Analysis Of the Impact of ESG Rating Divergence on Stock Returns

Xinran Zhang *

School of Finance, Shandong University of Finance and Economics, Jinan, China

* Corresponding Author Email: 202203140224@mail.sdufe.edu.cn

Abstract. With the increasingly serious problem of extreme climate, China's emphasis on sustainable development is increasing, and the ESG concept is gradually receiving attention from all sectors of society. Environmental, Social and Governance (ESG) rating results have become an important reference for investors when making decisions, and enterprises also incorporate ESG decisions into their management. However, at present, the rating results of various ESG rating agencies at home and abroad are different, with significant differences, which interfere with investor judgment and also have a certain impact on the stock returns of enterprises. This article reviews the literature on ESG rating divergence and stock returns, summarizing and elaborating on investor sentiment and internal corporate governance, and draws relevant conclusions. The divergence in ESG ratings may lower the reputation of the company and the positive market expectations of investors, affecting the effectiveness of ESG rating information for the company, thereby reducing investor demand for the company's stocks and leading to a decrease in stock returns.

Keywords: ESG rating divergence; stock returns; investor sentiment; internal governance.

1. Introduction

Environmental, Social and Governance (ESG), as a sustainable development concept, has received widespread attention from all sectors of society as global environmental issues become increasingly serious. ESG rating is a quantitative evaluation of ESG information disclosed by enterprises by professional rating agencies according to certain standards. With the increase of market demand, relevant rating agencies have also emerged. However, due to the lack of a unified ESG evaluation system at present, there are obvious differences in ESG ratings among different rating agencies for the same company [1], which makes it difficult for investors to judge the true value of the enterprise [2], leading to varying degrees of impact on the company's stock returns.

At present, academic research in the field of ESG mainly focuses on ESG rating systems and the causes of ESG rating disagreements. There is still considerable research space in the field of the economic consequences of ESG rating disagreements, and there is little literature that comprehensively reviews the intrinsic impact mechanism between ESG rating disagreements and stock returns. Existing research has shown a significant positive correlation between ESG performance and corporate financial performance [3]. Therefore, theoretically, ESG ratings have a positive impact on a company's stock returns. However, differences in ESG ratings, reflect divergent evaluations by various rating agencies on the ESG performance of the same company. This divergence can influence investors' views on the company's ESG credentials, often leading to confusion. Consequently, investors' buying and selling behavior of the target stock may be affected, potentially reducing their demand for the company's shares. Ultimately, this could have a negative impact on the company's stock return [4].

Based on this, this article will explore the intrinsic relationship between ESG rating divergence and corporate stock returns from a micro perspective. Differences in ESG ratings can affect investor sentiment, leading to a decrease in demand for stocks. Differences in ESG ratings may also affect the effectiveness of internal corporate governance and reduce decision-making efficiency, both of which will further affect stock returns for companies. The marginal contributions of this paper are potentially as follows. Firstly, by establishing a correlation between the disparities in ESG ratings and stock returns, this research both expands the scholarly inquiry within the ESG field and enhances the understanding of factors that influence corporate stock returns. Secondly, it provides valuable insights for regulatory authorities in developing a standardized rating system, thereby cautioning stakeholders such as investors against over-reliance on ratings issued by a single agency. Furthermore, it encourages companies to improve their internal governance based on their current standing, which holds significant importance in fostering a rational market perception of ESG rating disparities.

2. Reasons for Differences in ESG Ratings

Under the new development pattern in our country, the basic concept of ESG is highly consistent with the goals of the dual carbon strategy. By practicing the ESG concept, enterprises can be guided to implement the green development concept, promote green transformation, and have a positive promoting effect on achieving China's "carbon peak and carbon neutrality" strategic goals. However, due to the lack of a unified ESG evaluation system, there are significant differences in ESG ratings among different rating agencies for the same company. In existing literature, some scholars have analyzed the reasons for rating differences. Berg et al. found that differences in ESG ratings stem from differences in the range of indicators, measurement methods, and weights of the ESG evaluation system, and the impact of these three factors on ESG divergence is 56%, 38%, and 6%, respectively [4].

