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VIEWPOINT

ESG Investing: A New Approach

JOSEPH R. SHAPOSHNIK | MARCH 2016

Summary

An increasing awareness that public corporations have a meaningful impact on the environment and on communities along with a growing body of evidence that companies that manage their resources more efficiently deliver strong risk adjusted returns has led to the growth of Environmental, Social, Governance (ESG) investing. Public corporations, for the first time, are providing substantial information on their ESG performance which has given investors an opportunity to evaluate businesses using a unique new lens. This unique lens assists investors to both invest in more socially aware businesses, and also find better managed, higher performing enterprises, and equity securities.

Introduction

Responsible investing has been an investment theme for some time though it has evolved significantly. The first iteration of responsible investing was Socially-Responsible Investing (SRI). SRI portfolio construction begins with an unrestricted portfolio, and then filters out certain undesirable categories. The classic example is eliminating tobacco and alcohol manufacturers and marketing the portfolio as "socially responsible." The motivation for SRI is purely ethical; the overlay reduces the investable universe but is not actually part of the investment philosophy.

ESG investing takes a different approach. ESG analysis integrates environmental, social, and governance factors into the investment process along with more traditional financial metrics. The philosophy is predicated on the idea that strong ESG factor performance has positive implications for the long-term financial performance of the business. As a result, an ESG investment framework is not adopted solely to express ethical values; it is also used to generate strong risk-adjusted returns by utilizing an underutilized source of information to identify well managed businesses.

Responsible investing has been in existence for many decades, with the first SRI mutual fund having been launched in 1921. However, interest and growth in the area has clearly accelerated recently. In the mid-1990s, there were almost 60 SRI mutual funds with assets totaling $640 billion. Since then, assets under management in responsible investing strategies has grown ten-fold to $6.57 trillion at the beginning of 2014, or approximately 18% of the $36.8 trillion of total assets tracked by consulting firm Cerulli Associates. The ESG-specific style has grown even more dramatically, from $12 billion of assets across 55 funds in 1995 to $4.31 trillion of assets across 925 funds in 2014.

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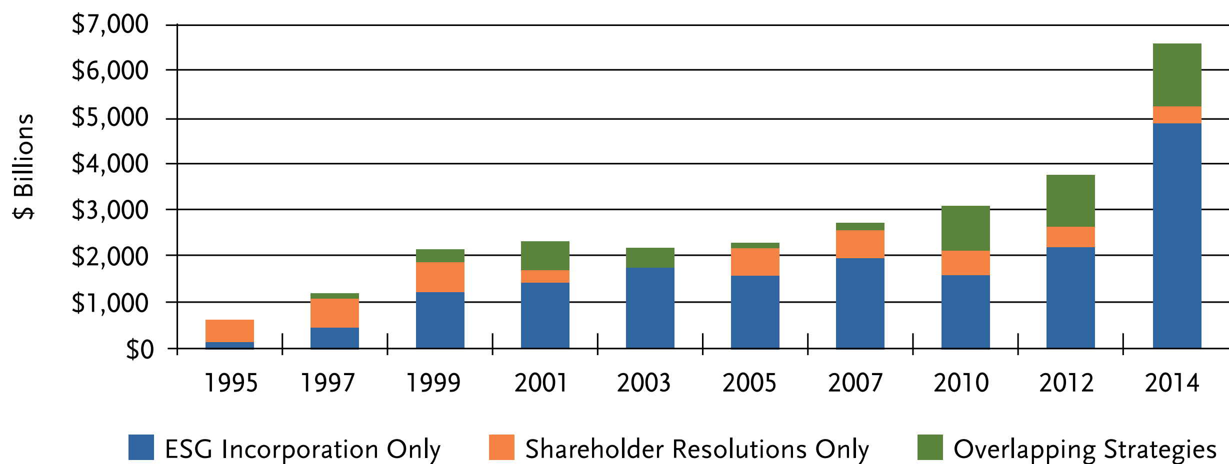
Most ESG funds apply ESG factor analysis at the end of the investment process. Typically, funds begin with a large investment universe, apply several traditional quantitative and qualitative filters and finally, after the list of possible investments is narrowed to a few, the funds incorporate ESG analysis. While this approach may achieve an ESG result in the portfolio, it may not harness the full potential of ESG factor analysis – namely, to assist the investment manager in identifying those businesses that manage their resources and people in a more skillfull manner.

