Discovering An ESG Premium on Equities - An Insight into Long-Term Risk Mitigation's Impact on Valuation

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Introduction

Environmental, Social, and Governance (ESG) considerations have increasingly become a central focus in modern corporate and financial decision-making. ESG represents a framework used to evaluate a company's commitment to sustainable practices, ethical governance, and social responsibility. As global challenges such as climate change, social inequality, and corporate misconduct gain prominence, investors and stakeholders demand greater accountability and transparency from corporations. This shift has accelerated the growth of ESG investments and fundamentally altered how companies are assessed and valued.

The primary objective of this paper is to explore the concept of the ESG premium — the potential valuation premium companies may receive for strong ESG performance. By investigating the extent to which ESG practices correlate with financial performance, we aim to provide insights into whether ESG initiatives create shareholder value. The paper also examines the challenges posed by short-termism in corporate governance, which often conflicts with the long-term nature of ESG investments. Additionally, we analyze a landmark study by Flammer & Bansal to understand how long-term executive incentives may influence ESG outcomes.

The empirical portion of this paper outlines our methodology for estimating the ESG premium. We provide a detailed overview of the data sources used, the construction of ESG performance measures, and the econometric models applied. Ultimately, we seek to contribute to the ongoing discourse on sustainable investing by offering quantitative evidence on the financial impact of ESG integration.

Environmental, Social, Governance - Trends and The Emerging Ecosystem

Firstly, let's discuss Environmental, Social Governance. Environmental, Social, and Governance (ESG) considerations have become central to how companies are evaluated and how investors allocate capital. The growth of ESG as a focus area reflects a broader understanding that companies failing to address these issues may expose themselves to reputational damage, regulatory sanctions, operational inefficiencies, and ultimately diminished shareholder value. On the other hand, companies that excel in ESG are increasingly viewed as more resilient, forward-thinking, and better positioned to generate sustainable long-term returns.

The growth of sustainable fund flows highlights the increasing investor appetite for ESG-aligned investments. According to Morningstar's Global Sustainable Fund Flows Report, global sustainable funds attracted approximately $68 billion in net inflows during 2023, despite broader market volatility and macroeconomic uncertainty. While this figure represents a decline from the record peak of $160 billion in 2021, it underscores the resilience and steady demand for

ESG-focused strategies. Moreover, as of the end of 2023, total global sustainable assets under management reached an impressive $2.75 trillion, reinforcing the importance of ESG considerations in modern portfolio construction and long-term capital allocation decisions. Therefore, investors can no longer rely solely on traditional financial statements, which do not capture a company's environmental footprint, social impact, or governance quality. In response, several rating agencies and international organizations have developed ESG standards and scoring systems, each with unique methodologies and areas of emphasis.

As investor demand for ESG-aligned investments has grown, the need for standardized, robust ESG data and metrics has become paramount. ESG is usually conceptualized as having three pillars. The environmental pillar considers factors such as carbon emissions, pollution control, water usage, energy efficiency, and climate change adaptation. The social pillar examines a company's relationships with its employees, customers, suppliers, and the communities within it operates — covering areas such as labor standards, employee diversity and inclusion, customer data protection, and community engagement. Finally, governance refers to the structures and processes that determine how a company is directed and controlled, including board independence, executive compensation alignment with long-term performance, shareholder rights, and audit quality.

One of the most widely used frameworks is the **MSCI ESG Ratings**, produced by MSCI Inc., a global provider of investment decision tools. MSCI evaluates companies on a scale from 'CCC' (laggard) to 'AAA' (leader), assessing how well a company manages ESG risks and opportunities relative to industry peers. The MSCI methodology breaks down ESG evaluation into ten overarching themes — including carbon emissions, product safety, human capital development, and corporate governance — which are further assessed using over 1,000 data points sourced from company disclosures, media reports, and third-party databases. Each company receives pillar-level scores (E, S, and G), which are aggregated into a final rating. Crucially, MSCI's analysis is industry-relative, meaning companies are judged against sector-specific risk profiles, acknowledging that what matters in the oil & gas industry differs significantly from what matters in financial services. Investors rely on MSCI ratings to identify companies that may be better positioned for long-term resilience or to avoid firms that face unaddressed ESG risks.

Another foundational standard is the **KLD Research & Analytics Ratings**, now part of MSCI, which was among the first ESG rating systems in the United States, dating back to 1990. The KLD framework focuses heavily on identifying both positive strengths and controversies within seven categories: community relations, diversity, employee relations, environment, human rights, product quality/safety, and corporate governance. Each category includes both "strength" indicators (e.g., strong environmental policies, charitable giving, workplace safety initiatives) and "concerns" (e.g., pollution incidents, product recalls, labor controversies). Companies are scored based on whether they demonstrate robust practices in these areas or whether they have been involved in controversies that undermine stakeholder trust. Importantly, the KLD model also considers corporate lobbying, political involvement, and efforts to influence policy in ways that may either support or hinder sustainable progress — areas that investors are increasingly scrutinizing.

Beyond these core systems, additional frameworks are shaping how ESG data is standardized and reported. The **Sustainability Accounting Standards Board (SASB)**, for example, focuses on identifying financially material sustainability issues across 77 different industries. SASB standards specify which ESG factors are likely to affect financial performance, helping companies report on metrics that investors consider directly relevant to valuation and long-term growth.

Taken together, these ESG frameworks and metrics are reshaping how companies communicate with stakeholders and how investors allocate capital. By converting broad sustainability goals into measurable, comparable indicators, they enable the financial market to distinguish between companies merely using ESG as marketing language and those genuinely building long-term value. As ESG data collection and standardization efforts continue to evolve, companies will face increasing pressure to demonstrate transparency and accountability. For investors, these metrics represent not just a snapshot of corporate behavior but a window into how well companies are preparing for future challenges and opportunities in an increasingly sustainability-focused economy.

Short-Termism in the World of ESG

Now that we have established what ESG is, lets discuss the recent discussions revolving an idea known as “short-termism.” Short-termism is defined by the CFA Institute as the excessive focus on short-term results at the expense of long-term interests. This mindset is particularly prevalent in corporate decision-making, where companies prioritize immediate financial performance, often driven by quarterly earnings reports, market pressures, or executive compensation structures. While short-term goals can provide quick financial gains and satisfy investors at the moment, they can also lead to detrimental long-term consequences in corporate strategy. These include underinvestment in research and development, neglect of sustainable practices, and diminished innovation. Understanding the causes and impacts of short-termism is essential for companies, investors, and policymakers striving to balance short-term financial performance with long-term growth and stability.

In the context of ESG, this can present severe challenges. The main focus of ESG is to promote long-term sustainability through mitigating various risks, however, this can come at odds with the phenomenon of short-termism. The conflict between short-termism and ESG considerations arises from their fundamentally opposing objectives. Short-termism drives companies to prioritize immediate gains and shareholder returns. In contrast, ESG initiatives require long-term investments in sustainability, ethical governance, and social responsibility, which is costly and may not yield immediate financial benefits. For instance, reducing carbon emissions, improving supply chain transparency, or enhancing employee welfare often involves upfront costs that can reduce short-term profitability. This tension is further exacerbated by market pressures, as investors and executives facing performance expectations may deprioritize ESG commitments in favor of short-term financial targets. Balancing the demands of short-term financial performance with the long-term benefits of ESG integration remains a critical challenge for businesses seeking sustainable growth.

A Landmark Study - Flammer & Bansal's Research: "Does a Long-Term Orientation Create Value?"

In *"Does a Long-Term Orientation Create Value? Evidence from a Regression Discontinuity,"* Caroline Flammer and Pratima Bansal set out to examine whether adopting a long-term orientation enhances firm value. Their primary goal was to address the long-standing debate on whether long-term executive incentives contribute to sustainable growth or if they hinder short-term performance. Specifically, they sought to provide causal evidence on the impact of long-term executive compensation plans on firm performance, focusing on shareholder value, operational outcomes, and strategic investments. Given the pressures of short-termism in corporate decision-making, the study aimed to determine if aligning executive incentives with long-term goals could mitigate these challenges and lead to greater long-term value creation.

To establish a causal relationship, the authors used a regression discontinuity design (RDD). This methodology exploited the somewhat random nature of shareholder votes on long-term executive compensation proposals, which are typically contested and can narrowly pass or fail (pass with 50.1% or fail with 49.9% of the vote). By comparing firms where proposals barely passed to those where they barely failed, the authors were able to simulate a randomized control trial. This approach reduced endogeneity concerns and provided a cleaner estimate of the causal effect of adopting a long-term orientation. The key metrics used to evaluate firm performance included abnormal stock returns on the day of the vote, return on assets (ROA), and Tobin's Q (a measure of market valuation relative to asset value). Additionally, the study assessed changes in R&D spending and stakeholder-related investments to gauge shifts in strategic priorities.

The results demonstrated that firms adopting long-term compensation plans experienced a significant positive abnormal stock return upon proposal approval, reflecting increased investor confidence in the firm's long-term prospects. Over subsequent years, these firms showed notable improvements in operational performance, as evidenced by increases in ROA and Tobin's Q. Although the authors observed a temporary decline in short-term financial results, this was offset by stronger long-term gains, suggesting that initial investments in R&D and stakeholder relationships paid off over time. Notably, the study also found that firms with greater financial flexibility benefited more from the adoption of long-term incentives, indicating that access to capital is a key factor in executing long-term strategies.

A significant contribution of the study was its examination of how a long-term orientation influenced corporate strategy. Firms that adopted long-term executive incentives increased their R&D investments and engaged in more sustainable business practices, further validating the argument that aligning executive pay with long-term goals fosters innovation and stakeholder engagement. The findings also provided evidence that the market values such long-term commitments, as reflected in the initial positive stock price reaction. These insights reinforced the importance of structuring executive compensation to counterbalance the pressures of short-termism.

Ultimately, Flammer and Bansal's study offered empirical evidence supporting the value of a long-term orientation in corporate governance. By aligning executive incentives with sustainable growth objectives, firms can enhance both financial performance and stakeholder value. The research further emphasized the role of shareholders in driving long-term behavior through governance mechanisms. For policymakers, investors, and corporate boards, the study underscored the importance of promoting executive pay structures that prioritize long-term value creation, ultimately contributing to more resilient and sustainable businesses.

The ESG Premium - A Market Overview

With the rise of ESG (Environmental, Social, and Governance) or sustainable investing, the question arises as to whether this increased demand results in a higher price for securities. This increased price, often referred to as an "ESG premium," has been extensively discussed in academic literature, with the majority of studies finding a correlation between financial performance and ESG efforts. A 2015-2020 study by NYU's Metadata team found that 58% of corporate studies focusing on operational metrics such as ROE, ROA, or stock price showed a positive relationship between ESG efforts and financial performance. In contrast, 13% indicated a neutral impact, while 21% presented mixed results.

Although many studies suggest a positive relationship between sustainability efforts and stock price, some diverge from this view. These papers argue that while prices for ESG-conscious firms may be higher, the returns on these investments may be lower compared to conventional investments. For example, a 2023 study by Harrison Hong and Edward Shore from Columbia

University suggests that “socially responsible firms have a lower required rate of return since shareholders are willing to pay higher prices for such firms because they mitigate externalities.” This argument makes sense: investors are willing to pay more for less volatile investments, and ESG investing inherently seeks to minimize long-term risks by focusing on sustainability. However, while investors may pay more for lower risk, their return is diminished, as volatility and returns are generally correlated in financial markets.

In addition to the significant discourse surrounding ESG's role in providing a lower-risk profile and higher price for investors (which may lead to lower returns), it is important to remember that ESG investing is simply another methodology. It is neither better nor worse than other intangible assets that contribute to long-term value creation and generate positive externalities for society. Investors seeking alpha (returns beyond what is justified by their risk profile) should not prioritize ESG over other characteristics that create alpha. That being said, the increasing demand for sustainable securities—driven by investors who seek to mitigate risk and capitalize on the asymmetric benefits of ESG investing—continues to drive up prices.

