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# How socially responsible investing can help reduce market volatility

The increasing popularity of socially responsible investing is not only due to greater attention to social values, but also due to its ability to enhance performance and reduce portfolio volatility.

ESG investing, investing with a lens of environmental, social and governance considerations, is no longer a negative economic trade off; it's now a win/win. Recent research reveals that investing in companies that have strong governance characteristics and take into consideration social and environmental impacts achieve higher returns through better insulation of one's portfolios against various types of risk during market volatility.

For example, the first period in February 2018 showed that 65% of "sustainable equity funds" (i.e. funds with ESG considerations) outperformed their counterparts when the S&P 500 fell by 7.2% in the first nine days of the month, according to MarketWatch.[1]

Similarly, during even longer periods of volatility in the fourth quarter of 2018, MarketWatch showed that 65% of socially responsible investing and ESG exchange traded funds had outperformed the SPDR S&P 500 ETF Trust (SPY), while 71% of total market ESG ETFs had outperformed the Vanguard Total World Stock ETF (VT). Furthermore, not only did these funds outperform their peers in the fourth quarter, but nearly two-thirds of them also ranked in the top half of all fund performance for the full year, as well.[2]

An extensive study by the Umeá School of Business, Economics and Statistics in Sweden[3] reiterates these findings through a study of ESG considerations on share price volatility, and vice versa. Economists here used two different proxies for volatility to run panel regressions on a sample of 481 firms in the S&P 500. They referenced Thomson Reuters' ESG metrics and scoring method[4] to test whether a high ESG score can lead to reduced share price volatility.

These scores are designed to measure a company's relative ESG performance in the three categories as well as across specific industries. According to the regression results, economists found that ESG scores and share price volatility have an inverse relationship in both proxies of volatility used. Under general assumptions that "the rational investor is risk averse and should strive to minimize risk at any given level of return," the economists argue that total risk (systemic market risk + idiosyncratic risk) should be the relevant risk consideration, rather than our usual disregard to idiosyncratic risk under the capital asset pricing model (CAPM). In doing so, idiosyncratic risk (a company's individual risk), which is proven to decrease drastically with ESG considerations, is also taken into account when investing and results in a strong negative correlation with share price volatility. On average, the economists found that a firm with an ESG Score of 90, compared to a firm with an ESG Score of 20, has a 0.027% lower volatility per day.

Though the economists admit the need for further research in efforts to understand the distinct underlying drivers of value creation within ESG considerations, the results of this study and other continuing efforts to expand on the financial benefits of ESG consideration reveal a growing interest in alternative sustainable investments both to firms and investors.

Historically, doing social good is often seen as a trade-off to profitability. Impact investing argues otherwise. By investing in companies with high ESG standards, we are investing in inherently more risk averse (and less reactive) companies in the face of market volatility.

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[1] https://www.marketwatch.com/story/when-stock-markets-turned-turbulent-esg-funds-punched-above-their-weight-2019-01-29

[2] Ibid.

[3] https://pdfs.semanticscholar.org/243b/747b896a211458952d56526b4a44268bcedc.pdf

[4] https://www.refinitiv.com/content/dam/marketing/en_us/documents/methodology/esg-scores-methodology.pdf



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