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 could hurt returns, 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, by offering higher quality products or services, companies can avoid reputational damage and, as a 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 increased 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 ACWI 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 on 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

Leeds, despite the concerns 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 [investor] implement[s] 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.” While others, from his perspective, may worry when integrating ESG factors into investment analysis is as simple as focusing on factors that are more likely to contribute to portfolio performance in the longer term. “In other words, from his perspective, the key when integrating ESG factors into the portfolio allocation process is as simple as focusing on factors that are more likely to influence the sustainability of a company’s/its business model and its share price performance. Bos stresses that the decision must not only be directly 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 this leads to an increased effort to contribute to portfolio performance in the longer term.

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