A newer and perhaps better approach in the construction of ESG portfolios is to apply the ESG factor analysis at the beginning of the investment process. Given that a number of studies show that ESG market leaders are better managed businesses that generate high rates of returns, high rates of free cash flow, and operate with lower debt levels, applying ESG screens from the outset of the process should result in higher quality names in a portfolio.

Figure 1. Sustainable and Responsible Investing in the United States, 1995–2014



Source: U.S. SIF Foundation

Environmental Concerns and Firm Performance

The first pillar of an ESG framework is investing in businesses that operate in an environmentally responsible way and place an emphasis on sustainability. Well-designed frameworks typically examine quantitative environmental factors such as reduction in carbon emissions, energy usage, and water usage.

There are several key reasons for including environmentally-conscious factors as part of the research process. Many studies indicate that all of these factors impact the financial returns and performance of the business as well as the riskiness and volatility of the asset's value. For example, a University of Oregon study found that environmental performance had a positive correlation with a company's return on assets, even after controlling for the firm's growth rate, size, capital intensity, R&D intensity, advertising intensity, market share, and industry concentration – the seven variables most prevalent in studies of both ROA performance and industry growth rate.

Additionally, corporations mindful of environmental responsibility mitigate unquantifiable idiosyncratic risks. For example, a company excessively polluting the environment runs the risk of regulatory penalties and unfavorable media attention. These risks can come to a head in catastrophic events, such as the BP Deepwater Horizon oil spill, which ultimately cost BP and shareholders $18.7 billion in fines, plus tens of billions more in civil settlements.

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Newsweek's Green Rankings, which utilize some of the metrics typically used in ESG factor analysis, are evidence that environmental responsibility has positive implications for a corporation's financial results. A University of Michigan paper from 2011 looked at the relative stock performance of the top ranked companies in the 2009 Green Rankings, and found that they produced returns that were meaningfully higher than firms that ranked poorly. Environmental Leader performed analysis on the Green Rankings and found similar outperformance, a summary of which appears below.

Figure 2. Total Return of Companies Grouped by Newsweek Green Scores

	Total return from January 2007-October 2011 (%)		
Newsweek Green Rankings sector	**Top half (highest green scores)**	**Bottom half (lowest green scores)**	**Difference**
Consumer Staples	25.29	15.62	+62%
Energy	34.20	27.70	+23%
Materials	25.67	22.19	+16%
Utilities	46.59	23.26	+100%

Source: Environmental Leader

Social Factors and Firm Performance

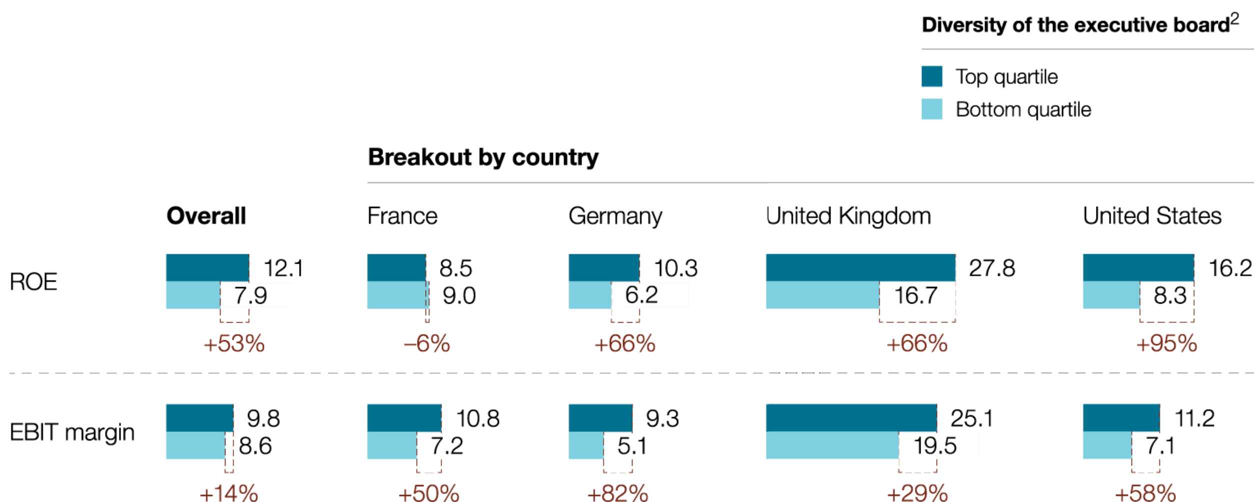
The next area that is typically examined in the ESG factor incorporation process is social responsibility. Specifically, ESG conscious fund managers look at workforce and management diversity, employee rights and safety, employee turnover, supplier relations, and customer satisfaction.

Demonstrated excellence in the social factors drives significant benefits in the organization, which in turn can positively impact the financial results of the company. For example, strong employee rights and an emphasis on worker safety can improve workforce morale and productivity within the company and reduce costs related to employee acquisition/training. Similarly, customer satisfaction is often an indicator of sustained demand for the firm's products and can be a competitive advantage in an industry.

One of the more measurable factors within an organization is diversity. A social factor analysis typically includes the proportion of women and minorities both as a percentage of the overall workforce and as a percentage of upper management. A diverse workforce helps bring a variety of viewpoints and ideas into the decision making process. Views that are generated from a workforce that mirror our ever changing society are critical in adapting and growing a business in today's world. A recent McKinsey study comparing the financial performance of the largest companies with the highest and lowest diversity levels

suggests there are tangible benefits to diversity. The study found that companies ranking in the top quartile of executive board diversity handily outperformed those in the bottom quartile on return on equity (ROE) and earnings before interest and tax (EBIT) margins. ROEs for the top quarter were 53% higher, on average, than the bottom quartile, and EBIT margins were 14% higher on average. The results were consistent across each country studied, with the one exception being ROE performance in France.

Average Returns on Equity (ROE) and Margins on Earnings Before Interest and Taxes (EBIT),[1] 2008-10, %



[1] Comparison of top quartile vs bottom quartile of DAX 30 (Deutscher Aktienindex), CAC 40 (Euronext Paris), the top 30 by market cap of the FTSE 100, and the 80 Fortune 500 companies with the highest and lowest diversity levels; diversity analysis based on women and foreign nationals/ethnic minorities on companies' executive boards; adjusted for statistical outliers.

[2] Our multivariate regression analysis of diversity with country-specific fixed effects gives a coefficient of +9.89 (significant at 1% level) or +4.71 (significant at 10% level).

Source: McKinsey, Bloomberg, Thomson Reuters Datastream

Governance Factors and Firm Performance

The third and final foundational element to ESG factor incorporation is assessing the strength of the company's corporate governance practices. Corporate governance and boards, which broadly refers to the processes by which corporations are controlled and managed, play a critical role in selecting firm management, putting in place incentive plans, approving long-term business plans and presiding over key strategic and capital allocation decisions. Decisions made by boards and governing bodies have a direct impact on employees, communities, and shareholders. Corporate governance factor incorporation assesses the composition of corporate boards (diversity and board member independence are key factors), ESG linked compensation, separation of the chairman and CEO roles, share structures, and executive compensation plans.

