HARNESSING ESG AS AN ALPHA SOURCE IN ACTIVE QUANTITATIVE EQUITIES

By Anna Lester, Chen He and Chris McKnett

We engage in environmental, social and governance investing (ESG) across a broad range of asset classes and investment styles. Our active quantitative equities (AQE) team views ESG as a source of alpha that could lead to positive portfolio performance over time. In this article, we look at how AQE includes ESG as a measure of quality when evaluating stocks.

WHY ESG MATTERS

In the past, a great company had to be financially sound and operationally excellent. Looking forward, we believe that great companies must also be ESG-proficient. ESG investing is based on the idea that environmentally efficient, socially responsible and well-governed firms are better positioned to withstand emerging risks and capitalize on new opportunities. This premise rests on the thesis that value creation (or destruction) is influenced by more than financial capital alone, especially longer term.

Investment theory centered on determining intrinsic value, was historically linked to physical assets and book value. The idea that all material fundamental data could be pieced together in a mosaic to form an assessment of investment opportunity now needs further recalibrating to reflect the increasing importance of intangibles and non-traditional factors.

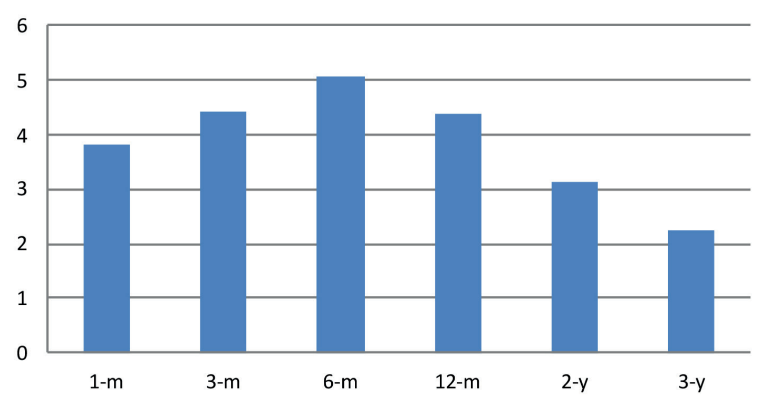
WHY ESG FOR AQE?

Markets are not efficient due to behavioural biases and limits to arbitrage that create opportunities for excess return. Over the long term, high-quality stocks with reasonable valuations and good sentiment are the most likely to outperform.

Earnings quality — evaluating the strength of a firm's financial statements with an emphasis on the balance sheet — is the typical measure of quality. ESG, however, can provide unique insights. For example, firms that have poor ESG scores are more likely to be involved in an organisational scandal or impropriety. While these types of incidents can directly affect a stock's valuation, the opportunity cost may be greater than expected as management focuses on fixing problems rather than long term growth prospects.

Our AQE team believes that ESG is a source of alpha that leads to positive portfolio performance. As such, ESG is grouped with our other quality measures and contributes to evaluating all the stocks in our investable universe.

Figure 1: MSCI ACWI Annualised Decile Returns, September 2009-March 2017



Source: BNP Paribas and Bloomberg

ESG RESEARCH AND MATERIALITY

Researchers have been analyzing how to invest with an ESG mindset over the last three decades. Earlier research suffered from inconsistently defined data, but over the years, ESG data has been improving and the scope of research has been expanded from developed to developing countries and from large to small capitalisation firms.

As ESG data becomes more consistent and abundant, and accounting standards are likely to become more aligned, we expect to see a new generation of empirical research. An important shift has been the focus on materiality, which means: tailoring ESG metrics by industry to ensure that only the subset of available metrics that link to financial value are used in an ESG evaluation. The Sustainability Accounting Standards Board (SASB) develops standards that identify material topics and metrics, by industry, which can be used to identify ESG information to include in financial disclosures and investment analysis.

The benefits of a materiality-based approach were confirmed in a paper by Khan et al. (2016), where the authors used the SASB sustainability map to generate a score for each firm that measures only material sustainability issues and showed that such an approach can generate positive returns. This work lends credence to the concept of responsible investing as defined by the Principles for Responsible Investment (PRI), which state that using ESG criteria can lead to better investment performance without making any claims on moral or ethical grounds.

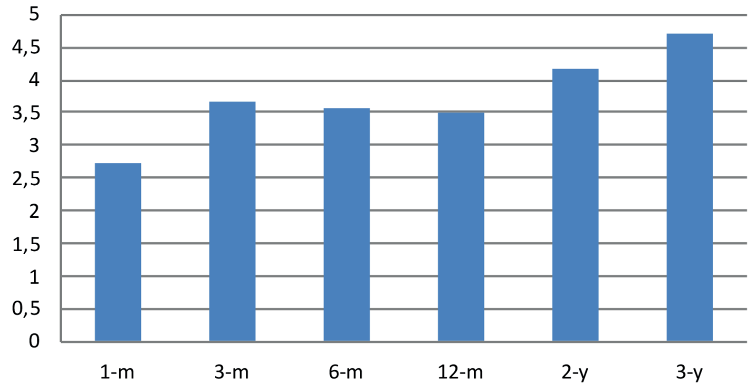
CHALLENGES OF ESG INFORMATION

ESG information comes from a variety of sources. There are several limitations of the data that must be understood to properly analyze ESG.

The historical data is abbreviated, with higher coverage starting in 2009 or later. Further, the robustness of corporate ESG practices varies considerably by region. While accidents and impropriety can happen at any time, the ESG themes manifest themselves over longer time horizons as opposed to more traditional financial metrics whose consequences can impact more quickly. A long term view of performance is required. ESG information tends to be most effective at identifying firms that are more likely to underperform as opposed to predicting future outperformers. Hence, using ESG information may be more valuable for identifying firms whose risks should be more closely evaluated. Finally, ESG data providers can in fact have very different scores for the same company coming from several sources.

We have met these challenges by creating our own proprietary industry materiality mapping. We developed this mapping by evaluating the frameworks across different providers. We then employed both quantitative and qualitative techniques to select the relevant metrics for each industry. We also tested metrics to determine whether our approach would positively impact our portfolios.

Figure 2: MSCI ACWI Decile Returns, September 2009-March 2017



Source: SSGA, Sustainalytics, and MSCI, data as of April 2017.
Past performance is not an indication of future results. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect capital gains and losses, income, and the reinvestment of dividends.

EMPIRICAL RESULTS OF THE ENHANCED APPROACH

Using our proprietary ESG signal, which incorporates our definition of materiality, generates positive returns in the MSCI All Country World Index (ACWI) universe on a back-tested basis. In the figures, we assess securities in the ACWI universe by ESG and compute the average return over investment horizons ranging from one to 36 months for the top 10% and bottom 10% of securities, using historical data starting in 2009. We then calculate the spread returns. The positive spread indicates that during this testing period, an investment strategy that favoured securities with higher ESG scores would outperform.

FUTURE OF ESG RESEARCH

Improvements in data availability and quality, more unique data, the evolution of ESG reporting standards and the growth of new data techniques such as artificial intelligence will only enhance our ESG research. We believe the integration of material ESG metrics with other key financial measures is a powerful combination that offers the potential for long term outperformance. Unlike many traditional stock selection metrics, ESG is in its infancy with industry standards and data still evolving. These challenges are in fact an opportunity for AQE to make full use of its research capabilities and build a framework for continuous ESG research. «

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