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Market Ethos

The latest market insights from the Richardson GMP team

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Sometimes it pays to be good

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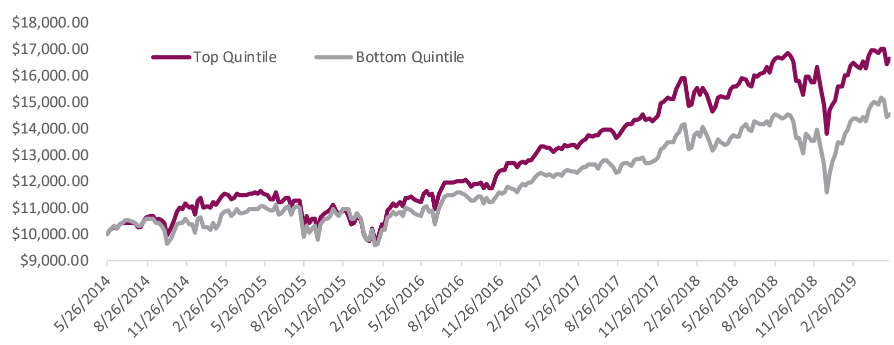
The next wave of ESG investing

Investors unfamiliar with Environmental, Social and Governance (ESG) investing principles might express skepticism or perhaps worry about how such an approach might affect the performance of their investments. Many institutional portfolio managers around the globe now view ESG not as its own investing style, but as an alpha-generating supplement to existing methodologies.

The United Nations Principles for Responsible Investment has over 1,600 signatories from some of the largest asset management and institutional investment companies in the world. Collectively this group manages assets totalling $70 trillion. In a survey conducted by the CFA Institute, over 82% said they use ESG in their investment decision making. Given the choice of 10 reasons why they incorporate ESG factors, 63% said ESG integration is a *material factor* to increasing their investment performance. Thus, this "trend" may not be a trend after all, but rather an emerging philosophy behind investing that is here to stay. According to research by Morningstar[1], three-quarters of Americans have a moderate to high interest in sustainable investing. Moreover, contrary to common belief, the same study shows that although millennials and women may have a slightly stronger preference for sustainable investing, interest is not confined solely to this demographic but is instead rising rapidly across the board.

Chart 1: Top Quintile of ESG Scoring Universe Has Outperformed Bottom Quintile Over the Long-Run



[1] "The True Faces of Sustainable Investing: Busting the Myths Around ESG Investors," By Ray Sin and Samantha Lamas, Morningstar behavioural researchers; and Ryan O. Murphy, Morningstar Investment Management.

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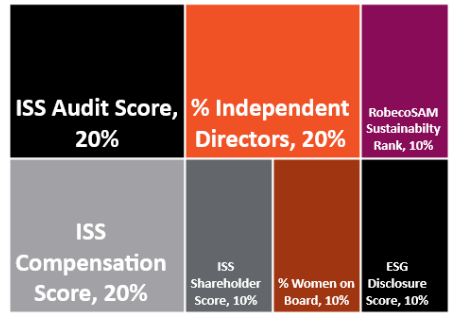
Many investors, including us, have at least heard of the ESG framework of analysis. However, very few of us can quantify how to use it to improve our analysis and, as a result, our performance. We have now identified three primary strategies for useful implementation:

1. The use of engagement and active ownership from shareholders to influence corporate behaviour;
2. An integration of ESG factors into individual stock valuation and financial analysis; and
3. Assessing behavioural biases and benefits.

Chart 2: ESG Factor Scoring Weights



Engagement to influence corporate behaviour

Many investors do not have enough proxy votes to change the decisions made by management, but some do! For instance, BlackRock took a stance against gun violence in 2018 when they used proxy voting, proposals and shareholder activism to win a big fight against the U.S. retailer Dick's Sporting Goods. The result forced the company to stop selling assault rifles and raise its gun-purchasing age to 21 in response to the tragic school shooting in Parkland, Florida. By using this strategy of engagement and active ownership, shareholders can significantly influence corporate behavior through direct engagement, such as communicating with senior management and/or boards, and filing shareholder proposals using ESG guidelines, in order to sway proxy voting.

Integration of ESG in financial analysis

Explicit integration of ESG factors into traditional financial analysis of individual stocks can also improve risk-adjusted returns. To illustrate this, we screened the S&P 500 using a variety of publicly available factors. Fortunately, all the heavy lifting is done for us by research providers such as Institutional Investor Services (ISS), and RobecoSAM. Our study incorporated seven different factors (Chart 2). It is important to note that not all ESG factors impact performance equally. As an example, failing an audit will likely be more impactful to a company's performance than how much the company is willing to disclose regarding ESG factors. Thus, we weighted some factors more than others. We then normalized the data, going back five years. Running the screen at that point in time and then rebalanced the model on an annual basis, comparing the top quintile to the bottom. As you can see (Chart 1) over the past five years, companies scoring higher in our model have outperformed the weakest ranking securities. The risk statistics are also substantially better (Chart 3).

