STANDpoint

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Can ESG Add Alpha?

BY JEFFREY L. HERTEL, CFA

The May 2017 Standpoint covered different types of responsible investing, and its tremendous growth over the last ten years. You can find that article here. One popular subset of responsible investing is Environmental, Social, and Governance investing (ESG). We often hear from our clients regarding ESG investing, "These types of investments fit with my beliefs, and I'm willing to take less return because I feel strongly about responsible investing." What we are seeing, however, is that there may not necessarily be a trade-off between good investment results and ESG investing, and that ESG investing may lead to alpha generation and lower volatility returns.

Criteria for ESG Investing

Due to the popularity of ESG investing, third-party data providers such as MSCI and Sustainalytics have set forth quantifiable standards to rate global companies. This enables Hartland to compare ESG and standard indices to determine the variations in composition and performance. The increased coverage gives us detailed ESG information on companies to make better informed decisions.

The table on the next page details the standards MSCI uses to rate each company. These standards are common among other data providers, and provide a measurement system to capture differences in ESG scoring between companies.

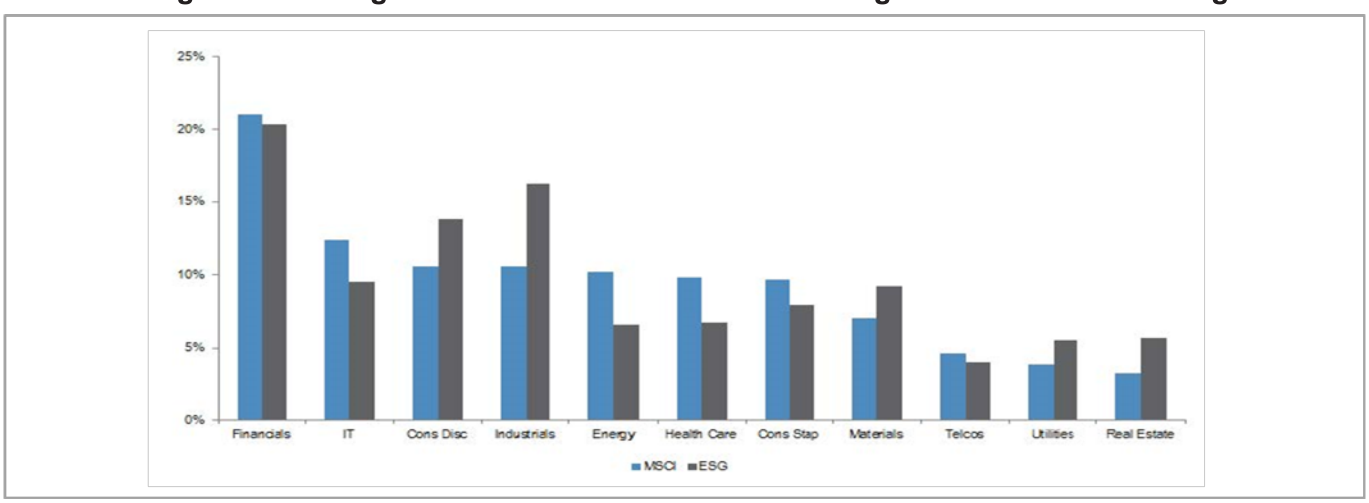
3 Pillars	*10 Themes*	*37 ESG Key Issues*	
Environment	Climate Change	Carbon Emissions* Energy Efficiency Product Carbon Footprint	Financing Environmental Impact Climate Change Vulnerability
	Natural Resources	Water Stress* Biodiversity & Land Use	Raw Material Sourcing
	Pollution & Waste	Toxic Emissions & Waste* Packaging Material & Waste	Electronic Waste
	Environmental Opportunities	Opportunities in Clean Tech Opportunities in Green Building	Opp's in Renewable Energy
Social	Human Capital	Labor Management* Health & Safety*	Human Capital Development Supply Chain Labor Standards
	Product Liability	Product Safety & Quality Chemical Safety Financial Product Safety	Privacy & Data Security Responsible Investment Health & Demographic Risk
	Stakeholder Opposition	Controversial Sourcing	
	Social Opportunities	Access to Communications Access to Finance	Access to Health Care Opp's in Nutrition & Health
Governance	Corporate Governance*	Board** Pay**	Ownership** Accounting**
	Corporate Behaviour	Business Ethics* Anti-Competitive Practices*	Corruption & Instability Financial System Instability

Source: MSCI ESG - * indicates "universal" issues assessed for all companies in MSCI World ** Board, Pay, Ownership, andAccounting carry weight in the ESG Rating model for all companies. Currently, they contribute to the Corporate Governance score directly and 0-10 sub-scores are not available.