Furthermore, analyzing an ESG premium for equity markets is challenging. The metrics used to determine how sustainable a company is can vary widely, and there is a significant amount of qualitative analysis involved. While many studies show a positive relationship between financial performance and ESG efforts, the lack of standardization in ESG data complicates these results. Different studies use different ESG scores from various data providers, which can lead to inconsistent findings. Additionally, researchers often fail to distinguish between material and immaterial ESG issuers, as well as between ESG leaders and improvers. To address these challenges, our analysis aims to create a more standardized rubric by following the SASB’s materiality standards and leveraging both MSCI and KLD data.

How We Plan to Determine an ESG Premium

In determining the ESG premium, we have employed a comprehensive range of metrics to assess the extent to which companies benefit from proactive ESG initiatives. Our methodology integrates multiple data sources and frameworks to ensure a well-rounded and accurate analysis.

For our analysis, we leverage established scoring frameworks, including MSCI ESG Ratings, which assess corporate performance across ESG factors. We also incorporate risk scores from respected industry standards, such as reports from the Sustainability Accounting Standards Board (SASB). These frameworks provide a nuanced perspective on a company’s capability to manage ESG-related risks and opportunities, such as climate risk management and governance, while also indicating how deeply sustainability principles are embedded in corporate strategy.

We made a rubric that evaluates the materiality of the data. For MSCI and KLD data, and SASB reports, we categorized them into three levels: present-based, which measures existing (occurring and documented) ESG practices of the company; future-based, which measures practices set up for future and long-term impacts; and redundant, which is information not differentiated between ESG-focused firms and other firms and is thus unrelated to this project. In our observation, present-based information usually contains past tense and quantifiable actions ("we have been investing 1.5% of our revenue into sustainability-based infrastructures"), future-based data often contains forward-looking language and focus on potential impacts ("we expect a reduction of emissions after implementing our sustainable initiatives"), and redundant data only repeats other information and has little to no long-term acknowledgment ("we made a donation in 1999"). By classifying them into these categories, we could greatly refine our dataset and use only relevant data for our analysis, making our analysis rigorous.

With the filtered data, we then plan to compare it with the stock return information of corresponding companies, so the new combined dataset would tell us what level of stock return a company with a given level of ESG performance generates. With the new combined dataset, we will use Stata to conduct regression analysis to determine if there exists a statistically significant relationship between stock return and ESG performance, our main variables, and we will run multiple regressions with different models to ensure the relationship does not have statistical deficiencies. If we do have a statistically significant relationship, the results could support us in determining whether there exists an ESG premium for ESG-aligned companies.

Based on previous studies (Flammer and Bansal), we hypothesize the findings will present a statistically significant relationship between stock return and ESG performance. As we progress through all the data analysis work, we will utilize various models estimated in prior literature with more control variables other than the two main variables. We are likely to control for many factors to test if the proposed relationships exist in all circumstances and test numerous models involved in previous studies. The limits of our methods could involve neglecting other factors that could contribute to the performance in stock returns. There might also exist unbalanced panels in the data, meaning not every single variable has every single observation, so dealing with that is also necessary.

Conclusion

In conclusion, the growing prominence of Environmental, Social, and Governance (ESG) considerations in financial markets reflects a fundamental shift in how companies are evaluated and how investors allocate capital. As ESG factors become increasingly integrated into investment strategies, understanding their impact on corporate performance and market valuation is essential. This paper has explored the evolving ESG ecosystem, the challenges posed by short-termism, and the methodologies used to measure ESG performance. Furthermore, we examined the existing literature on long-term corporate strategy and its relevance to ESG investing, particularly through Flammer and Bansal's research on executive compensation and firm value.

Our empirical approach aims to assess whether an ESG premium exists by leveraging a structured dataset that filters material ESG factors and applies rigorous econometric modeling. While previous studies suggest that ESG-aligned firms may benefit from increased investor confidence and lower risk exposure, the relationship between ESG performance and stock returns remains a subject of debate due to inconsistencies in ESG measurement and data availability.

By refining ESG data classification and employing robust statistical techniques, our study seeks to provide clearer insights into the financial implications of ESG investing. If a significant ESG premium is identified, it could have profound implications for corporate strategy, investor behavior, and regulatory policies. Regardless of the findings, this research underscores the importance of long-term value creation and the role of ESG metrics in shaping a more sustainable financial landscape.

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