2.1. Differences in ESG rating indicators range

Regarding the reasons for the differences in ESG ratings, Yuan Rongli believes that different rating agencies have different subcategories of indicators, resulting in a widespread phenomenon of differences in ESG ratings among enterprises [5]. According to Klynveld Peat Marwick Goerdeler, there are approximately 30 major ESG data providers worldwide, and institutions with significant international market influence include FTSE Russell, Sustainable Fitch, Thomson Reuters, Dow Jones, Bloomberg, and Morning Star Sustainability. According to table 1, it can be seen that these six rating agencies alone have different dimensions and subcategories of indicators. These indicators can be divided into theme categories common to rating agencies such as biodiversity, employee development, energy, green products, health and safety, labor practices, product safety, and compensation, as well as many theme categories unique to each rating agency. This makes it difficult for investors to judge the true value of the company, and also increases the cost of information.

Table 1. ESG rating indicator system for different institutions

Rating agencies	Indicator system
FTSE Russell	11 fields, over 300 indicators
Thomson Reuters	10 fields, over 178 indicators
Dow Jones	3 levels, over 600 indicators
MSCI	10 themes, 37 key indicators
Bloomberg	Covering over 120 ESG indicators
Sustainalytics	Focusing on specific industries, each industry should have at least 70 indicators

2.2. Differences in Measurement Methods

Measurement differences are also one of the reasons for differences in ESG ratings. Berg et al. found that there are also differences in the measurement methods of rating agencies [4]. For example, the average correlation coefficient of scores for evaluating company environmental policies between different databases is only 0.55. Even the simplest and most clear indicators may not have highly correlated measurement results from various institutions. For example, the indicators of whether a company has joined the United Nations Global Compact and whether the Chief Executive Officer also serves as the Chairman of the Board are both clear and readily available information, but the average correlation coefficients of ratings from various institutions for these two indicators are actually 0.92 and 0.59, respectively. In addition, there are several negative correlations, such as the lobbying project between Sustainalytics and Moody's ESG, and the rating of Indigenous Rights project between Sustainalytics and Asset4. This indicates that there are significant measurement errors in each database.

2.3. Differences in Rating Indicator Weights

Dimson et al. argue that different institutions assigning different weights to rating indicators have led to differences in ESG ratings [6]. For example, foreign research suggests that setting too many non-economic goals for state-owned enterprises can lower their governance level and damage their ESG performance [7], while domestic rating agencies will focus on the social responsibility that enterprises undertake. This is the main reason why there are significant differences in ESG rating reports issued by different domestic and foreign rating agencies for the same listed enterprise [8].

3. The Impact of ESG Rating Divergence on Company Stock Returns

3.1. Investor Sentiment, Internal Corporate Governance, and Stock Returns of the Company

Investors have systematic biases in their expectations for the future, and those with biases are known as investor sentiment. Investor sentiment can effectively reflect investors' judgment of future stock trends and their level of enthusiasm for participating in trading. Li Xiang et al. proposed a significant correlation between investor sentiment and stock returns [9]. When investor sentiment continues to be optimistic, the rising investment sentiment continues to spread, causing the existing investor risk preference in the market to increase, increasing capital investment in order to obtain more returns. At the same time, investors outside the market will also continue to enter the market, resulting in a rise in stock prices and a continuous increase in stock returns. The increasing stock returns will further enhance investor sentiment, forming a positive cycle, with the stock price spiraling upwards, far higher than its true price. When investor sentiment remains pessimistic, investors tend to become increasingly averse to risk, leading to the emergence of panic sentiment. Consequently, the rise in divestment behaviors triggers a decline in stock prices, further compounding the fall in stock returns.The continued decline in stock prices will further exacerbate investors' pessimistic sentiment, thereby having a significant impact on the company's stock price returns.

Good corporate governance will increase stock returns [10]. Corporate governance refers to the coordination of the interests between a company and all stakeholders through a set of formal or informal, internal or external systems or mechanisms, in order to ensure the scientific decision-making of the company and ultimately maintain the interests of all aspects of the company. Corporate governance is divided into internal governance and external governance, among which good internal governance can improve the operational efficiency of a company and reduce operating costs. Through a reasonable decision-making mechanism and supervision system, the company can more effectively identify and avoid operational risks, ensuring long-term stable growth. The improvement of operational efficiency and the reduction of costs will directly affect the company's profitability, thereby positively affecting stock returns.

