



# SEARCHING FOR ALPHA THROUGH ESG

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## ABOUT THE AUTHOR

Waleed is responsible for ESG quantitative research and analysis, the development of ESG Investment tools and integrating ESG factors into our stock selection and portfolio construction processes.



## KEY TAKEOUTS



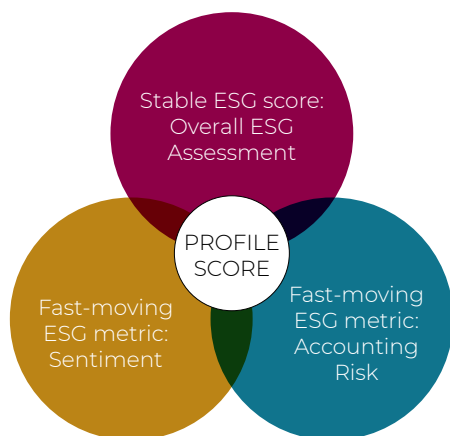
- SUSTAINABILITY IS RESHAPING THE INVESTMENT LANDSCAPE
- OUR BESPOKE ESG RISK SCREENING MODEL ASSESSES LONG-TERM RETURNS
- THE FOCUS IS ON PORTFOLIOS WITH BETTER-RATED ESG PROFILES

We have always contended that investing in a portfolio of companies that rate well based on environmental, social and governance (ESG) factors need not result in sacrificing returns. In fact, empirical research shows that carefully considering these factors can lead to superior returns and that there are intuitive explanations for this. To gather our own evidence, and to enhance both our ESG quantitative research process and risk screening across markets, we developed a proprietary ESG Risk Screening Model using external data vendors<sup>1</sup> to assess long-term investment risk and opportunities associated with a company.

## CREATING THE ESG RISK SCREENING MODEL

To gain insights into the sustainability practices of any company and, consequently, its long-term investment returns, we need adequate ESG data. And ESG data has a temporal dimension, meaning that some ESG data is long-lived while other ESG data points are short-lived in nature. Looking at the short- and long-term data sources independently has both pros and cons. We believe the optimal approach to assessing long-term investment risk associated with a company requires combining the short- and long-term ESG data sets into a single metric.

Our proprietary ESG Risk Screening Model is a blend of the long-term ESG risk profile of a company, which is derived from analysing a company's risks and opportunities that arise from ESG factors that may not be captured by conventional financial analysis of a company<sup>1</sup>, and the faster, more short-term ESG news flow on potential controversies and accounting risks. Additionally, we developed a one-year ESG Profile Momentum score to capture changes in the ESG profile of a company, investor sentiment and price behaviour.



## THE QUANTITATIVE RESEARCH

Our research hypothesis was that the better-rated ESG companies should outperform both the lower-rated ESG companies and the benchmark over time, and therefore incorporating ESG factors when investing across all markets can lead to superior returns.

Using our model, each underlying ESG metric was individually tested for volatility and performance attributes as the basis for ensuring the optimal weighting when blending the metrics. To account for the different ESG methodologies, statistical measures were used for calculating each metric separately to ensure standardisation when combining the scores.

While we conducted the research globally across various markets, this article only focuses on the MSCI All Country World Index (ACWI) and the MSCI Emerging Markets (EM) Index.

We applied our proprietary ESG Risk Screening Model to the above indices' constituents from 30 June 2015 to 31 January 2019. We used this period as we only had consistent accounting risk measures from June 2015.

The constituents in the aforementioned indices were ranked into quintiles from the highest performing companies within the index (Quintile 1) to worst (Quintile 5) per our proprietary model and ranked relative to their peers. Each quintile basket of stocks was equal weighted and rebalanced monthly.

## THE FINDINGS

The summary table on the following page shows the key elements of the attribution analysis on the MSCI ACWI Index (developed and emerging markets). The attribution analysis evaluates and compares the performance of each quintile portfolio (best to worst rated per our proprietary ESG model) within the MSCI ACWI Index. The attribution analysis by our proprietary ESG Risk Screening Model provided compelling support for our hypothesis. As you can see, there is an almost ordinal distribution in cumulative returns from quintile 1 through to quintile 5. This means that if you invested in the quintile 1 portfolio, which is our best measure in terms of ESG for the research period, you would have had a 25.96% return, which is an active return of 6.84%. However, if you invested in the quintile 5 portfolio you would have had a return of 10.86%, which underperformed the benchmark by -8.25% and the quintile 1 portfolio by -15.1%. Very interesting to note is that the quintile 1 portfolio also outperformed the MSCI ACWI ESG Leaders Index (MSCI best-in-class ESG index) over the time period by 3.52%. I must point out that certain risk control measures, such as tracking error and sector neutrality, are not discussed in this article, given that the main focus is to highlight the ESG alpha signal of our proprietary risk screening model.

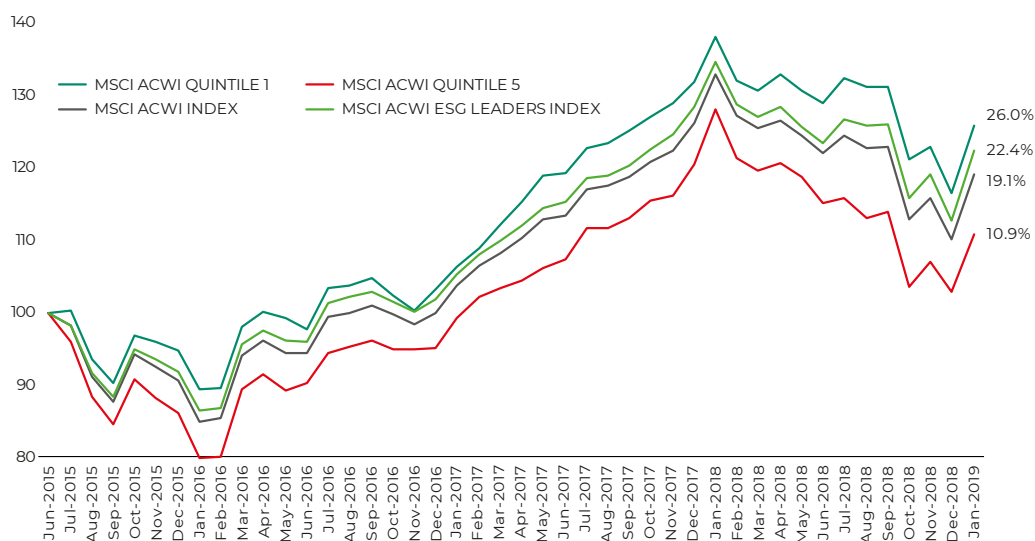
<sup>1</sup> MSCI Inc., which is a global provider of equity, fixed income, hedge fund stock market indices and multi-asset portfolio analysis tools.

If you look at the second last row in the table labelled “ESG profile specific factor”, you will see that quintile 1 profile specific factor return of 1.85% compares with quintile 5, which is at -2.08%. The ESG profile specific factor is the residual source of return that is not explained by the common traditional factors, which in this case is the ESG profile score from our risk model, as this is the only additional factor we introduced. This evidence gives us conviction in our model, as this is attributable to the quality of the ESG profile scores in each quintile portfolio. What is noteworthy is that the ESG specific factor for quintiles 4 and 5 is negative, which implies that poorer rated ESG companies lead to lower returns when aggregated with other sources of returns from common factors.

### MSCI ALL COUNTRY WORLD INDEX (ACWI) PROPRIETARY PROFILE SCORE ATTRIBUTION (CUMULATIVE RETURNS IN US\$)

SOURCE OF RETURN	ACWI QUINTILE 1	ACWI QUINTILE 2	ACWI QUINTILE 3	ACWI QUINTILE 4	ACWI QUINTILE 5	MSCI ACWI ESG LEADERS INDEX
<b>Cumulative return</b>	<b>25.96%</b>	<b>22.31%</b>	<b>22.99%</b>	<b>14.07%</b>	<b>10.86%</b>	<b>22.44%</b>
MSCI ACWI Benchmark cumulative return	19.12%	19.12%	19.12%	19.12%	19.12%	19.12%
<b>Total active return</b>	<b>6.84%</b>	<b>3.20%</b>	<b>3.87%</b>	<b>-5.05%</b>	<b>-8.25%</b>	<b>3.33%</b>
Residual	9.02%	3.23%	3.35%	-5.89%	-9.00%	2.74%
Common factor	7.16%	1.63%	2.16%	-3.61%	-6.92%	1.45%
Industry	0.24%	-0.43%	0.35%	-0.23%	0.05%	-0.92%
Country	5.07%	1.54%	1.42%	-2.79%	-4.95%	2.21%
<b>ESG profile specific factor</b>	<b>1.85%</b>	<b>1.60%</b>	<b>1.19%</b>	<b>-2.27%</b>	<b>-2.08%</b>	<b>1.29%</b>
Currency	-2.17%	-0.03%	0.52%	0.84%	0.75%	0.59%

### MSCI ACWI PERFORMANCE (CUMULATIVE RETURNS IN US\$)



Sources: MSCI, Old Mutual Investment Group | Time series: 30 June 2015 – 31 January 2019

To ensure our research was relevant to South Africa, we also tested the performance in emerging markets. The constituents in the MSCI EM Index were also ranked into quintiles from highest performing companies to worst per our proprietary ESG Risk Screening Model and each quintile basket of stocks was equal weighted and rebalanced monthly. And as can be seen in the chart below, the quintile 1 portfolio outperformed

its peers, the MSCI EM Index and the MSCI EM ESG Leaders Index.

During the period under assessment, companies with higher ESG profile scores per our proprietary ESG Risk Screening Model outperformed their peers and the benchmark (MSCI EM Index). Our quintile 1 portfolio (which is our best measure in terms of ESG) outperformed the MSCI EM ESG Leaders Index. The quintile 1 portfolio had a return of

21.44%, outperforming the MSCI EM Index by 11.74% and the MSCI EM ESG Leaders Index by 3.22%. The quintile 1 portfolio specific factor attribution is 7.02%, which is attributable to the better quality ESG rated companies per our Proprietary ESG Risk Model.

**MSCI EMERGING MARKET INDEX PERFORMANCE (CUMULATIVE RETURNS IN US\$)**



Sources: : MSCI, Old Mutual Investment Group | Time series: 30 June 2015 – 31 January 2019

## CONCLUSION

Sustainability is a macro-thematic trend that is reshaping the competitive landscape. Companies that are able to respond to this trend early on, will reap the benefits of stronger growth prospects, enhanced operating efficiencies, stronger social licence to operate, enhanced staff retention, lower cost of capital and, ultimately, a stronger and more sustainable competitive advantage. They will also reduce operational risk and be positioned towards more sustainable growth, ensuring improved financial performance. And for investors searching for alpha, greater emphasis will have to be placed on portfolios whose ESG profile is better rated.