

ESG Resilience in Focus

What US–EU Divergence Means for Portfolio Performance

Morningstar Sustainalytics
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Key Highlights

- ▶ In the US, ESG quality remains both a return driver and a risk shield. Low ESG risk portfolios deliver risk-adjusted outperformance over time and can provide stability through volatile cycles. However, the spread between high and low ESG risk portfolios has narrowed since 2022, signaling that the market is gradually normalizing the consideration of ESG factors as a standard part of financial analysis.
- ▶ In the EU, ESG integration is a structural performance differentiator — a systemically embedded factor that still produces significant performance dispersion across portfolios. However, this differentiation reflects systematic penalization, rather than market speculation. The EU market does not reward ESG excellence with speculative upside, but it severely discounts poor ESG performers under a robust regulatory and disclosure regime (i.e., SFDR, CSRD, and EU Taxonomy).
- ▶ In terms of global ESG positioning, the US and EU follow two distinct and stable ESG models. The US rewards low ESG risk companies through market-driven performance, while the EU applies a policy-driven system that penalizes companies with high ESG risk. This means low ESG risk exposure in the US supports return generation, while that in the EU offers stability and alignment with regulatory expectations.
- ▶ Our analysis demonstrates that Morningstar Sustainalytics' ESG Risk Ratings are not only effective measures of financially material ESG risk, but also meaningful inputs for understanding financial resilience and performance when applied through a rigorous, market-based framework. By combining ESG Risk Ratings with empirical performance analysis, this report shows how the ratings can be used in practice to interpret ESG risk across different regulatory and market regimes.

US versus EU ESG Risk Portfolio Performance

ESG Risk Category	US True Return Volatility	EU True Return Volatility	US Info. Ratio	EU Info. Ratio	Implications
Low	1.16%	3.45%	+1.08	+0.33	Strongest performer in both regions. The US rewards financial efficiency, while the EU reflects stability without evidence of financial efficiency being penalized.
Medium	0.97%	3.92%	+0.89	-0.14	The US still rewards mid-level ESG risk, while in the EU, moderate ESG risk does not provide sufficient protection from underperformance.
High	3.83%	4.22%	-0.34	-1.10	The US penalizes high ESG risk mildly, while the EU shows strong, persistent penalization due to regulatory expectations.
Severe	6.08%	5.01%	+0.21	-1.27	The US demonstrates investor polarization, allowing firms with severe ESG risk to partially recover. The EU enforces strict accountability with sustained underperformance.
Negligible	2.64%	3.94%	-1.16	-1.43	Both regions show negative performance due to sample size, valuation premium, and growth limitations, which is not due to the ESG risk level.

Two Distinct ESG Regimes: US versus EU

Over the past decade, environmental, social, and governance (ESG) risk ratings have evolved from an ethical preference into a structural determinant of financial resilience.

Using consistently constructed ESG risk-tier portfolios and Morningstar US Market TR-based excess-return analysis, the comparison reveals two distinct uses of ESG research:

- ▶ Alpha discovery and normalization in the US, and
- ▶ Systematic enforcement and performance penalization in the EU.

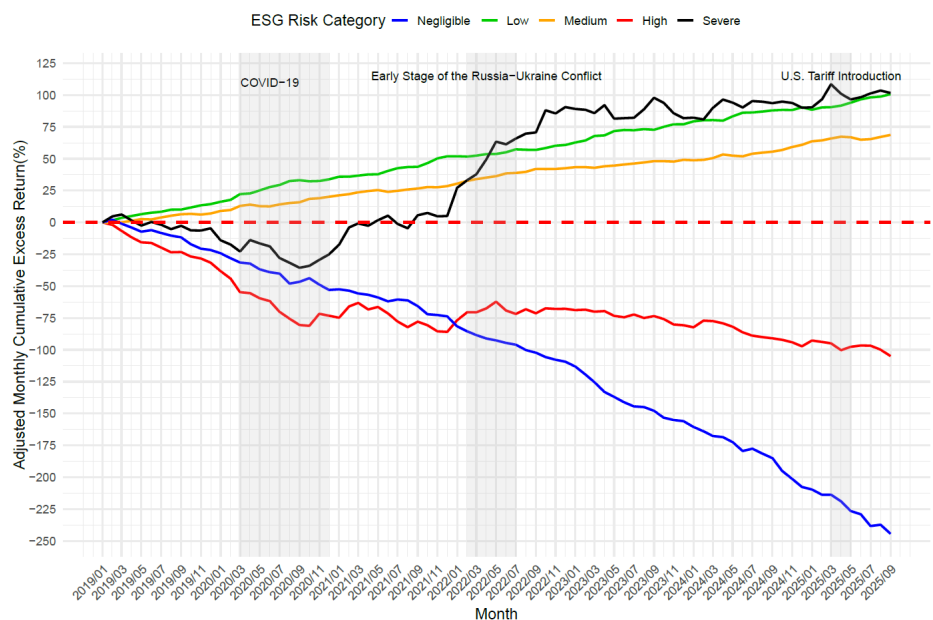
While both markets reward lower ESG risk, the EU market exhibits relatively higher volatility and punishes companies for poor ESG performance. In contrast, the US market has displayed steadier overall performance but less dispersion between low and high risk portfolios since 2022.

Building on Morningstar Sustainalytics' July 2025 report, [ESG Risk Ratings: A Protective Instrument Amid Economic Shocks](#), we extended the same quantitative framework to the US and EU equity markets.

US Market: ESG as a Source of Alpha and Converging Stability

The US cumulative excess return series spans -250% to +125%, covering three major stress phases – the covid-19 pandemic (2020), the early part of the Russia-Ukraine conflict (2022), and the US government's introduction of tariffs in early 2025. Despite these disruptions, portfolios with stronger ESG profiles maintained upward momentum and lower drawdowns, underscoring the dual role of ESG as both a performance enhancer and a shock absorber.

Exhibit 1 US Adjusted Monthly Cumulative Excess Return by ESG Risk Category (2019–2025)



Source: Morningstar Sustainalytics and Morningstar Direct. Data as of November 9, 2025.

Exhibit 1, above, highlights several key visual patterns in the cumulative performance of portfolios across ESG risk categories. For example, low ESG risk portfolios finish just under +100%, maintaining a steady upward trajectory through each major stress period. Medium ESG risk portfolios also remain

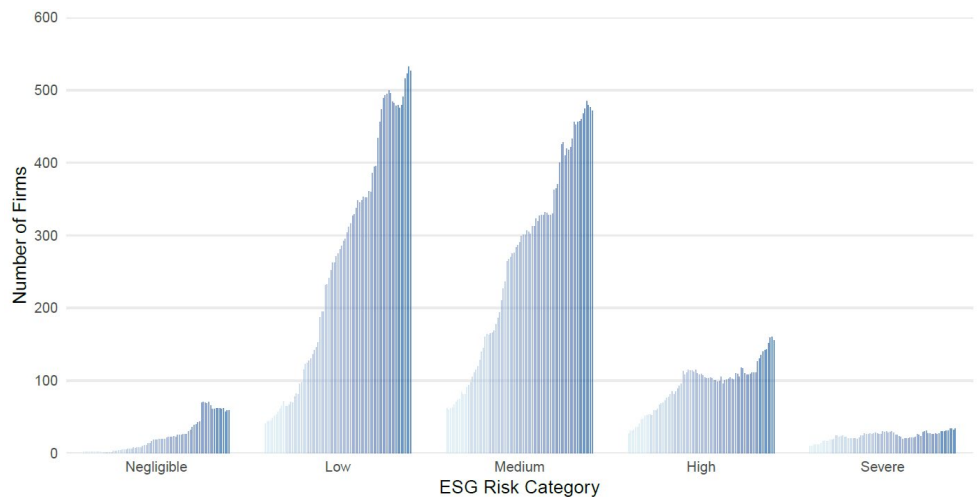
consistently positive, although they advance at a more moderate pace. In contrast, high ESG risk portfolios underperform overall, but their decline slowed noticeably from 2021 onward. Severe ESG risk portfolios experienced a sharp plunge during the 2019–2020 period, followed by a rebound and partial convergence toward low ESG risk portfolios in the early phase of the Russia–Ukraine conflict, likely reflecting temporary gains driven by repricing in the energy sector. Meanwhile, negligible ESG risk portfolios persistently lag behind all other categories, approaching the lower –250% band.