3.2. Impact of ESG Rating Divergence on Investor Sentiment and Internal Corporate Governance

Companies with excellent ESG performance tend to garner investors' favor. However, significant disparities in ESG ratings issued by different rating agencies cast doubts on a company's ESG performance, affecting investors' value judgments and diminishing their confidence in ESG investments. This, in turn, plunges investors into a pessimistic sentiment.

When a company faces ESG rating disagreements, the management will reassess its internal governance strategy, requiring a longer period of time to analyze the reasons for the ESG rating disagreements and find countermeasures; Furthermore, ESG disagreements may also increase the company's risk exposure. To address these risks, the company needs to strengthen risk management measures to ensure that there are no major errors or violations on ESG issues. This increases the difficulty of management decision-making, which in turn affects the efficiency of corporate governance.

3.3. Impact of ESG rating divergence on company stock returns

2.3.1 Investor sentiment

The divergence of ESG ratings represents different evaluations of the ESG performance of the same enterprise by different rating agencies, which can lead to the failure of ESG indicators, reduce the accuracy of ESG ratings in predicting market information, and increase investor confusion. In order to reduce the possibility of losses in investment returns, investors tend to give up buying stocks of the company and instead purchase stocks of companies with high ESG ratings and small rating differences. This will reduce the demand for purchasing stocks of the company, thereby lowering its stock returns.

2.3.2 Internal governance of the company

Differences in ESG ratings may affect the effectiveness of internal governance and reduce the efficiency of company decision-making [11]. When a company receives ESG ratings with significant differences from different rating agencies, management needs a longer period of time to analyze the reasons for the differences in ESG ratings and find countermeasures, increasing the cost and difficulty of its strategic decision-making. The longer a company responds to ESG rating disagreements, the longer the fermentation time for the negative impact of ESG rating disagreements on the company, and the greater the negative impact on the company's stock returns.

4. Conclusion

Given that a unified ESG rating standard has not yet been established, there are often significant differences in ESG ratings for the same company. This may lower the reputation of the company and the positive market expectations of investors, affecting the effectiveness of the company's ESG rating information and leading to a decrease in the company's stock returns. Based on this, this article explores the impact of ESG rating divergence on company stock returns from the perspective of ESG rating divergence. The research results indicate that differences in ESG ratings can reduce a company's stock returns through both investor sentiment and internal governance. Firstly, differences in ESG ratings can put investors in a pessimistic state, and to reduce risk, investors may choose companies with smaller differences, which can have a certain impact on the stock returns of larger companies; Secondly, in order to reduce the risk exposure caused by rating differences, the management will spend a certain amount of time identifying the problem and providing reasonable response measures, which will reduce the internal governance efficiency of the company. The longer the negative impact of ESG rating differences on the company, the greater the negative impact on the company's stock returns.

Based on the impact of differences in ESG ratings, it is necessary to improve China's ESG evaluation system as soon as possible. China's ESG is still in its early stages, and its performance in various aspects is not yet mature. Different rating structures have strong subjectivity, resulting in significant differences in ESG ratings for Chinese enterprises, which seriously hinders the healthy development of enterprises and capital markets.

Investors should establish a rational ESG investment concept, pay attention to the ESG performance and ESG rating differences of enterprises, externally motivate enterprises to actively assume ESG responsibilities, and call on relevant departments to improve China's ESG ecosystem construction as soon as possible.

From the perspective of internal governance, enterprises need to improve their corporate governance capabilities. Differences in ESG ratings can affect the decision-making efficiency of management and reduce the effectiveness of internal governance within the company. By optimizing the internal governance structure, improving the efficiency of company decision-making, reducing the impact of negative news such as ESG rating differences on the company's stock price, and better leveraging the inhibitory and regulatory effect of internal governance on the relationship between ESG rating differences and stock returns.

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