Access the opportunities.

Sustainable Investing

The case for taking a sustainable approach

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For many years it was thought that sustainable investing came at a cost. Chase a green investment and you'll miss out on returns. But this is a myth. Research is mounting that basing your portfolio on environmental, social and governance (ESG) characteristics can not only make the world a better place, but it can improve investment returns.

Research from academics, asset managers and index providers has found a link between good ESG performance and improved financial outcomes, largely through risk reduction. Targeting high ESG performers can therefore pay real dividends to investors.

In this research paper we present evidence from several sources that the commitment to ESG investing doesn't come at the cost of lesser returns. We find that the opposite holds true: companies with strong ESG profiles typically enjoy enhanced corporate performance and financial returns – and targeting these companies can enhance returns for investors, society and the world as a whole. On the other hand, not implementing ESG can 'cost' companies and investors better returns.

ESG leads to lower risks, better returns

Increasingly, investors are coming to understand that a company's commitment to ESG is important because it provides greater transparency of their risk management through increased reporting thereby allowing them to better assess the company's long-term performance potential.

Dr. Philipp Krueger, an Assistant Professor of Responsible Finance at the University of Geneva, has recently studied the relation between ESG characteristics and investment performance. Krueger says in a 2017 study he co-authored:

> *High sustainability footprint investors also display higher risk-adjusted performance …*
> *We further document that this enhanced risk-adjusted performance of high sustainability footprint portfolios is primarily driven by a strong reduction in total portfolio risk, suggesting risk mitigation as being one of the main channels through which portfolio-level sustainability generates long-term value.*[1]

In its 2015 research paper, Finding Alpha in ESG[2], Credit Suisse finds that all five portfolios that it constructed based on ESG data added alpha over a seven-year time horizon. Credit Suisse examined the opportunity to capture alpha using data from each of the three ESG pillars and concludes:

> *For the Environment pillar data we conclude that strong management of environmental issues "pays" and weak management of environmental issues "costs" at the portfolio level.*
>
> *We found similar results using the Governance pillar data, i.e., strong governance "pays" and weak governance "costs" at the portfolio level.*
>
> *For Social pillar data, we find that that companies which have overall the weakest management capabilities and highest exposure to social issues significantly underperform all other companies, i.e., poor social performance "costs" at the portfolio level.*

Credit Suisse found that integrating ESG factors can enhance portfolio performance through both lower exposure to negative risks related to ESG factors and higher exposure to related opportunities, which can lead to material cost advantages, improved efficiencies and/or new revenue sources. In addition, ESG ratings are a possible lead indicator of management quality in that companies which are better managers of ESG factors may also be better managers of shareholder capital, Credit Suisse found.

1 Gibson, Rajna and Krueger, Philipp, The Sustainability Footprint of Institutional Investors (January 14, 2018). Swiss Finance Institute Research Paper No. 17-05.

2 Hitchens, Richard and McCullagh, Sanda and Parks, Chris, ESG-α Series: Finding Alpha in ESG (June 19, 2015).

Link between ESG and profitability

Other research finds a link between good ESG governance and improved financial performance. In its study, *A Quantitative Perspective of how ESG can Enhance your Portfolio*[3], JP Morgan says the evolution of ESG investing means it now offers investors a measurement system to manage reputational and operational risk that companies face, which may impact on their long-term profitability. JP Morgan concludes:

> *ESG can enhance your portfolio by reducing volatility, increasing Sharpe ratios and limiting drawdowns … Our research highlights that the key attributes of ESG investing lie within portfolio construction.*
>
> *While the return profile may not be the selling point, not having ESG factors in your portfolio significantly increases volatility, lowers potential Sharpe ratios and leads to a higher probability of suffering larger drawdowns during times of market stresses.*

A paper from leading global index provider MSCI, *Foundations of ESG Investing*, evaluates in detail how ESG characteristics can enhance corporate and portfolio performance.

MSCI is a leading global ESG researcher, with a team of over 170 analysts worldwide assessing all of the stocks in its global universe on a 'AAA' to 'CCC' scale according to their exposure to industry specific ESG risks and their ability to manage those risks relative to their peers. That's one reason why the paper is so important: it is well backed by thorough analysis.

