Wealth Management

The Benefits of ESG Investing:

How Socially Responsible Investing Can Drive Outperformance

ESG investing is a lens through which investors analyze companies and assess how these corporations compare to their peers in terms of performance when considering environmental, social, and governance factors alongside financial factors. While critics often fear that ESG investing can hurt returns, diminish diversification, and be difficult to implement when constructing a portfolio, recent research suggests that these assumptions are untrue and that ESG investing can instead help investors achieve better overall performance.

Competitive returns

Although investors often worry that ESG investing can diminish returns, a 2015 report by Oxford University and Arabesque Partners finds that it is in the best economic interest for corporate managers and investors to implement sustainability considerations into their decision-making processes. Specifically, good ESG quality can help a company to develop a competitive advantage, which can then drive outperformance. For example, Coca-Cola successfully improved their ESG quality and produced superior performance as a direct result when the company reduced the water intensity of their production process by 20% over the last decade. Additionally, Marks and Spencer reaped similar benefits when they introduced 'Plan A' to source responsibly, decrease waste, and help communities, leading the firm to save $200mn annually. These results highlight the substantial impact that sustainable product innovation has on a company's revenues. Therefore, by shedding light upon ESG issues in their corporate sustainability frameworks, companies will ultimately be able to realize cost savings through innovation, resource efficiency, and revenue enhancements via sustainable products, which should lead to margin improvements and higher returns.[1]

Diversification benefits

A challenge that institutional investors often struggle with when integrating ESG standards into their strategies is determining how to implement these principles without sacrificing diversification. According to an MSCI report, one way to do so is by increasing the weights of companies with strong ESG profiles while minimizing exclusions to a core group of objectionable stocks. Backtested performance of the MSCI ESG Universal Index produced a superior ESG profile to the index's parent ACWI index while keeping similar risk-return characteristics, with a 1% tracking error. Figures 1 and 2 show that the ESG Universal Index outperformed the MSCI ACWI Index, thus illustrating that targeting companies with stronger ESG profiles than their peers produces a result with similar risk-return characteristics as the parent index. Such approaches could help large asset owners seeking a more systematic way to integrate ESG considerations into their investment strategies.[2]

Simple portfolio construction

Lastly, despite the concern that investors have regarding the difficulty of implementing ESG factors into portfolio construction, the integration is rather simple. In an interview with the CFA Institute, Jeroen Bos, CFA, head of Global Equity Research at ING Investment Management and member of the board of directors of the CFA Society Netherlands, advises that "when [investors implement] analyst's recommendations, ESG factors should … already be part of this recommendation, and this leads to a decision to overweight or underweight a stock in the portfolio, taking into account the context of that specific portfolio as well." In other words, from his perspective, the key when integrating ESG factors into investment analysis is as simple as focusing on factors that are more likely to influence the sustainability of a company's business model and its share price performance. Bos stresses that the decision must not only be driven by a firm's ESG score, but also by the overall analysis which includes ESG factors. He also finds it important for both portfolio managers and analysts to be actively involved with companies on topics that relate to ESG, as he feels this engagement can further contribute to portfolio performance in the longer-term.

While there is often a debate attached to ESG investing regarding its potentially negative effects on investor's returns, diversification, and portfolio construction, these appear to be misconceptions that do not accurately reflect the benefits of socially responsible investing. Since the introduction of the investment style, ESG investing has become increasingly popular as more investors are realizing how it can help their portfolios and provide them with significant opportunities in growing areas such as clean energy, energy efficiency, and new technologies. Thus, all signs point to great reward for investors who choose to embrace the trend of socially responsible investing and use the investment process to reflect their values and beliefs.

Appendix

Figure 1

The MSCI ACWI ESG Universal Index narrowly outperformed the MSCI ACWI Index	ACWI index	ACWI ESG Universal
Total return* (%)	9.1	9.2
Total risk (%)	13.4	13.3
Return/risk	0.68	0.69
Sharpe ratio	0.65	0.67
Active return	0.0	0.1
Tracking error (%)	0.0	1.0
Information ratio	NaN	0.13
Historical beta	1.00	0.99
No. of stocks***	2450	1904
Turnover** (%)	2.8	22.0
Price to book***	1.9	2.0
Price to earnings***	16.7	16.7
Dividend yield*** (%)	2.6	2.7

Backtested simulation from Nov. 30, 2009 to June 30, 2017

Figure 2

Backtested simulation from Nov. 30, 2009 to June 30, 2017

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