Using ESG to help improve investment outcomes

Risk-adjusted returns mean as much to ESG investors – those that consider environmental, social and governance criteria in their investment process – as the sustainable impact they seek to attain. SSGA global head of ESG business Chris McKnett discusses how ESG integration and its alignment with factor investing has the potential to improve investment outcomes

Is a consensus forming around a concrete definition of ESG investing?
McKnett: ESG is an investment strategy that considers environmental, social and governance credentials in addition to traditional financial metrics. There is no true standard, but the financial industry is beginning to agree on the metrics and data to measure it. ESG is not an asset class or even a distinct investment style, but a variety of strategies that target desired outcomes. Some investors may seek to create a specific impact, such as increasing gender diversity in the workforce or promoting a low-carbon economy. Others may seek to integrate ESG insights into the investment process in order to outperform.

How is ESG best integrated into the investment process?
McKnett: The traditional socially responsible investing portfolio is constrained and tends to limit the investment universe. Some clients want that, but the shift we see is that ESG is a structure to be integrated – along with financial rigour into the investment process as a wider lens that can enhance decision making. In this way, ESG is an opportunity to harness additive insights. These insights can potentially improve returns by selecting better investments or manage volatility by avoiding those investments for which there isn't adequate compensation for ESG risk.

How does ESG work with factor investing and how do they intersect?
McKnett: We have done substantial research on the intersection of ESG and factor investing, and how ESG relates to established factor risk premia: namely value, low volatility, small size, momentum and quality. Thinking about ESG through the frame of existing factors marks an innovative confluence of these two powerful trends in the market. We have found that equities with high ESG ratings might not have desired factor characteristics, and companies with desired factor characteristics might not have the appropriate ESG profile. For example, highly rated ESG stocks can typically give an investor exposure to value – relatively cheap stocks – as well as low volatility, and higher quality, but they do not expose an investor to momentum or small size. The challenge is to include highly rated ESG companies into the portfolio while delivering positive momentum and small-cap exposure. We use a variety of tools to balance and align these competing objectives to capture them all. Our research shows that investors can incorporate their views on ESG as they tilt their portfolios toward long-term, durable-factor premia designed to enhance return, mitigate risk and provide diversification.

What about ESG and other investment strategies?
McKnett: We've seen some performance benefits – especially in lowering volatility – in the active quantitative strategies that we manage by including ESG scores, alongside traditional alpha factors, in the stock selection process. ESG has been helpful in markets where investors are defensive; it tends to add a quality bias, which can benefit the portfolio in those market regimes. And our active fundamental teams implicitly consider ESG as an input related to a company's long-term earnings power and sustainability. There's a tendency to view ESG investing as an active proposition, but most of the portfolios we manage are index based. We optimise index-based portfolios to track a benchmark as closely as possible to deliver precise ESG exposure. Accordingly, investors with an active view can often implement it through a rules-based index approach. We're also starting to see more adoption of ESG benchmarks.

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