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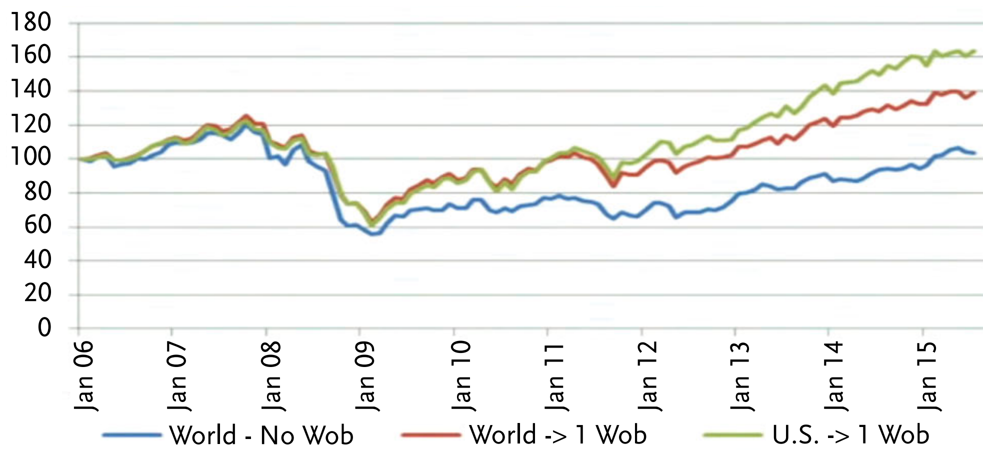
A recent study from Credit Suisse on corporate board diversity found that companies that took diversity seriously and incorporated women on their boards of directors experienced stronger equity returns relative to the broader stock market indices.

Outperformance Within the MSCI ACWI Index (Companies > $10bn Mkt Cap)



Source: Credit Suisse, Bloomberg

A seminal work on corporate governance and firm performance was written by Professors Gompers, Ishii, and Metrick at Harvard University and the University of Pennsylvania. The study found that an investment strategy that bought firms in the highest decile of the corporate governance index and sold short firms in the lowest decile of governance index produced excess returns of 8.5% per annum over the studied period. The study also found that firms at the higher end of the corporate governance index had higher firm value, higher profits, higher sales growth, lower capital expenditures and took on fewer corporate acquisitions. Each of these financial factors is correlated with strong risk-adjusted returns.

Investment Implications

We have found that companies that manage their environmental and social resources effectively and employ strong corporate governance practices tend to generate higher levels of free cash flow relative to their market capitalizations but are less volatile businesses. We believe that these two attributes are strongly correlated with excess returns.

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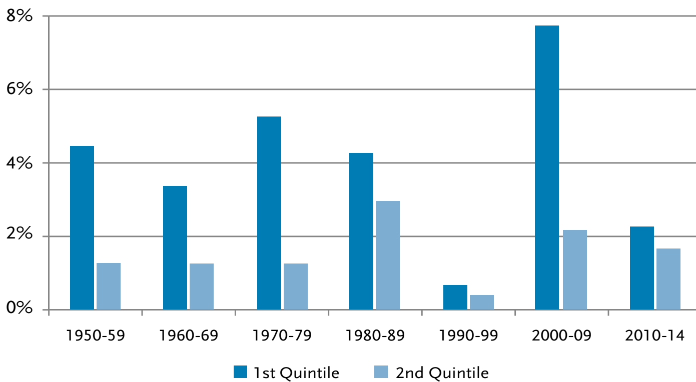
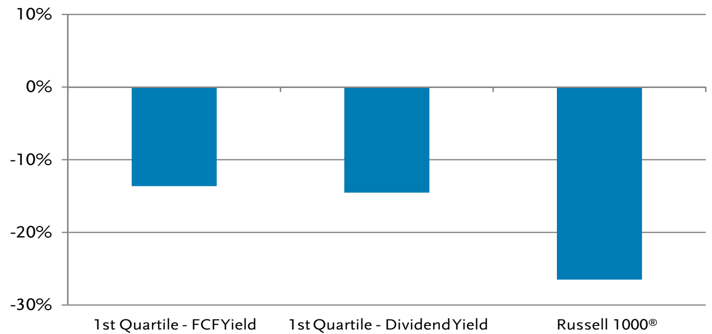
Long range data from Empirical Research Partners concluded that high free cash flow yielding businesses have generated strong returns in every decade since 1950. A study from Manning & Napier, "Free Cash Flow and Dividends: How A Focus On Yield Can Help Investors provide for Today and Prepare for Tomorrow," found that high free cash flow yielding businesses may provide downside protection as they outperform high dividend yielding business in market downturns.