ESG Rating Coverage

An important consideration in assessing ESG investing is to compare the ESG universe to that of traditional equity universes that do not consider ESG. For example, the chart below compares industry weightings of the global MSCI ESG universe to the MSCI standard universe, which is an all-world equity universe. We see that the ESG universe does not deviate significantly from the MSCI benchmark. This is important, as investors do not want the MSCI ESG weights to lead to returns that could be dramatically different.

Average Sector Weights based on MSCI Benchmark weights and ESG Score weights



Source: J.P. Morgan Quantitative and Derivatives Strategy, MSCI. (Data between January 2007 and November 2016).

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Higher Returns with Less Risk

There is a common perception that ESG strategies do not perform as well as traditional strategies; that they do not create alpha. Now that better data exists, we are able to measure the performance differences between ESG and traditional approaches.

The data compiled by JPMorgan below compares the returns of ESG benchmarks to traditional benchmarks. Several ESG weighted indices outperformed their respective traditional benchmarks over the time period (2007-2016)[1]. Not only did several outperform, but they also produced better risk-adjusted returns. This means they experienced higher returns relative to their benchmark while exhibiting less volatility.

Comparing Regional Benchmarks with their ESG Indices

	Returns	Volatility	Sharpe	Hit Rate	Drawdowns
MSCI World	3.0%	17.1%	0.18	56.4%	-54.0%
World ESG	2.6%	17.2%	0.15	55.0%	-54.2%
MSCI EM	0.4%	24.2%	0.02	50.9%	-61.6%
EM ESG	3.6%	22.8%	0.16	54.1%	-58.9%
MSCI USA	11.8%	11.5%	1.03	63.5%	-15.9%
USA ESG	12.9%	11.6%	1.11	67.6%	-16.6%
MSCI Australia	1.7%	25.8%	0.07	54.5%	-63.3%
Australia ESG	2.0%	25.6%	0.08	55.0%	-62.0%
MSCI Canada	0.4%	22.3%	0.02	50.9%	-56.2%
Canada ESG	2.0%	22.5%	0.09	52.3%	-54.8%
MSCI UK	(0.9%)	19.2%	(0.05)	52.7%	-59.0%
UK ESG	(1.4%)	18.7%	(0.07)	52.3%	-57.1%
MSCI Japan	0.8%	16.3%	0.05	54.5%	-45.7%
Japan ESG	1.0%	16.7%	0.06	55.0%	-46.4%
MSCI AC Europe	(1.1%)	21.4%	(0.05)	50.0%	-60.1%
Europe ESG	0.2%	21.1%	0.01	53.2%	-58.6%

Source: MSCI, J.P. Morgan Quantitative and Derivatives Strategy (Performance between September 2007 and November 2016).
Past performance is not an indicator of future results.

These are ESG weighted benchmarks and are not actively managed. Actively managed ESG strategies incorporate the ESG factors with their unique process and philosophy. Our goal at Hartland is to identify the top managers in the ESG universe that will deliver consistent, long-term quality performance and client service.

Factors That May Explain the Outperformance

Investors typically seek attributes such as stable cash flows, predictable earnings, high return on equity, stable and capable management teams, and shareholder-friendly corporate boards. These factors can drive value creation over time and reduce the risk of failure. Studies have shown that highly ranked ESG companies exhibit many of these qualities, which may explain their outperformance over time.

Stable and predictable earnings are two desirable characteristics because they enable investors to model a more reliable estimate of future earnings and ultimately allow managers to find undervalued securities to add to the portfolio. High ESG ranked stocks have exhibited lower earnings volatility and may be a better predictor of future earnings volatility[2]. The chart below depicts the best ranking ESG securities had one-third the volatility in earnings relative to the worst ranked ESG stocks.