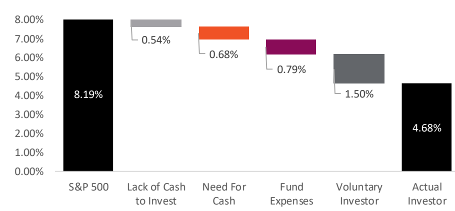
Chart 3: Top vs. Bottom Quintile Performance Data

	Top Quintile	Bottom Quintile
5-Year Return	13.3%	9.0%
Up Capture	93.4%	85.9%
Down Capture	93.3%	96.8%
Downside Deviation	6.1%	6.3%
Standard Deviation	6.9%	7.3%

Economic behaviour

According to a study conducted by two renowned economists, understanding social norms is critical to understanding economic behaviour; after all, human behaviour *does* have a direct correlation with market outcomes (Becker 1971; Merton 1987). As the importance of ESG continues to evolve by becoming a factor in risk evaluation and a point of consideration in opportunistic investing, it seems inevitable that a company's stock and shareholder value would be impacted.

Chart 4: Dalbar's Quantitative Analysis of Investor Behaviour



Taking ESG considerations into account when assessing a company can help determine their business strategy's lifespan, as preliminarily addressing industry challenges tends to better prepare a company for changing industry standards. Utilizing this methodology is no longer solely about choosing what is right for society, but rather about doing what is right for your portfolios to best serve your clients.

Another consideration is the behavioural principle of the "Mind Gap", which shows up in studies by Morningstar and DALBAR. Both studies show that realized returns tend to be significantly lower than the underlying investment vehicle. Chart 4 shows DALBAR's findings versus the S&P 500. The primary reasons, which include loss aversion, recency and other biases, caused humans to buy and sell at the wrong times. A subsequent study by George Mason University and Centered Wealth showed that the “Mind Gap” for 864 U.S. ESG funds were 1.23% less. Jina Penn-Tracy from Centered Wealth explains that if you incorporate clients’ values and what they care about into the investment process, they associate their investments as a product of their own values. As a result, their reaction to external market triggers becomes less erratic and, by extenstion, more resilient to volatility.

Even the Securities and Exchange Commission (SEC) is taking notice and is developing a comprehensive framework of standards for disclosure principles that will require public companies to disclose identified ESG factors. As of March 2019, there is a principles-based framework in place primarily focusing on the impact of climate change, board diversity and labor practices on businesses. The current level of disclosure was a consideration in our analysis.

With society’s growing concern for environmental and social issues, as well as corportate governance, it was inevitable that this would spill over to the financial markets. According to a study of turnover among the top 2,500 global public companies released by PwC in 2018 (a year dominated with revelations about harassment and problematic behaviour among corporate management), 39% of the top executives dismissed had been accused of ethical lapses. In fact, more top executives were forced out of companies due to questionable ethical behavior than for poor performance (Chart 6). The results can be devastating for shareholders. For your consideration, look back at the charts of Wynn Resorts (March 22, 2018, Steve Wynn cuts ties) and CBS Corp. (December 2018, Leslie Moonves is terminated). It only takes a single slip-up in any of a variety of ESG factors that could result in devastating results for shareholders.

Chart 5: CEOs Misbehaving

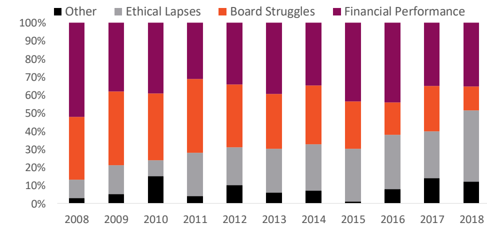


Chart 6: Wynn Resorts Cuts Ties

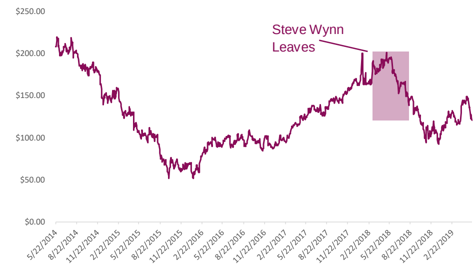
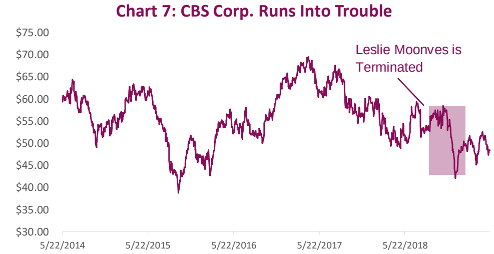


Chart 7: CBS Corp. Runs Into Trouble



Conclusion

As the world continues to embrace ESG investing it is proving to be profitable for investors who incorporate it into their investment process. It is also becoming increasingly important for companies to enhance their environmental and social standards while improving corporate governance, not only to attract investor capital but, also increase the lifespan and resilience of their business model. Do not forget that ESG investing can not only enhance your portfolio performance, as the self-fulfilling prophecy raises demand by all stakeholders, but it changes the world for the better.

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP.