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Hello everyone and welcome to Theory Meet Practice, our video series about academic research into sustainable finance and the lessons investors can take from it. We're all inundated by news these days, so which sustainability related news about companies matter the most for investors? Well, as it happens, investors' reactions to such news really depends on whether the news could affect the company's fundamentals and whether that news is positive or negative.

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And we know this and so much more that we're going to dig into today thanks to the work of my guest today, Aaron Yoon, an Assistant Professor of accounting and information management at Northwestern University's Kellogg School of Management. Early in Professor Yoon's career, he had co-authored a seminal piece of research with Mo Kahn and George Seraphin, showing that companies scoring well on financially material sustainability issues significantly outperformed both companies that scored poorly on those issues, as well as companies that scored well, but on non-material ESG issues.

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The Financial Times have called that a turning point in investors' understanding. In the academic world, the debate on when exactly ESG adds or detracts from firm value actually rages on, and as do so many issues often do in academia. Professor Yun received his doctorate at Harvard University. He has a

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master's and a bachelor's from Northwestern, and prior to academia, he worked as an equity sales trader and a research analyst at Credit Suisse. He has been recognized by multiple awards, including being named by “Poets & Quants” to its list of the best 40 under 40 business school professors, and being awarded the Carlisle Prize for best paper in quantitative investing from Panagora Asset Management for his paper on the impacts of sustainability news on financial performance.

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I'm really thrilled to be in conversation with Aaron Yoon today. Welcome. Thank you. Thank you, Linda, for having me. Great. So, Professor Yoon, you know, I've really admired your research for such a long time. You've been very prolific in tackling the topic of ESG and performance from different angles. And what has really particularly struck me about your research is the focus that you have had on the human element, the S in ESG. And that's where I'd really like to begin today. You know, we're often asked by the many companies that we analyze:

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what should we be prioritizing? There are just so many topics under sustainability. Our investors, our employees, our customers, they all care about different things. So which topics should we actually focus on? So your 2022 paper, do high ability managers choose ESG projects that create shareholder value? You found that high ability leaders who allocate resources to sustainability efforts actually outperform companies quite significantly.

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Versus low ability leaders with low investment to sustainability. So who in your research is actually considered a high ability leader and what actually prompted you to be looking at this role of managerial ability when it comes to linking ESG and performance? Yeah, so thank you for your question. So this paper is published that review of accounting studies and my co-author, Kyle Welch and I, use Glassdoor employee survey data. And we use that as a proxy for

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high ability managers. As you know, ESG is very amorphous and confusing. But, you know, we all know that it consumes resources at the firm and who makes the resource allocation decisions? It's the managers, like senior managers at the firm. But who executes it? It's usually the, of course, employees. So essentially that paper is looking at that link between

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senior managers revision and employees buy into that vision as a very important factor that makes foreign ESG investments relevant to shareholder value. And were you surprised by this outcome? To be frank, I was not. And let me sort of give you a sense as to why. People both in academia as well as in practice have been thinking about the link between ESG efforts and shareholder value. It's very difficult, right?

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Oftentimes ESG efforts are hard to quantify, it's longer term, but as we know, especially up until 2022 when ESG got a lot of pushback, firm managers have been getting a lot of push and pressure from asset managers and asset owners to engage in ESG. So firm managers are faced with this constrained optimization problem where their capital allocators are pressuring them to engage in ESG and they have to pick.

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Our paper finds that when you engage in a high level of ESG using the MSCI ESG performance data as a proxy. When you have more sort of high ability CEOs and senior managers, these group of firms predict future higher stock returns. And if you think about it, it's very intuitive because CEO compensation and senior manager compensation is often tied to share price.

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So when managers are pressured to engage in ESG, in essence what the paper is finding is that they will pick ESG projects first. Those ESG projects that increases sort of future near-tar, like one, two, three year shareholder value. Yeah, and I found that so fascinating because of course we at MSCI work with investors and we've devoted substantial time in intellectual capital to be systematizing and putting into frameworks

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what we think are the financially material sustainability issues for companies in an industry. But what you're showing is that corporate leaders might not actually need some sort of a blueprint or

a framework from standard setters about which issues are actually material. I mean, the really good ones seem to have an instinct for which issues and initiatives are going to be most value positive and they're able to invest accordingly to deliver the most value for shareholders out of

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the universe of different sustainability type of ESG initiatives. Is that how you would characterize it and how would you think about it in terms of whether high ability managers just don't actually really necessarily need a blueprint? At the fundamental level, I am viewing ESG as an investment activity that consumes resources by the firm. The problem with ESG currently is that this ROI is incredibly difficult to cap.

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Because there's a discrepancy between how it is accounted for, managerially and managerial accounting. And there's also a gap across companies and across time. And there's a gap between how that managerial accounting is linked to financial accounting. And a lot of standards currently, like SASB, ISSB, of those sorts, are pushing out a very important framework, a needed framework, to provide sector or industry level guidance

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on which ESG issues are important. Of course, it's very difficult to exactly measure what investments that they're making because a lot of firms don't keep track of it. Even if they do it, that data is not available to external consumers, right? If you flip it to the investor side, they're doing due diligence and sort of, you know, bottom-up type of approach to understand firms' ESG efforts or sustainability efforts to value, that's also

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the onus is on the investors, right, to do the correct due diligence. And this obviously has very strong links to this current debate about whether and how much we standardize ESG information. And at the same time, we're trading off sort of this rich firm level or institutional or country specific unique issues, right? So how do you sort of facilitate that ecosystem?

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Is a big sort of a problem that I'm sure you think about. I'm sure a lot of regulators, I'm thinking about it in my office. But I think it's a great starting point to have, you know, that sort of first level industry sector level guidance and KPIs, and then which would allow many investors to sort of dig deeper on the company time level issues, right, because back in the days, they didn't even think about this high level framework. Now they have it.

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So how do you sort of close that gap to, you know, whether you think it's a risk or a mispricing is a different story and another sort of, you know, the debate, but it gives sort of investors and analysts to sort of look at this link bar closely. Yeah, I mean, I think there's certainly always this trade off between standardization and comparability and then the nuance and the context, right? And so I think, you know, where you land and I think different types of investors with different

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strategies as well as different time horizons would value different types of information differently. So in terms of turning to something else when we're talking about noise, I do want to talk about the research that you've published around ESG news and how investors react to news. You've become very well known for this set of research. And so why don't we just start with you telling us what is actually corporate ESG news?

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Oh, well, you know, ESG is a very broad term, right? And people have trouble how to define it and classify it. So to avoid that, the paper that I have with George Seraphim on this, we just use ESG defined by the data vendor. And the data vendor largely anchors on SASB, a sustainability accounting standards boards, you know, five themes and you have 26, 28 different topics in defining

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ESG issues. The data vendor collects news that are publicly available but not voluntarily disclosed by the company and it classified those news into different ESG issues within the SASB framework. And what we find in the paper is that market reacts to ESG news but

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there is a little bit of a nuance in terms of different raiders' ability to predict ESG news, and there are disagreements among ESG raiders, and how sort of the market and investors could take advantage of that very important but nascent institutional feature. And so how much is the reaction and how have and how can investors actually harvest that information and the noise that you're talking about?

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Yeah, so I just wanted to clarify. So there was two papers, one in Financial Analyst Journal, and then one in the Review of Accounting Studies. So Review of Accounting Studies work with George, looks at the role of disagreement, then how different raters have different predictive ability, and how that could be used to predict future return. And then the other paper, also with my colleague and co-author George Seraphine, looks at just plain market reaction

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to ESG news events. The caveat is that we are not able to exactly identify exact news, day by day, but we have a daily sentiment score based on the news. And we know how many news articles were written on that particular day. And this is using the old True Value Labs data. And, you know, so,

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during like the day of and the three day, you know, we find market react, pretty significant short-term, um, you know, event study market reaction, you know, anywhere ranging from 30 to, you know, 40 basis points around a three day of different ESG news. And it sort of varies across

different types of news. So can you talk a little bit about, I mean, let's focus on that study because I think that what was interesting about that was that there's

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different reactions, whether it's positive news versus negative news. And I think, I believe that you found a bigger reaction from positive news, which I found surprising because I tend to think that companies would probably fear negative news a little more than thinking about kind of what bump that they might get from positive news. So I think that's a great point. I was surprised too, and let me give you sort of some context as to why that is.

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So, I mean, as you know very well, ESG 1.0 or CSR 1.0 started from this mitigating tool, and a lot of folks have focused on this as a downside risk, right? So if you look at the data and look at the time series of data, different data vendors have different ways in which they collect ESG news, and ESG news data set in and of itself is pretty nascent, but most of them,

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focus on negative news and they only have negative news because oftentimes positive news are those that are related to PR, even if it's not from the exact company, it could be influencing other sort of media and likely companies are less reluctant to disclose negative news than positive. So I agree with you that it was a little bit of a surprise to us.

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I would have to sort of caveat that the limitation of this particular paper is that we are not able to observe exactly the content of news. We are relying on the data vendors classification of positive and negative news and the sentiment score change. So in an ideal world, you know, I, you know, do my NLP and collect all the news and, you know, do my own thing, but it was, it was definitely not the case.

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But I think what this paper could potentially suggest is that people's view on ESG is also shifting from risk mitigating toll to potential value creation. And from my understanding of the literature before the paper was written, there was very little evidence on sort of

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this type of event study not just on positive news, but news that are financially material. So the purpose of this test was, of course, one of the objective was to show the role of this positive news, ESG news, but also to show or shed light on short-term value implications of firm ESG activities, particularly

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financially material ESG activities. Yeah, I think that some of the news items will be around things like product safety or some of the more social elements. One of the things that we've all struggled with in this field is that the S is really a puzzle for most investors. So for example,

actually a survey we've just released with Stanford Business School of the largest institutional investors globally, many of them,

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most of them actually cite social factors among the sustainability factors they actually consider the least and I think in our own research at MSCI on financial performance of MSCI's ESG Ratings, you know when we disaggregated the E and the S and the G, we were able to do that for 11 years of history It's really actually the S score that has actually performed the strongest of the three pillars so there's this discrepancy and I really,

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we all really struggle as to why it is that investors in general have been typically slower to acknowledge the significance of social issues and to actually factor those issues into how they price whether they're opportunities or risks of their portfolio companies. Do you have a view on kind of the trouble that S seems to cause for investors and companies? Yeah. Well, thank you for asking that question. This is a very important question. So G, we tend to think

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that we know quite a lot about. I do have to point out that the G score in major ESG ratings and the G score that academics typically view very important like E index, G index, and et cetera, they're not that highly correlated. So it's something to think about, I think, generally. But an E is much more quantifiable. I mean, whether it is correct or not,

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and what is the role of assurance and audit of those information is a separate story, but E is more quantifiable and everyone generally, especially these days, tend to agree that E or climate issues are very important issues. S is very values driven, right? And people have different values and that tend to drive not only their investment thesis from an asset manager's perspective, but also company's narrative on S. So,

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there's a lot of disagreement, which causes a lot of confusion. I think that's the first element with an S why it's not potentially being priced very quickly or accurately. I think second has to do with data and information collection. And what I've noticed was that most ESG rating agencies or raters or information providers largely anchor their data on

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disclosure and policies, right? And how the company is able to meet targets and et cetera, to vouch the data, which I think it's a sort of the best practice. But what I've observed is employee satisfaction score from Glassdoor. And of course that's also biased because some people really get upset and they say things about the company or they're really happy, et cetera, et cetera. So there are office biases to surveys.

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But the employee satisfaction score, any of the six or seven that's out in Glassdoor, and the correlation with S or employee satisfaction related scores in major data vendors, the correlation is very low. I would say the highest correlation that I saw was around 8 to 9%, if I remember correctly. And a lot of people, when they think about ESG, they think about certain major topics that they think

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are very important. For example, climate or DEI or corruption. But there's many things that go into an ESG score. So you really need to sort of look into the details, but also I think think about what the outcome of these variables should be and how it's correlated with sort of real performance. So I think that's the second reason why we're still sort of super confused on

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on S generally? That totally makes sense. One, there's even more disagreement under what counts for S or what matters in S than other elements of the SGA. And then the second, the measurement problem is just much greater. I think on a lot of the S issues, especially to do with employees, that is just not

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information that's very readily available. So I wanted to turn to something else because I think you have an amazing knack for researching topics that are top of mind for investors. And I think right now, what happens in supply chains is definitely an area of growing interest. I believe you have a paper in the pipeline that looks at the performance differences of companies whose suppliers have experienced ESG incidents. And I think if I'm not mischaracterizing it, then firms with fewer supply chain ESG incidents

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exhibit superior future accounting performance, so things like profit, sales, inventory efficiency. This relationship is stronger when companies have more pro-social shareholders and customers and are in a more volatile supply chain environment. I think you also see some stock price reactions to supplier ESG incidents.

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Tell us a little bit about that research and also how these findings inform how we think about the opportunity for greater disclosure or transparency on supply chains. Yeah, thank you for asking. So that paper is still sort of a working paper and it's been a fun project because what we've done is we created a proxy for supply chain risk management by masmaskingsing to a focal firm

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negative supply chain related incidents at the tier one supplier the firm is experiencing both from private and public suppliers like publicly listed and private companies that are suppliers. And the gist of the paper is that that signal is able to predict future stock market and the accounting performance.

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Why I think this has interested me is the following. So we have this huge wave of ESG-related regulations, right, across the globe. Why do we regulate and have investors and firms either disclose this information and all these things? At the end of the day, we want to make that information decision useful for investors.

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Right, especially, you know, the supply chain related information being disclosed in certain parts of Europe, et cetera. But we have actually very little evidence on whether and how supply chain ESG issues are related to shareholder value. And that got me motivated to work on this project with my three co-authors in Hong Kong and China.

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You know, most investors have told me the feedback after seeing my research is that they have not yet thought about linking supply chain related information to the focal firm largely because the data is very difficult to collect. So you know, I'm not saying that, you know, the proxy that we created is a perfect proxy, but it's a step towards getting at some of these issues.

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Because similar to the employee satisfaction paper that I have with my co-author, Kyle, I'm really interested in highlighting when and why and how different ESG issues create value. You know, my narrative is not saying that all ESG issues create value all the time. It's highlighting the circumstances in which, and also highlighting different ESG investments,

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within a spectrum of ESG issues. And of course, people have different views on what ESG is generally. You know, the hope is to inform, you know, regulators and capital market participants that certain information, whether it is value generating or destroying, it could inform investors. Because at the end of the day, as you know, your investors face tremendous amount of time constraint. Firms also, you know, face

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tremendous amount of constraints. I've talked to a firm in local to Chicago, and apparently they spent at least five, six months just preparing ESG disclosure for capital market participants. So we're in an era where people say that it's important and think it's important, but we don't know which ones are important and why, and when they are important and when they're not or when they're less important. So I think that supply chain paper is an attempt sort of...

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you know, get at that question from a fresh angle that has been less explored by other people in general. So I would like to wrap up with a question that we've asked all of our guests. And that is if you were stranded on a desert island and you could only have one academic paper with you on sustainable finance, other than one of your very, very good ones, and you weren't actually planning to use that paper to make a fire.

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So it's one that's close to your heart and that you would recommend and want to read over and over. So which one might you bring? So thank you for asking that. I hope I'm not stranded in an island to be frank. There's a paper called Socially Responsible Corporate Customers that was published at the Journal of Financial Economics in 2021. And it's written by three authors, Rui Dai, Hao Liang, and Lillian Ng.

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And the paper essentially sheds light on the role of customers disciplining, you know, their suppliers and, you know, what role they can play in terms of generating or inducing for us to integrate ESG, et cetera, right. Or follow through on their performance. I thought this was a very interesting paper and I would like to, of course, read it again. To me, when I read it, the heart of it gets at what is the role of different important stakeholders?

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And I do believe that consumers really have that buying power to shift companies and, you know, bring about change alongside of capital. So I wanted to, you know, highlight that paper. Thank you for asking. That's a very, very good reminder because I do feel like investors and capital allocators more generally have felt a lot of both the responsibility and the opportunity, I guess,

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to actually be incorporating a lot of sustainability and climate risk concerns. However, it is only one part of the full ecosystem, and I do think that other stakeholders, particularly customers, whether they're business customers or whether they're consumers, they really do actually play a really big part in the equation in terms of shifting corporate behavior. So that's a really, really great one. I will certainly look into that paper.

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Well, Professor Yoon, it's really, really such a pleasure to speak with you, and I really appreciate your time and your insights. Thank you very much. Thank you very much, Linda.