The paper is split into two parts. Part 1, *How ESG Affects Equity Valuations, Risk and Performance*[4], concludes:

- High ESG-rated companies tend to show higher profitability and paid higher dividends to investors, with lower idiosyncratic tail risks than low rated companies.
- High ESG-rated companies tend to show less systematic volatility, lower values for beta and higher valuations.
- ESG rating changes or ESG momentum, can be a financially significant indictor and linked to returns.

In Part 2, *Integrating ESG into Benchmarks*[5], the research concludes that two key ESG indices, MSCI ESG Leaders index and the MSCI ESG Universal Index, enhanced risk reduction and led to better risk-adjusted returns than their parent index the MSCI ACWI Index[6].

The index provider tests the performance of its MSCI ESG Leaders Index — a "best-in-class" approach that selects index constituents with strong ESG ratings — and the MSCI ESG Universal Index — a re-weighting methodology that relies on ESG ratings and changes in ESG ratings.

While not indicative of future performance, the ESG indices achieved enhanced risk reduction which led to better risk-adjusted returns during the study period.

The index provider found that there was a clear reduction in all relevant risk measures for both ESG index methodologies: total risk (that is, volatility), value at risk (VaR), expected shortfalls, maximum drawdowns and tail-risk measures such as skewness and kurtosis all declined compared to the MSCI ACWI Index.

In combination with reduced risk levels, this resulted in better risk-adjusted returns, as reflected in improved Sharpe ratios and positive information ratios, as the table on the next page shows. On average, risk reduction metrics were slightly stronger for the MSCI ESG Leaders Index.

3 Chaudhry, Khuram and Shaikh, Viquar and Hanif, Ayud and Lakos-Bujas, Dubravko and Smith, Robert and Hlavaty, Berowne and Kolanovic, Marko, ESG - Environmental, Social & Governance Investing: A Quantitative Perspective of how ESG can Enhance your Portfolio (December 14, 2016).

4 Giese, Guido and Lee, Linda-Eling and Dimitris, Melas and Nagy, Zoltan and Nishikawa, Laura, Foundations of ESG Investing, Part 1: How ESG Affects Equity Valuation, Risk and Performance (November 2017).

5 Giese, Guido and Lee, Linda-Eling and Dimitris, Melas and Nagy, Zoltan and Nishikawa, Laura, Foundations of ESG Investing, Part 2: Integrating ESG into Benchmarks (May 2018).

6 These results were observed during MSCI's study period from 30 November 2009 to 31 December 2017.

Exhibit 1: Key Performance Indicators of Select ESG Indexes

	MSCI ACWI Index	MSCI ACWI ESG Universal Index	MSCI ACWI ESG Leaders Index
Total Return* (%)	10.0	10.1	10.2
Total Risk (%)	13.1	12.9	12.7
Return/Risk	0.76	0.78	0.81
Sharpe Ratio	0.74	0.75	0.78
Active Return (%)	0.0	0.1	0.3
Tracking Error (%)	0.0	1.0	1.0
Information Ratio	NaN	0.10	0.27

Data from November 30, 2009 to December 31, 2017

The table below suggests that the financial effects MSCI found in Part 1 of its paper fed directly into the corresponding risk characteristics of both ESG indices.

Exhibit 2: Key Risk Indicators of Select ESG Indexes vs. MSCI ACWI Index

	MSCI ACWI Index	MSCI ACWI ESG Universal Index	MSCI ACWI ESG Leaders Index
Absolute Risk Metrics			
Total Return* (%)	13.1	12.9	12.7
Annualized Downside Deviation* (%)	8.1	7.9	7.8
Sortino Ratio*	1.23	1.27	1.32
VaR @ 95%	-6.5	-6.4	-6.3
VaR @ 99%	-9.4	-9.1	-9.1
Expected Shortfall (CVaR) @ 95%	-8.4	-8.0	-8.0
Expected Shortfall (CVaR) @ 99%	-9.4	-9.5	-9.4
Max Drawdown (%)	22.9	21.9	21.3
Max Drawdown Period (in months)	5	5	5
Skewness	-0.26	-0.23	-0.24
Kurtosis	3.82	3.59	3.82

Data from November 30, 2009 to December 31, 2017. Period reflects the longest time period data was available for all three indexes

In Australia, institutional investors have been at the forefront of sustainable or responsible investing. It is estimated that around $866 billion in assets under management (AUM) was invested through some form of responsible investment strategy as at 31 December 2017.

