AN EVOLVING INVESTMENT THESIS FOR ESG

Consideration of environmental, social and governance criteria was once driven by ethical forces. Now investors are discovering how it plays a key role in broader financial performance and managing volatility.

Increasingly, investors are embracing ESG, a framework for investment based on environmental, social and governance criteria. There are two motivations. One is based on the spirit of responsible and sustainable investing—supporting a company's low carbon emissions or gender equality, for example, through capital allocation. The other is to mitigate risk and generate incremental returns, and there is a growing body of research that suggests that focusing on ESG issues can create long-term value. "Challenges such as climate change mitigation, labor force management and healthy corporate governance practices can have meaningful implications for long-term performance," says Chris McKnett, Global Head of ESG Business at State Street Global Advisors (SSGA).

Once seen as vague and peripheral, ESG is progressively becoming a core tenet to the risk-return equation and to goals-based investing. Historically, investors practiced socially responsible investing by excluding investments that didn't meet sustainable or social standards. The success of constrained portfolios that align with such principles and policies is decidedly mixed. While many still follow this approach, most investors' objectives are to add return and reduce investment risk, and they're finding that ESG can do the job. A recent survey by SSGA on ESG adoption found that 84 percent of institutional investors are satisfied or very satisfied with the financial performance of their ESG strategies, and 69 percent say that ESG has helped to manage volatility. Performance is a motivator, as 75 percent expect the same returns from their ESG investments as their non-ESG investments.

The rise of interest in ESG is driven by a combination of ethical and financial forces in the market. ESG is becoming a secular trend as climate change, workplace diversity and corporate governance become more publicly prominent issues. Client demand is a powerful motivator for investment managers. Pension participants themselves are requiring more ESG options from plan sponsors, and regulations and legal developments are creating a more accepting and enabling environment. Managing headline and reputation risk is also a prevalent reason to consider ESG.

A newer driver is the conviction that ESG factors play a key role in broader financial performance, and they can be used as a way to manage volatility within an investment portfolio. "Where earlier approaches focused on avoiding negative impacts, we are now examining how to allocate capital in such a way to create a positive impact," says McKnett. This means incorporating ESG themes into investment decisions by tilting portfolios toward companies that have the attributes that investors want exposure to. The objective is to deploy capital to create, or reinforce, positive impact with the aim of achieving market-like returns. There is increasing evidence in academia and in the industry that supports the investment thesis of ESG: ESG-based investment products are more seasoned and have longer track records, as well. "As ESG gets talked about more, researched more and practiced more, you see increasing levels of sophistication for integration, as well as more robust tools and analytical processes for investors to use," McKnett says.

Macro drivers are also adding a tailwind, as investors use ESG analysis and data to understand systemic transitions in the global economy, such as the economic and investment effects of climate change. "That's really the intersection between ESG and traditional investing that brings a lot of investors, who wouldn't necessarily identify as socially responsible or ethical, to ESG," says McKnett. "It will help them to position their portfolios for the future." —Howard Moore

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Using ESG to Help Improve Investment Outcomes

Risk-adjusted returns mean as much to ESG investors—those that consider environmental, social and governance criteria in their investment process—as the sustainable impact they seek to attain. Chris McKnett, Global Head of ESG Business at SSGA, discusses how ESG integration and its alignment with factor investing has the potential to improve investment outcomes.

Is a consensus forming around a concrete definition of ESG investing?
McKnett: ESG is an investment strategy that considers environmental, social and governance credentials in addition to traditional financial metrics. There is no true standard, but the financial industry is beginning to agree on the metrics and data to measure it. ESG is not an asset class or even a distinct investment style, but a variety of strategies that target desired outcomes. Some investors may seek to create a specific impact, such as increasing gender diversity in the workforce or promoting a low-carbon economy. Others may seek to integrate ESG insights into the investment process in order to outperform.

How is ESG best integrated into the investment process?
McKnett: The traditional socially responsible investing portfolio is constrained and tends to limit the investment universe. Some clients want that, but the shift we see is that ESG is a structure to be integrated—along with financial rigor—into the investment process as a wider lens that can enhance decision-making. In this way, ESG is an opportunity to harness additive insights. These insights can potentially improve returns by selecting better investments or manage volatility by avoiding those investments for which there isn't adequate compensation for ESG risk.

How does ESG work with factor investing and how do they intersect?
McKnett: We have done substantial research on the intersection of ESG and factor investing, and how ESG relates to established factor risk premia: namely value, low volatility, small size, momentum and quality. Thinking about ESG through the frame of existing factors marks an innovative confluence of these two powerful trends in the market. We have found that equities with high ESG ratings might not have desired factor characteristics, and companies with desired factor characteristics might not have the appropriate ESG profile. For example, highly rated ESG stocks can typically give an investor exposure to value—relatively cheap stocks—as well as low volatility, and higher quality, but they do not expose an investor to momentum or small size. The challenge is to include highly rated ESG companies into the portfolio while delivering positive momentum and small-cap exposure. We use a variety of tools to balance and align these competing objectives to capture them all. Our research shows that investors can incorporate their views on ESG as they tilt their portfolios toward long-term, durable-factor premia designed to enhance return, mitigate risk and provide diversification.*

What about ESG and other investment strategies?
McKnett: We've seen some performance benefits—especially in lowering volatility—in the active quantitative strategies that we manage by including ESG scores, alongside traditional alpha factors, in the stock selection process. ESG has been helpful in markets where investors are defensive; it tends to add a quality bias, which can benefit the portfolio in those market regimes. And our active fundamental teams implicitly consider ESG as an input related to a company's long-term earnings power and sustainability. There's a tendency to view ESG investing as an active proposition, but most of the portfolios we manage are index-based. We optimize index-based portfolios to track a benchmark as closely as possible to deliver precise ESG exposure. Accordingly, investors with an active view can often implement it through a rules-based index approach. We're also starting to see more adoption of ESG benchmarks. ●

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*Diversification does not ensure a profit or guarantee against loss.

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