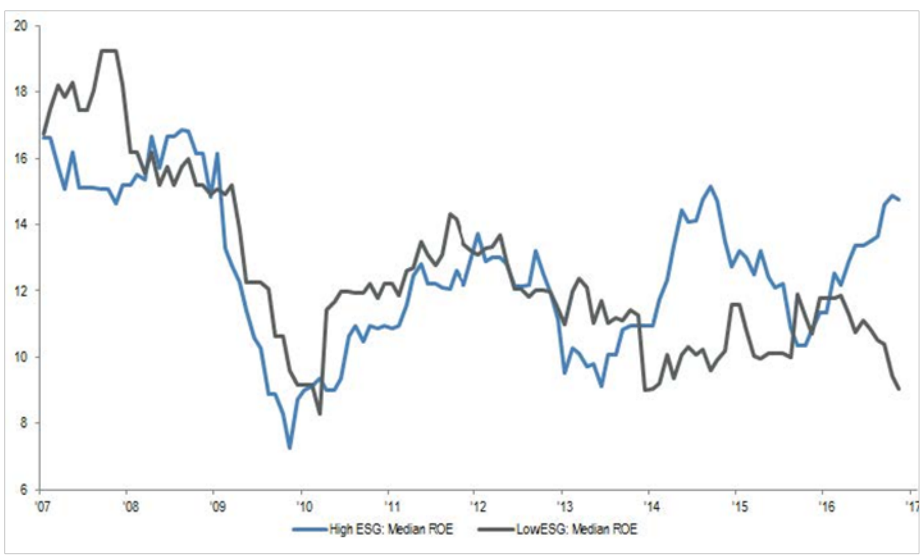
Subsequent five-year median change in EPS volatility by overall ESG percentile ranks

Overall ESG Rank (from worst to best)	Median change in EPS volatility over next 5 years (%)
1st to 20th percentile (worst)	92%
21st to 40th percentile	64%
41st to 60th percentile	65%
61st to 80th percentile	37%
81st to 100th percentile (best)	32%

Source: BofA Merrill Lynch US Equity & Quant Strategy based on Thomson Reuters data.
Past performance is not an indicator of future results.

ROE is an important metric used by investors to evaluate the earnings quality of a company. When a company earns a ROE in excess to its cost of capital (the rate at which it borrows), value is created. If a company cannot earn in excess of its cost of capital, value is lost and may lead to failure over time. What we see is high ranked ESG portfolios earn a higher ROE relative to low ranked ESG portfolios in recent years[1].

Median ROE of high and low ESG portfolios in MSCI ACWI



Source: J.P. Morgan Quantitative and Derivatives Strategy.
Past performance is not an indicator of future results.