This was up 39 per cent from $622 billion in 2016, representing 56 per cent of all assets professionally managed in Australia, according to the Responsible Investment Benchmark Report 2018 from the Responsible Investment Association Australasia[7].

According to the report, "the comparison of responsible investment funds against mainstream equivalent funds and their benchmark index indicates outperformance across the majority of time periods"[8].

ESG analysis takes a lot of work

Careful analysis is required of a company's policies, procedures and practices before investors can fully assess its ESG worthiness.

Considerations as varied as labour standards, workplace diversity including gender and ethnic diversity, efficiency of resource use, risk controls, management competency, environmental impacts and whether a company produces controversial products such as weapons or adult entertainment, are just some factors which need to be considered as a part of an ESG framework.

While such analysis has traditionally been the domain of active funds management, MSCI is now the leading global ESG researcher. With its large team of analysts and extensive research, its ESG ratings can help investors avoid the risk of an ESG failure overwhelming a company's financial performance or reputation.

Many active fund managers maintain that they incorporate ESG factors into their investment analysis. However, investors need to ask whether their ESG analysis is in-depth or superficial. If they don't have a big team crunching the numbers and examining all aspects of a company's management operations, corporate policies and governance, then their ESG analysis is likely to produce little insight.

In contrast, MSCI's expert team delivers the analysis necessary to construct a portfolio with companies that demonstrate both higher MSCI ESG ratings and a positive ESG trend, while maintaining a broad and diversified investment exposure.

Indices and ETFs make it easy

MSCI found in its Integrating ESG into Benchmarks paper that switching to an ESG policy benchmark such as tracking an index may lead to a more consistent approach across an entire investment portfolio than adopting an ad hoc or arbitrary approach to ESG integration. In particular, the adoption of an index can help asset owners apply a consistent approach to integrating ESG at both the strategic asset allocation level as well as across all individual allocations.

Swiss Re, one of the world's largest reinsurers, said in 2017 it would shift its entire investment portfolio worth around US$130 billion to MSCI's ESG index family, choosing benchmarks that systematically integrate ESG criteria rather than more traditional benchmarks.

Guido Fürer, Group Chief Investment Officer at Swiss Re, explained his decision:

> *These benchmarks represent a suitable tool to achieve the desired investment behavior and set the right measurement both from a performance and ESG perspective … MSCI is a leader in providing ESG indices for institutional investors, helping them with their ESG integration needs*[9].

One of the world's largest pension funds, The Government Pension Investment Fund for Japan (GPIF), also selected MSCI indices as benchmarks for their ESG investment strategy in 2017[10].

7 P4, Responsible Investment Benchmark Report 2018 Australia.

8 P5, Responsible Investment Benchmark Report 2018 Australia.

9 Press Release, Swiss Re Among First in the Reinsurance Industry to Integrate ESG benchmarks into its Investment Decisions (July 6, 2017).

10 Press Release, GPIF, One of the World's Largest Pension Funds, Selects NEW MSCI Japanese ESG Indexes in a Significant Step towards ESG Integration (July 30, 2017).

The way forward

Interest in investing according to ESG guidelines has grown considerably over the past few years. Now that research is finding that ESG factors may add to investment returns by reducing the risks which investors face, investors can have more confidence that their choices can improve their portfolio returns, as well as align their investments to their personal values. On the other hand, ignoring ESG factors can cost investors real dollars, not just missed opportunities.

Investment providers are responding to this and launching new products that meet ESG criteria, including VanEck. Investors committed to sustainable investing and who want to align their investments to their ethics have never had so many choices – however very few ESG products deliver an all-encompassing solution. Until now.

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