis also uses equally weighted quintiles in order to ensure that the performance results are not influenced by a few large companies. The quintiles are recalculated each month on the basis of the adjusted figures, and the performance is thus determined.

ESG performance by region

This quantile analysis of MSCI ESG scores was used to determine that companies with higher MSCI ESG ratings outperformed their lower-scoring peers both in the MSCI ACWI Index as well as in the MSCI World Index over the long-term analysis periods. This statement also applies when considering the indi-

[1] Giese, Guido, and Shah, Drashti (2024): MSCI ESG Ratings in Global Equity Markets: A Long-Term Performance Review

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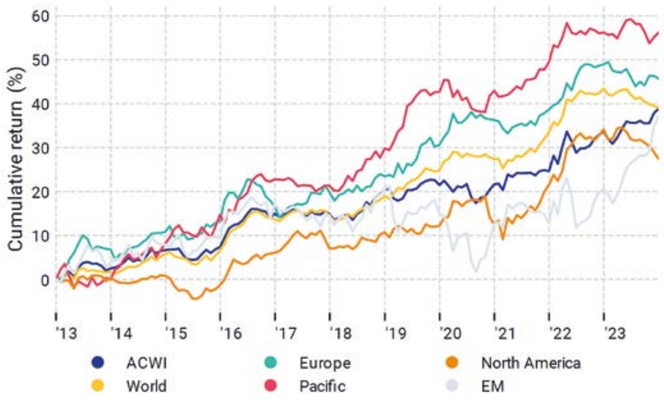
vidual regions of Europe, North America, Pacific and emerging-market countries in isolation. The chart below shows the cumulative difference for each region between the uppermost and lowest quintile performance between 31 December 2012 and 29 December 2023.

Q5-Q1 regional ESG score performance



Source: MSCI ESG Research

Fundamental explanation of the performance

The following breakdown of total return can be used to explain the basis of this outperformance:

$$\textit{Total equity return} = \underbrace{\textit{earnings growth} + \textit{P/E expansion}}_{\textit{price return}} + \textit{dividend yield}$$

In analysing the individual factors, MSCI ESG Research determined that the outperformance of companies with high MSCI ESG ratings in the MSCI ACWI universe during the analysis period was primarily a result of the following points.

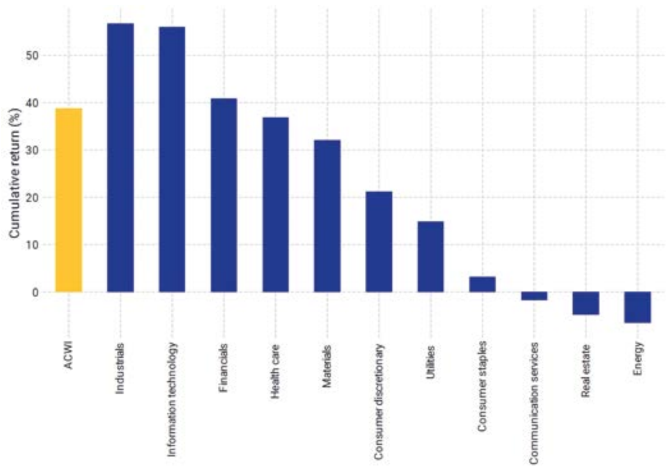
- Companies with higher MSCI ESG ratings reflect higher earnings growth on average than companies with lower ratings.
- Companies with higher MSCI ESG ratings have higher and slightly increasing dividend yields compared with companies with lower ratings.
- There was no indication that outperformance was driven by price-earnings expansion.

ESG performance by sector

The MSCI ESG ratings follow a dedicated, sector-specific approach in which the key financial topics are selected in each industry in order to calculate the ratings. Consideration of the performance of the MSCI ESG ratings by sector is therefore important in order to determine the extent to which the selected key topics are actually reflected in the share price trend.

In a similar approach to that taken for the regions, the performance results of the size- and region-adjusted ESG scores are reviewed here too. The following chart is based on the equally weighted GICS sectors (Global Industry Classification Standard) of MSCI ACWI and shows the cumulative difference for each sector between the highest and lowest quintile performance from 31 December 2012 to 29 December 2023.

Q5-Q1 sector ESG score performance



Source: MSCI ESG Research

The analysis shows that there are considerable differences between the individual sectors in terms of performance, and that companies with higher MSCI ESG ratings achieved a sometimes considerably better performance in seven out of eleven sectors versus companies with lower MSCI ESG ratings. Consumer staples and communication do not reflect any trend, whereas energy and real estate companies with higher MSCI ESG ratings showed a slight underperformance.

Focus on carbon-intensive sectors

Awareness of climate change in carbon-intensive sectors as a potential risk has increased over the past ten years. This applies primarily to energy, utilities and materials. Companies' commitment and the management of climate change risks in the valuations of MSCI ESG ratings have a higher relative weighting in these sectors compared to others. It is therefore interesting to look at the impact on performance.

The materials and utilities sectors showed a clear outperformance among companies with a high MSCI ESG rating, which makes sense against the backdrop of climate change posing an increasing risk. By contrast, it does not seem logical that the energy sector should reflect a slightly negative performance difference although it is one of the sectors most heavily affected by climate change.

The performance results in industrialised countries in comparison with emerging-market countries could provide an explanation. In the industrialised countries, companies with higher MSCI ESG ratings in all three carbon-intensive sectors achieved a substantially better performance than companies with lower MSCI ESG ratings, while the opposite was true in emerging-market countries.

The different political and market environments for carbon-intensive activities may explain the observed performance deviations between industrialised countries and emerging-market countries. Both industrialised and emerging-market countries have taken increasing steps to introduce climate-related measures and rules in order to promote a low-carbon transition of the economy. However, industrialised and emerging-market countries are at different stages in terms of distancing themselves from fossil fuels. Emerging-market countries are thus relatively more dependent on coal, and many of these countries are expanding the use of coal to produce energy, in parallel to making greater use of renewable energy sources. This may explain why the partial results are so divergent.

Performance of MSCI ESG indices

Finally, we would like to take a look at the specially developed MSCI ESG indices in which the MSCI ESG ratings are used as a basis for calculation. They are based on a base index (e.g. MSCI ACWI Index or regional index) and on companies that are selected or weighted on the basis of their MSCI ESG ratings. They include, among others, the well-known MSCI ESG Leaders Index (50% best-in-class sector approach) and the MSCI SRI Index (25% best-in-class sector approach).

Given the similar use of the underlying ESG data it would be very surprising if the results were to lead off in a completely different direction. We can therefore confirm that over a ten-year period, an outperformance versus the underlying base index was observed for all MSCI ACWI ESG indices. Indices with a stricter ESG approach reflect better results.

Publications

Further publications on ESG are available at www.zugerkb.ch/en/esg

We are signatories to or members of the following organisations

Signatory of: PRI Principles for Responsible Investment

Swiss Sustainable Finance

ASSET MANAGEMENT ASSOCIATION

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