Why responsible investing can drive long-term returns

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In our March 2018 Observations piece, *Can an eye to ESG enhance long-term portfolio performance?*, we highlighted the importance of responsible investing and explored the key drivers of this trend. Importantly, we concluded that environmental, social and governance (ESG) criteria is increasingly being shown to reduce risk and potentially increase investment return over the long term.

In this article, we provide further evidence that ESG investing shouldn't come at the expense of returns—in either equities or fixed income. In fact, as this space evolves, the data increasingly shows that incorporating ESG factors into equity investing can improve long-term risk-adjusted returns for equities and preserve returns in bonds.

How we define ESG

Socially responsible investing can be quite encompassing and has become increasingly nuanced in its definition. At Crestone, we designed the following framework to help our clients better understand the landscape, and to help us rigorously tailor your portfolio to align your investments with your values:[1]

ESG factor investing focuses on maximising financial performance while protecting you from reputational and operational risk.
Ethical investing goes a step further than ESG by actively eliminating or selecting investments according to specific ethical guidelines.
Sustainable investing typically considers ESG factors as well as their impact on society, with investments increasingly linked to achieving the Sustainable Development Goals outlined by the United Nations in 2015.
Impact investing focuses on generating measurable positive environmental and social impact while delivering positive return.

Equities—improving long-term risk-adjusted returns

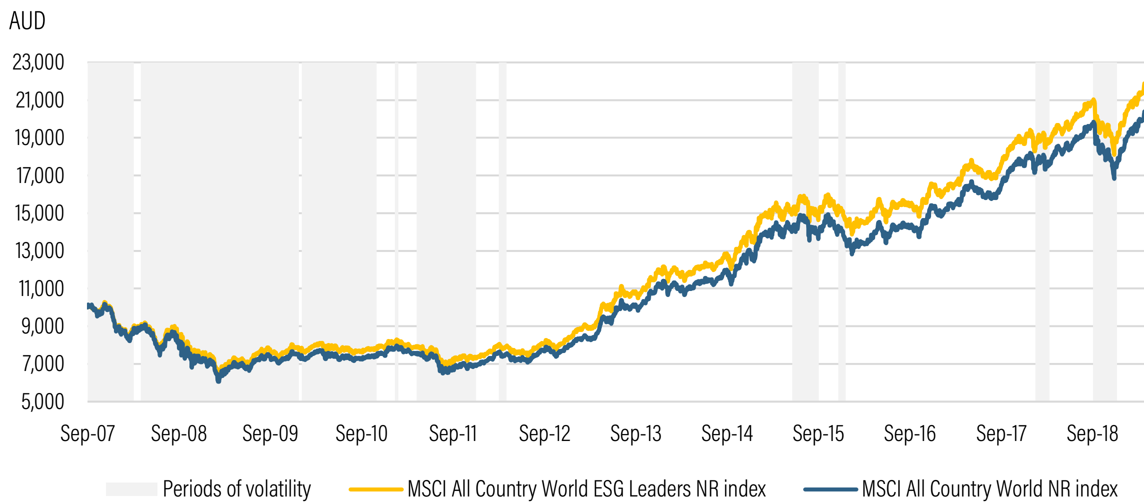
To compare the difference in long-term performance between traditional global equity investing and ESG investing, we analysed the MSCI All Country World Net Return index for traditional global equities and the MSCI All Country World ESG Leaders Net Return index for ESG investing.

[1] *Aligning your investments with your values*, Crestone Wealth Management, September 2018.

The ESG Leaders index includes companies with the highest MSCI ESG ratings and represents 50% of market capitalisation in each sector and region of the parent index (MSCI All Country World Net Return index). Companies with material involvement in industries such as alcohol, gambling, tobacco, nuclear power and weapons are excluded from the ESG Leaders index.

The chart below shows the growth in Australian dollars of the parent index versus the ESG Leaders index from October 2007 to May 2019, and highlights periods of significant market volatility. Over this period, the ESG Leaders index outperformed the parent index, delivering an annualised return of 6.57% versus 5.90% for the parent index. Importantly, it did this with less volatility, protecting on the downside when equity markets were weak, such as in 2008 (the standard deviation of the ESG Leaders index was 24.8% versus 25.0% for the parent index, based in US dollars).

MSCI All Country World ESG Leaders versus its parent index

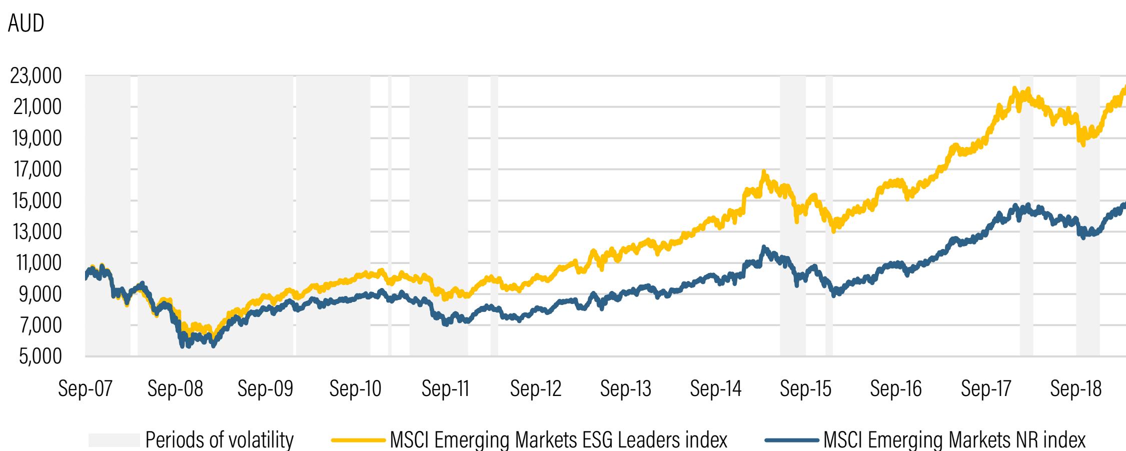


Source: Morningstar Direct. Data as at 31 May 2019.

In emerging markets, the outperformance is even more evident

However, it's important to note that the parent index is broad and not all markets behave the same. If we carve out emerging markets, we observe a particularly stark difference in returns between the traditional index and its ESG derivative. Over the observed period, the following chart shows that the MSCI Emerging Markets ESG Leaders Net Return index significantly outperformed its parent MSCI Emerging Markets Net Return index, delivering 6.52% versus 2.87%, and with lower volatility (the standard deviation for the MSCI Emerging Markets ESG Leaders index was 35.8% versus 37.5% for the parent index, based in US dollars). However, the case isn't the same for developed markets—the MSCI World Net Return index and its respective ESG Leaders index both deliver 6.30% over the period. Positively, this tells us that screening for ESG hasn't had a negative impact on developed market returns since late 2007 to date.

MSCI Emerging Markets ESG Leaders versus its parent index



Source: Morningstar Direct. Data as at 31 May 2019.

Why do ESG leaders outperform traditional equity indices?

ESG factors act as a risk mitigation tool, favouring quality businesses with preferred practices across the three pillars (environment, social, governance), and steering away from those with poorer practices and potential regulatory infractions. Given higher-quality companies tend to lag in 'risk-on' markets and perform better when equity markets are weak, we expect ESG-screened indices to do the same. Furthermore, these higher-quality businesses are less likely to be involved in environmental disasters, corporate governance issues, human rights and labour rights violations, as well as other controversies, which could incur significant cost to those businesses and ultimately affect share prices negatively. We have observed established companies such as Volkswagen and Pacific Gas & Electric suffer at the hands of such controversies. Therefore, more ESG-compliant companies should typically be less susceptible to surprises (financial or reputational) and in a better position to consistently deliver over the long term.

Why do performance differentials vary across markets?

The impact of an ESG overlay on the MSCI Emerging Markets Net Return index compared to the more encompassing MSCI All Country World Net Return index is an interesting one. In many cases, emerging markets may not have the same regulatory and governance infrastructure in place as some developed markets, which means infractions and governance issues may arise more often. These are naturally more inclined to incur costs to the business, and cause stock market volatility and potential underperformance. By downweighting or excluding those companies, the MSCI Emerging Markets ESG Leaders index should look notably different to its parent index and, therefore, should be materially less affected by negative surprises.

It's worth noting that ESG indices tend to have a stronger bias towards large-cap companies than traditional indices. This is because larger businesses tend to have more resources to dedicate to environmental, social, and governance issues, as well as disclosure, which ESG ratings are based on. As such, they typically score better than smaller firms. Such nuances may also exist across sectors, but that is beyond the scope of this paper.

Fixed income—mitigating risk and preserving returns

For fixed income, while the return differential is smaller, it shows that returns don't have to be sacrificed and risk can be mitigated by focusing on sustainable bonds. To compare the difference in performance between traditional bonds and sustainable bonds, we analysed the Bloomberg Barclays Global Aggregate index as a proxy for traditional bonds and the Bloomberg Barclays MSCI Global Aggregate Sustainable index as a proxy for ESG bond investing. The latter positively screens for issuers that better manage ESG risks relative to an industry peer group based on Bloomberg Barclays indices.

The following chart shows that between January 2008 and May 2019 both indices delivered similar returns (the Sustainable index delivered 4.98% while the Global Aggregate index delivered 5.04%). Volatility was also similar, with the Sustainable index generating a standard deviation of 5.56% versus 5.58% for the Global Aggregate index. Pleasingly, the Sustainable index outperformed during 'risk-off' periods such as in 2008 and 2011.

Sustainable and traditional bonds have delivered similar returns

Source: Morningstar Direct. Data from January 2008 to May 2019.

Why the lack of return differential?

The relationship between ESG and a bond's performance is less clear than with equities. Taking credit as an example, higher-quality companies (indicated by higher ESG scores) are likely to have lower credit spreads and should, in theory, generate lower returns.

The indices in the previous chart only capture investment-grade bonds. This means that sectors such as high yield that typically have lower ESG scores (and higher returns) are not included, which potentially reduces the return differential of the two indices. A high-quality tilt means the Sustainable index should outperform in risk-off periods, as we have observed. Finally, debt investors are prioritised above equity investors if a company faces financial difficulty. Bonds, therefore, tend to be less susceptible to shocks (compared to equity prices) that may be caused by certain ESG-related events that materially impact a company's balance sheet, such as environmental or regulatory fines.

We caveat our conclusions by recognising the limited data available in the fixed income ESG space. Notably, the period in the chart above spans a largely bullish market cycle. Given the long-term nature of debt, data over multiple cycles would be more informative to fully understand the impact of ESG risks on bond performance.

ESG investing in practice—not at the cost of diversification

By purely investing in stocks which score well from an ESG perspective, an investor is not guaranteed a better investment outcome. As with traditional approaches to bottom-up active investing, each investment in a portfolio needs to stack up in its own right, making a strong case for active management in this space.

Importantly, we believe that investing in ESG or related strategies shouldn't come at the cost of diversification and, at Crestone, we have built a strong product offering for our clients in this area. In doing so we have identified several active managers that we believe can offer solid risk-adjusted returns and diversification over the long term. Their approaches to ESG vary, with some managers incorporating ESG considerations in their fundamental analysis, while others exclude businesses with exposure to controversial sectors, such as tobacco and nuclear arms. While equity strategies have historically dominated the ESG space, we are increasingly seeing fixed income products come to the fore that should help investors build more diversified ESG portfolios.

Our current sustainable investing product offering

Domestic equities	Domestic fixed income
Ethical Partners Australian Share*	Pendal Sustainable Australian Fixed Interest
Legg Mason Martin Currie Ethical Income Fund	Perpetual Ethical SRI Credit
International equities	**International fixed income**
AB Sustainable Global Thematic	Affirmative Global Bond Fund
Fisher Investments Emerging Markets Equity ESG	PIMCO ESG Global Bond Fund
Nanuk New World	
Pengana WHEB Sustainable Impact	
Stewart Investors Sustainability Worldwide Leaders	
Stewart Investors Global Emerging Markets Leaders	

* Also available via the Crestone Discretionary Portfolio Management Service.

In addition to identifying appropriate managers, we have also engaged the services of **MSCI ESG Research Inc.**, allowing us to rate the ESG characteristics of over 400,000 direct equity and bond securities globally. MSCI's ESG analytical tools allow us to analyse portfolios of direct securities and determine how a portfolio rates, and can be improved, from an ESG perspective.

Asset managers are increasingly incorporating ESG into their investment process, and ESG-dedicated funds continue to increase in number, variety, and sophistication, allowing investors to flexibly allocate to investments that align with their values. With increasing evidence that such strategies can offer competitive returns and diversification, we expect them to form a growing portion of investor portfolios over the long term.

A commitment to responsible investing

To read more about how investing responsibly can help mitigate risk and potentially enhance return in your portfolio, please visit crestone.com.au/news

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