ESG RATINGS MATTER IN COVID-19 FINANCIAL MARKET CRISIS

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ABSTRACT

This research investigates ESG performance during equity market stress, specifically the flash crash ignited by the COVID-19 pandemic. This exceptional market event illuminated an opportunity to research whether top-tier ESG-rated businesses mitigate risk better than the lowest-tier ESG-rated businesses. An event study is used to test market-adjusted abnormal returns of the highest decile of 50 ESG ranked stocks for the S&P 500 (SP500) index constituents versus the lowest decile of 50 ESG stocks using the S&P 500 Global Rating methodology. The study's results indicate that ESG rating matters: ESG rated stocks outperform the SP 500 index returns, adjusted for systematic risks; and the highest ESG-rated firms outperform the lowest ESG-rated firms during the market crash caused by the onslaught of the COVID-19 pandemic.

Keywords: *ESG, Covid, Event Study, Cumulative Abnormal Return, Firm Value*

1. INTRODUCTION

Do environmental, social, and governance (ESG) ratings matter? ESG investing has attracted the focus of asset managers globally. According to the Global Sustainable Investment Alliance (2020) the assets under management invested in ESG related funds exceeded $35 trillion globally in 2020. Bloomberg (2021) has forecasted the assets invested in the ESG arena will reach $53 trillion by 2025, a growth rate over 50%. The rapid expansion of ESG investing has motivated a debate in the academic arena and the investment community of the importance of ESG ratings. Renneboog et al. (2008) point out, through a review of several studies, that little evidence exists to suggest investors rely on ESG ratings to achieve their risk - return goals.

Investors are generally motivated toward incorporating ESG investing into their portfolio diversification for the following reasons: investors are motivated to align their values with their investment interests; investors interested in impact investing are motivated to invest for the purpose of creating positive social change with a financial return; investors believe risk mitigation is an important motivator; and investors want to enhance portfolio performance (Bruno et al., 2021).

Hartzmark and Sussman (2019) discover no indication that high-rated, sustainability-focused funds outperform funds with a low sustainability rating during market shocks which is the focus of this research. The authors suggest investors look primarily for intrinsic value when investing in ESG funds. Albuquerque et al. (2020) use a process highlighting circumstances where funds employing a strategy of investing in shares with a high ESG rating reduce systematic risk exposure, increase product differentiation, and improve portfolio diversification. Zhou et al. (2022) test Chinese companies and their relationship between ESG performance, financial performance, and firm value. The authors find a high ESG rating investment approach improves shareholder wealth.

Research examining ESG performance during equity market stress is scant, yet researchers have tested data during the global financial crisis (GFC) of 2008-2009. Lins et al. (2017) find U.S. companies with high ESG ratings enjoy enhanced financial performance versus other businesses during the GFC. Cornett et al. (2016) suggest U.S. financial firms' financial performance was highly correlated with their ESG rating during the GFC. This finding is in line with risk mitigation resulting from investment in businesses with high ESG rating. Wong et al. (2021) investigate the importance of ESG certification on Malaysian