Harnessing ESG to drive performance

Pierre Lenders, head of ESG at Capital Fund Management (CFM) looks at whether ESG can contribute to performance for investors, both discretionary and those, like CFM, which take a quantitative approach to investing in financial markets

There's a lot of talk about the importance of environmental, social and governance (ESG) issues in investment decisions, but is there sufficient action? And if there is, what does that action look like, and can it deliver on performance as well as moral objectives?

When the CEO of the world's largest asset manager, BlackRock, says that "a company's ability to manage environmental, social and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth", and that "ESG will be increasingly material to corporate valuations", it's clear that ESG has finally moved into mainstream investment management. Add to that the fact that private equity and hedge fund managers are present and vocal at ESG conferences, when 10 years ago they would have considered these events peripheral, and it's clear the relationship between ESG and investors has changed.

It is no longer possible to ignore the science of climate change, nor deny the conclusion that we are at a tipping point in terms of the global environment. Action needs to be taken, now. The fact that this is acknowledged at the highest levels of the investment world is an encouraging signal that climate (and other ESG risks) are increasingly seen as investment as well as moral risks. Mid last year, BlackRock put its money where its mouth is and took voting action against 53 companies, including ExxonMobil and Volvo, over their lack of progress on tackling global warming. Another positive sign that talk from investors is translating into action.

Can ESG really be a performance driver?

Ever since the investment world started to take ESG seriously, the conundrum has always been the strong disconnect between ESG, or any ethically-driven restrictions, and financial value. In other words, doing good didn't necessarily translate into doing well – and doing well (or more specifically the fear of doing badly) frequently trumped doing good.

One reason was the way in which corporations made money and were valued, and the historical view of a corporation's objective, which was to increase profits for itself and its shareholders. Social responsibility did not play a role. The idea that a corporation has a social obligation as well as a profit objective has become much more widely accepted over the past decade or so and at the same time, the economic landscape has changed.

As the disastrous effect of depleting natural resources and global warming has become apparent, using natural resources as if they were limitless and free is not sustainable – and this has affected the profits and sustainability of 'old-world' businesses, like oil and gas and the automotive industry.

If we add in the rise of digital technology and how it has changed the way we live, shop and do business, it's clear that there are many 'new-world' businesses with very different value drivers. These are the businesses which create and sell intangible assets, like brand value, intellectual property or even active users of new technologies. Intangibles are outpacing tangible assets, and the kinds of businesses which are most profitable are changing.

ESG considerations are increasingly seen important, not only because of the dire state of our planet, but also as performance drivers because they capture some of the risk and return drivers which are not captured in traditional financial metrics, but are relevant to valuation in a way they weren't in the past.

ESG and quant investing

For quant investors, there have been challenges in addition to those which discretionary mangers face, when looking at incorporating ESG factors. For us, to be successful, strategies must pass a minimum statistical threshold, and be underpinned by economic rationale. ESG has always passed the second hurdle, but we've struggled with the first.

One of the problems is the lack of data (we don't have a long timeframe over which data has been collected), and the other is the lack of a consistent framework. Responsible investors are already reporting on ESG factors, and reporting diligently, but without consistency between frameworks, it is difficult to compare apples with apples.

Another problem is that incorporating ESG factors into systematic quantitative-based investment strategies can be a double-edged sword. On the plus side, a quantitative investment approach is well-suited to take advantage of large and growing collections of data sets and our experience and expertise in 'scrubbing' dirty data so that we can interpret and read it, is our bread and butter. Inconsistent data is good news for us: we have the means to clean it up and use it. It's less good news for discretionary investors, who typically face a much harder task with the speed and quantity of data to interpret. On the other hand, the fact that a lot of ESG data is reported differently, judged differently and interpreted through different databases with diverging methodologies means it might be better suited to the more qualitative analysis of discretionary managers.

For both discretionary and quant asset managers, the main focus is on the growing materiality of ESG factors to the price mechanism. Historically the best discretionary investment managers were better able to look long term and identify the ESG themes that were driving change in the future. Quant investing, on the other hand, which typically looks to the past to learn lessons about the future, struggled with the scarcity and inconsistency of historic ESG data.

The good news is that our ability to incorporate ESG into our quant-based strategies has improved rapidly in recent years. Advances in technology, machine learning and artificial intelligence (AI) are increasingly allowing us to monitor, analyse and identify trends and signals not only in the financial ecosystem, but outside it as well – and to make use of this data in our investment strategies.

Alternative data sources, which are increasingly being explored for investment insights, are growing exponentially in size and importance. Social media trends, imagery from satellites, even the kind of language CEOs use when issuing an earnings update is all data which has existed for a long time. What hasn't been possible has been the industry's ability to store and interpret this data, particularly given how much of this data is unstructured and dirty.

Making sense of this type of data and using it to inform investment strategies requires advanced statistical techniques such as neural networks – areas where quant investors have a serious advantage over discretionary managers. An added advantage is that AI allows us to mine information from not only in the financial ecosystem, but outside as well. This is important because some of the themes which fundamentally shape our future do not necessarily happen in financial circles. The first conversations about hydrogen powered cars, for example, weren't had by investment managers, they were had by academics and NGOs – but tracking these type of discussions and innovations through the plethora of media gives real insight into the ESG themes likely to shape the future.

Conclusion

More and more investment managers are starting to look at ESG as part of their performance toolkit, and as an active contributor to performance, rather than a necessary compliance process, entirely divorced from performance. Armed with new ways to systematically extract topical information from multiple sources, including text only datasets, quant funds can now compete with discretionary managers on selecting assets and build portfolios with sustainability tilts. Although ESG factors mostly emerged from ethical, non-financial intentions, some of them are gaining mainstream acceptance so forcefully that the much referred to 'trade-off' between the moral and the financial imperative fades away. It's quite on the contrary – a story of gradual re-alignment between value and values, which asset managers on the quant side are now equipped to participate in and contribute to as well.

As our clients, governments and society become ever-more engaged in and take action on ESG issues, so too will this increasingly impact financial markets. And whilst there are challenges, we believe there is also great opportunity to apply our quantitative and systematic techniques to meet our clients' requirements and for the quant industry to play its role in environmentally-conscious investing.

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In association with CFM INSIGHT.DATA.CLARITY.

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