The US market demonstrates a distinct ESG performance gradient: the lower the ESG risk, the greater the portfolio’s stability and risk-adjusted return. Following the onset of the Russia–Ukraine war, severe and low ESG risk portfolios began to converge, reflecting, in our view, the temporary impact of energy price surges and sector revaluations driven by supply shortages. Overall, low ESG risk portfolios maintained the most balanced performance, combining steady compounding with low volatility, underscoring investors’ enduring preference for companies that show strong ESG governance and effective risk management.

EU Market: ESG as a Structural Discipline with Persistent Dispersion

In Exhibits 2 and 3 below, we apply the same analytical framework used in Morningstar Sustainability’s ESG Risk Ratings: A Protective Instrument Amid Market Uncertainty report, to examine the EU market. Our analysis covers 1,341 publicly listed companies across European financial markets. This includes approximately 60% of the Morningstar Developed Markets Europe Index constituents, and these companies account for nearly 52% of the total sample. Exhibit 2 shows the monthly distribution of firms across ESG risk categories in the EU market. Within each category, each vertical line represents the number of distinct firms in a given month, arranged chronologically from left (earlier months) to right (later months). Note that the distribution of firms’ ESG risk category by month, from January 2019 to September 2025, follows an approximately normal distribution pattern, ensuring a balanced representation across the different levels of ESG risk.

Exhibit 2 EU Sample ESG Risk Category Distribution by Month (2019–2025)

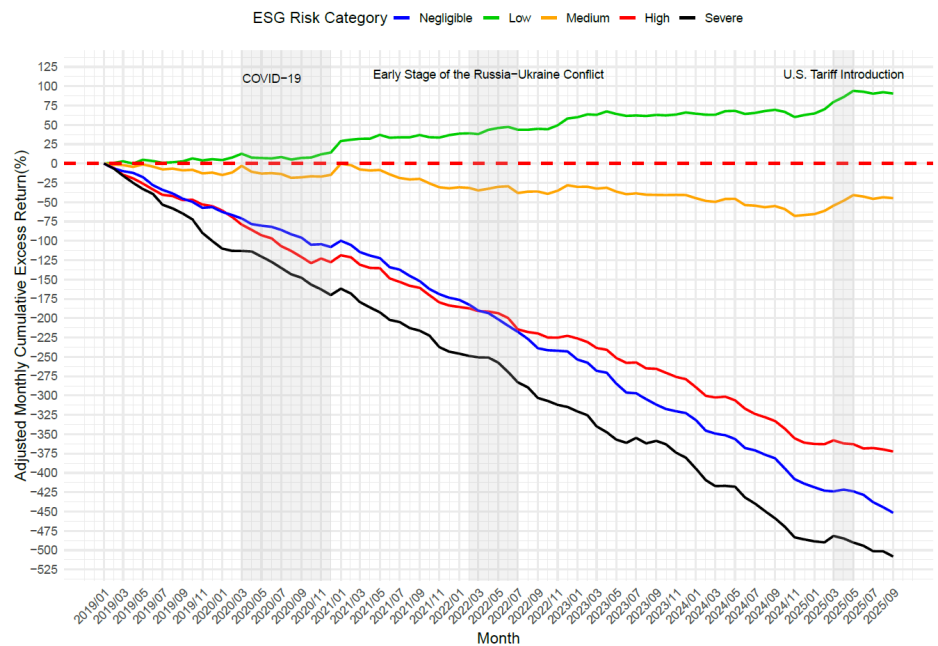


Source: Morningstar Sustainability and Morningstar Direct data. Data as of November 9, 2025.

The EU cumulative return series extends from -525% to +125%, more than double the US downside range. This does not indicate speculative volatility but rather a systemic repricing mechanism in which investors penalize weak ESG governance sharply, but still consistently reward low ESG risk.

Exhibit 3 highlights several key visual patterns in the cumulative performance of ESG risk portfolios in the EU market. For example, low ESG risk portfolios climb steadily toward +100%, closely mirroring the performance pattern observed in the US. Medium ESG risk portfolios remain near neutral throughout the period, indicating limited potential for excess returns. In contrast, high and severe ESG risk portfolios experience sharp declines exceeding -400%, then fail to recover meaningfully, illustrating the market's persistent punishment of firms with weaker ESG profiles. Negligible ESG risk portfolios also remain in negative territory, suggesting a valuation drag similar to the one observed in the US market. However, unlike in the US, low and severe ESG risk portfolios in the EU remain widely separated after 2022, indicating strong and consistent differentiation reinforced by both market and regulatory standards.