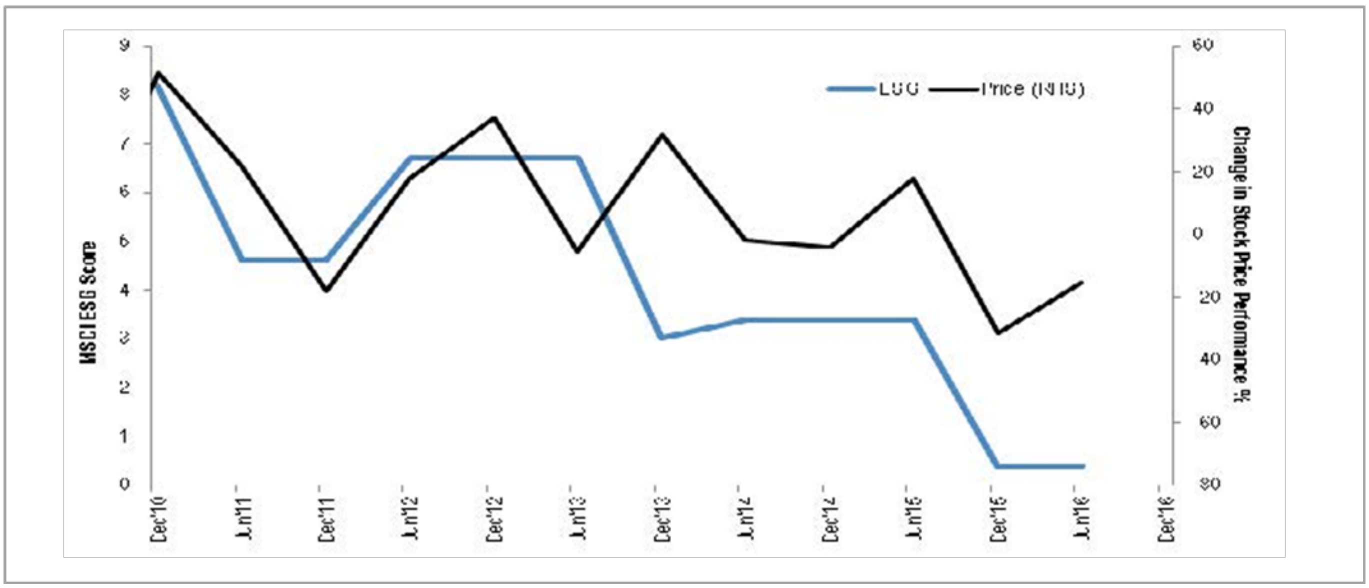
Starbucks

A good example of a highly rated ESG company and outperformer is Starbucks (SBUX). Starbucks excels in all aspects of ESG including astute corporate governance, reducing its environmental footprint, and increasing its social impact within and outside of the company. Starbucks provides a cost effective and quality product that benefits its customers, and also its employees. The company's quick response to a racial-bias incident in Philadelphia was admirable. All company owned stores were closed during business hours for mandatory anti-bias training with employees. Ultimately, customers want to do business with ethical companies and some of these attributes are reflected in their above average return on equity ("ROE") and free cash flow and earnings growth relative to peers. On the opposite side of the spectrum are multiple examples of stock underperformance due to poor corporate governance or unethical decisions, for example Enron, Volkswagen, and Wells Fargo.

Avoiding Pitfalls

Not picking losers is one way for portfolio managers to avoid underperformance. ESG rankings may help avoid unethical companies before events occur. A good example of this is Volkswagen. You may remember Volkswagen's recent emission scandal, during which the stock lost half its value. The chart below shows that the ESG scores for Volkswagen started to fall well in advance of the emission scandal and eventual decline in the stock price[1].

Volkswagen ESG Score and Stock Price Returns



Source: J.P. Morgan Quantitative and Derivatives Strategy; MSCI.
Past performance is not an indicator of future results.

If ESG factor ratings had been incorporated into the decision making process, perhaps 90% of the bankruptcies that occurred since 2008[2] could have been avoided. There are many ways in which companies fail, but avoiding negative ESG events such as litigation, environmental disasters, and poor governance policies ultimately protect cash flows and promote positive investor sentiment.

ESG in Hartland Portfolios

The increase in ESG data provided from companies and third party providers has allowed Hartland to get a better sense of what ESG attributes could provide value to a portfolio. This article touched on a few of the positive investment attributes high ESG ranked companies exhibit and how utilizing ESG rankings can help avoid pitfalls. Overall, ESG focused companies can benefit investors not only from the social impact they provide but from a risk-reward standpoint as well.

Definitions:

Alpha – the excess return of an investment relative to the return of a benchmark index. Often considered the active return on an investment and gauges the performance of an investment against a market index or benchmark.

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Sharpe Ratio - the average return earned in excess of the risk-free rate per unit of volatility or total risk. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return.

Return on Equity ("ROE") - the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. (Return on Equity = Net Income/Shareholder's Equity)

Sources:

(1) MSCI, ESG – Environmental, Social, & Governance Investing; A Quantitative Perspective of how ESG can Enhance your Portfolio (2016) J.P. Morgan.

(2) ESG Part II: a deeper dive, Equity Strategy Focus Point. (2017) Bank of America Merrill Lynch.

MARKET BENCHMARK RETURNS

May 31, 2018		1M	3M	12M	YTD
US Large Cap	S&P 500	2.4%	0.2%	14.4%	2.0%
US Small Cap	Russell 2000	6.1%	8.4%	20.8%	6.9%
Developed Intl	MSCI EAFE	-2.2%	-1.8%	8.0%	-1.5%
Emerging Intl	MSCI Em Mkt	-3.5%	-5.8%	14.0%	-2.6%
Real Estate	NAREIT	3.5%	8.0%	2.7%	-2.8%
Core Fixed	BarCap Agg	0.7%	0.6%	-0.4%	-1.5%
Short Fixed	BarCap 1-3Yr	0.4%	0.4%	0.2%	0.1%
Long Fixed	BarCap LT G/C	1.1%	0.8%	0.6%	-4.4%
Corp Debt	BarCap Corp	0.5%	-0.1%	0.1%	-2.5%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.