Free Cash Flow Yield - Excess Return



Source: Empirical Research Partners

Annualized Total Return Over Market Declines (1990–2012)

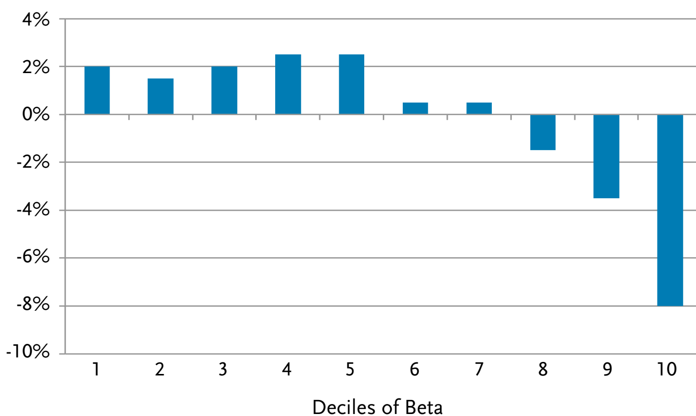


Source: Empirical Research Partners

Many studies have found that lower beta business have fairly consistently generated strong risk-adjusted returns. A study from MSCI and Alliance Bernstein found that from 1979-2013 businesses with an equity beta of 1 or less (below the 5th quintile) generated 200 bps of excess returns while businesses with an equity beta well in excess of 1 (above the 7th quintile) generated returns that were substantially negative. A subsequent study from Harvard University Professor Malcom Baker found that equity returns were inversely correlated to a company's beta.

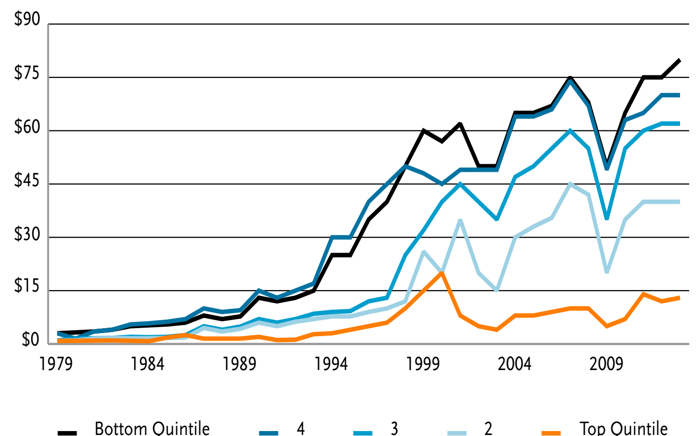
Annualized Relative Return by Volatility Decile (1979-2013)

Beta vs. Russell 1000 Index



Source: MSCI, AllianceBernstein

U.S. Stock Performance by Quintile of Beta



Source: Baker, Malcom, 2013. "The Low Beta Anomaly: A Decomposition into Micro and Macro Effects."

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Conclusion

Incorporating environmental, social, and governance factor analysis is not just an ethical approach to investing but also provides investors with unique insight into the quality and skill level of the management of the business, the strength and motivation levels of the company's employees and the quality and competency of the company's oversight board. We believe that all of these factors are directly linked to financial factors that have historically impacted equity returns. Because few market participants currently incorporate ESG analysis into their investment processes, investors may continue to be able to generate excess returns from employing these unique factors in their analysis of businesses and equity securities. ■

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