Exhibit 3 EU Adjusted Monthly Cumulative Excess Return by ESG Risk Category (2019-2025)



Source: Morningstar Sustainability and Morningstar Direct Data. Data as of November 9, 2025.

The EU market exhibits relatively higher volatility in low and medium ESG risk portfolios. This pattern may not be driven by speculative momentum; rather, it may reflect investors' stricter valuation adjustments for firms with elevated ESG risk. This stronger and more persistent repricing of ESG weaknesses, combined with broader macroeconomic pressures, contributes to the larger performance fluctuations seen in the EU market. Low ESG risk portfolios remain the most resilient, while high and severe ESG risk portfolios show deep, enduring underperformance.

The EU's well-established regulatory framework, supported by policies such as the Sustainable Finance Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD), and the EU Taxonomy, provides a robust system of structural accountability. This is reflected in our portfolio performance analysis, where high and severe ESG risk portfolios decline sharply, often falling below -400%, and do not recover, while low ESG risk portfolios show steady, consistent gains. These persistent

performance gaps indicate that the market systematically penalizes companies with weak ESG practices, rather than rewarding ESG leaders. Investors apply lasting valuation discounts to firms that fail to meet regulatory expectations for governance, disclosure, and sustainability management. The return patterns in the EU, therefore, point to a market that consistently prices down ESG laggards, because policy requirements make ESG weaknesses financially material and difficult to overlook.

Across both the US and EU markets, negligible ESG risk portfolios consistently show negative cumulative excess returns. This pattern is partly explained by the small sample size of companies assigned a negligible ESG Risk Rating, which leads to concentrated portfolios and higher idiosyncratic risk. Additionally, in our view, companies rated as having negligible risk often trade at valuation premiums, reflecting their reputation as “strong ESG companies.” Although this analysis does not directly measure valuation multiples, the observed performance patterns are consistent with market participants assigning different valuations across ESG risk categories. These elevated starting valuations can limit upside potential, resulting in long-term underperformance relative to other ESG categories. Thus, the negative excess returns for negligible ESG risk portfolios reflect both the effects of the structural sample size and valuation limitations.

Mapping Two Distinct ESG Pathways

Although low ESG risk portfolios show stable upside in both the US and EU markets, the underlying drivers differ fundamentally. In the US, stability reflects market-based reward for stronger fundamentals and lower risk. In the EU, stability reflects a structural penalization of poor ESG performers under a mature regulatory regime. Thus, the same upward trend emerges through different mechanisms: reward-driven in the US and enforcement-driven in the EU.

Exhibit 4 US versus EU ESG Risk Portfolio Performance

ESG Risk Category	US True Return Volatility (%)	EU True Return Volatility (%)	US Information Ratio	EU Information Ratio	Implication
Low	1.16	3.45	+1.08	+0.33	Strongest performer in both regions. The US rewards financial efficiency, while the EU reflects stability without evidence of financial efficiency being penalized.
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Source: Morningstar Sustainalytics

From an information ratio (IR) perspective, a metric that evaluates how efficiently a portfolio converts risk into excess return, the contrast between the US and EU markets is revealing. In the US, low and medium ESG risk portfolios record strongly positive IRs (+1.08 and +0.89 respectively), indicating that

ESG leadership not only enhances absolute returns, but does so with superior efficiency per unit of risk. The high and severe ESG risk portfolios, by contrast, exhibit weak or negative IRs, suggesting that poor ESG performance remains a structural drag on risk-adjusted value creation.

In the EU, however, even low ESG risk portfolios achieve only a modestly positive IR (+0.33), while those in the high and severe ESG risk categories fall deeply negative (-1.10 to -1.27). This pattern implies that European markets already price ESG quality into valuations. The upside potential for ESG leaders, therefore, is limited but the downside penalty for weak performers is far more severe.

These IR dynamics confirm a key divergence. In the US, ESG continues to generate alpha and reward differentiation, while in the EU, ESG primarily enforces accountability and penalizes underperformance within a mature, policy-driven investment environment.

Exhibit 5 Two ESG Regimes

Theme	US Market	EU Market
Volatility character	Low absolute fluctuations	Relatively higher volatility, reflecting stricter repricing
Post-conflict trend	Low and severe risk portfolios converge, with reduced dispersion after 2022	Low and severe risk portfolios remain far apart, showing sustained ESG differentiation
ESG alpha availability	High — positive IR for low and medium risk categories	Strong differentiation — negative IR for high risk categories
Market phase	ESG alpha discovery	ESG enforcement and systemic penalization
Investor behavior	Market-driven ESG integration	Policy-driven discipline and consistent penalization of laggards

Source: Morningstar Sustainalytics

The EU's ESG framework is widely seen as mature because ESG risk is consistently translated into observable financial outcomes. Across ESG risk categories, the EU market shows large, persistent performance gaps, with high and severe ESG risk portfolios experiencing sustained underperformance and limited recovery over time. This pattern indicates that investors broadly and consistently incorporate ESG considerations into valuation and capital allocation decisions, rather than treating them as optional or sentiment-driven inputs. The result is a market in which weak ESG performance leads to lasting financial consequences, reflecting a regulatory environment — anchored in the SFDR, CSRD, and the EU Taxonomy — that standardizes disclosure, reinforces accountability, and aligns investor behavior with consistent ESG expectations.

Exhibit 6 Market Integration versus Regulatory Enforcement

Dimension	US Market	EU Market
ESG role in pricing	Market-driven input	Regulatory constraint
High ESG risk outcomes	Moderate underperformance, partial recovery	Deep, persistent underperformance
Performance dispersion	Narrows over time	Remains wide
Investor alignment	Mixed and polarized	Broadly aligned
What this indicates	ESG integration phase	ESG enforcement phase

Source: Morningstar Sustainalytics

Investor implications differ meaningfully between the US and EU markets. In the US, ESG integration functions as an adaptive alpha factor, with higher ESG quality continuing to deliver measurable excess returns while maintaining relatively low volatility. In contrast, in the EU, ESG integration operates more as a structural performance filter. The market consistently rewards firms that demonstrate strong ESG discipline while imposing lasting penalties on weaker performers. This differentiation appears to reflect systemic enforcement driven by regulatory frameworks, rather than short-term speculative market sentiment.

From a global portfolio perspective, investors may benefit from combining low ESG risk exposure in the US, which offers stronger alpha generation potential, with low ESG risk exposure in the EU, which provides greater policy-driven stability. Such dual-market exposure can support a more balanced ESG risk-return profile by capturing both performance upside and structural resilience.

Investor Preference Divergence: US Polarization Versus EU Alignment

We gained additional insights from performance patterns in the US market. The severe ESG risk portfolio converges toward the low ESG risk portfolio after 2022. This suggests that US investors are not unified in their ESG preferences. Instead, the market appears polarized, with a meaningful segment expressing pro-ESG preferences, while another segment — influenced by sector fundamentals or ideological “anti-ESG” positioning — may be directing capital toward firms with higher ESG risk exposure. These offsetting behaviors compress performance differentials and allow severe ESG risk portfolios to track closer to low ESG risk portfolios than financial theory alone would predict.

In contrast, the EU market reflects broad investor alignment around pro-ESG principles, reinforced by regulatory structures such as the SFDR, CSRD, and EU Taxonomy. As a result, companies with high ESG risk face consistent and substantial valuation penalties, and generate persistent performance dispersion between low and severe ESG risk categories.

Repriced ESG Risk

ESG investing behavior has progressed in stages, from awareness and preference-based selection to full financial integration and, in the EU, regulatory enforcement. This helps to explain why ESG risk is priced differently across markets. Our comparative analysis highlights that the US and EU markets are at different stages of development in the way they apply ESG risk to financial assessment. In the US, ESG integration is moving from an early phase of alpha discovery toward normalization, as markets increasingly incorporate ESG risk into traditional valuation frameworks. In the EU, meanwhile, the consideration of ESG factors has transitioned a stage further into systematic enforcement, where weak ESG performance is structurally penalized under a mature regulatory architecture.

Looking ahead, the broader ESG ecosystem, including disclosure standards, regulatory frameworks, and impact-oriented reporting initiatives, continues to evolve toward greater transparency and measurement of real-world sustainability outcomes. ■■■

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