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# What will it take to expand ESG investing?

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# *Executive Summary*

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*Growth in ESG investing is driven more by pursuit of positive feelings than by conviction in ESG strategies' performance. The asset management industry needs to offer product strategies, marketing and reporting that meet ESG investors' differentiated needs.*

## Current state of ESG investing

Interest in ESG investing has resurged in recent years. ESG funds have seen net inflows totaling $340bn over the past two years[1].

ESG investing took more than a decade to grow to its current scale. Its progress was slowed by several headwinds, most notably the global financial crisis. Today, ESG investing is widely recognized as being driven by motives other than ethics and religious beliefs. ESG ratings also have become widely available to aid ESG investors. These developments are major changes in the ESG investing environment.

## ESG investment performance

While ESG investing itself is growing, it remains controversial in certain respects. One such respect is the relationship between ESG ratings and investment performance. Much academic research has been conducted using third-party ESG rating information but the research has yielded conflicting findings, resulting in a lack of consensus. On one hand, ESG equity funds make the marketing claim that stocks with high ESG ratings are more robust against market shocks. On the other hand, many researchers assert that factors shunned by investors are a key source of alpha and stocks with low ESG ratings are particularly attractive in the current environment.

One possible reason for the disagreement between these two camps is that their implicitly assumed investment horizons differ (see table). If we reframe ESG ratings as the equivalent of a popularity or sector factor[2], factor performance could very well differ between short- and medium-term timeframes. On a short-term basis, high-ESG stocks may enjoy strong downside support by virtue of

NOTE

1) Based on EPFR data on fund flows.

2) One study found that when returns are adjusted to account for sector exposures, exposures to standard factors and investor attention shifts (changes in popularity), ESG investment strategies deliver little if any alpha. According to the study, 75% of ESG investment strategies' alpha can be explained by standard quality factors. See Giovanni, B., M. Esakia and F. Goltz, "Honey, I Shrunk the ESG Alpha": Risk-Adjusting ESG Portfolio Returns (Apr. 2021, Scientific-Beta).

**ESG investing's impact by investment horizon**

| | Short-term (0–3 years) | Medium-term (4–10 years) | Long-term (> 10 years) |
|---|---|---|---|
| **Returns** | + (High-ESG stocks' popularity should cushion their downside when market shocks occur) | – (Long-term ownership of cheap low-ESG stocks should pay off) | ? (+ if only high-ESG stocks survive; – if they do not survive) |
| **Fundamentals** | Irrelevant | High profitability of socially undesirable businesses | Growth in ESG business opportunities, survival of only ESG-compliant businesses (will become the norm) |

Source: NRI

popularity-driven buying interest unrelated to fundamentals. Meanwhile, a portfolio of low-ESG stocks could outperform over the medium term as prices converge with fundamentals. For example, sin stocks disfavored by ESG investors (e.g., cigarette, alcoholic beverage, casino and defense stocks) generate stable cash flows that tend to drive favorable medium-term returns.

If the debate between the two camps were limited to short- to medium-term investment horizons, their different views are likely irreconcilable. Over a longer horizon, however, ESG investment returns may be affected by structural changes in society. For example, at some point in the distant future, the equity market may be populated solely by high-ESG stocks. Some ESG investors are betting on such an outcome. Whether they will be proven right depends largely on the extent to which society changes in the interim. Such long-term ESG investing would be practically impossible to objectively back-test given data availability.

The quintessential form of ESG investing over such a long time horizon is to realize differentiated returns by deploying capital with enough clout to affect market returns instead of tagging along with market performance.

## ESG as the third investment preference

Investors who get into ESG investing do so for different reasons. In general, investors, including retail investors, can be classified into the following three groups in terms of their attitude toward ESG investing.

(A) Those who consider ESG investing to have a favorable risk/return profile

(B) Those who believe ESG investing is prone to underperform because it is subject to constraints largely unrelated to investing
(C) Those who feel more comfortable owning high-ESG stocks than low-ESG stocks as long as expected risk/return profiles do not differ materially between the two

As already mentioned, there is a wealth of research and a major debate raging between investors in groups A and B regarding ESG ratings' effectiveness as a factor and the relationship between ESG ratings and valuation. There is no consensus between the two groups on how ESG ratings relate to performance. Both agree, however, that performance is important.

Group-C investors, by contrast, prefer to use ESG ratings as tertiary information behind risk/return information when selecting investment strategies, though they are not willing to sacrifice performance in favor of ESG objectives (anyone willing to do so would arguably be more of a philanthropist than an investor). Group C includes institutional investors under pressure to invest through an ESG lens, performance aside, out of concern about reputational risk.

Institutional investors in groups A and B need to compile evidence to justify their respective positions but those in Group C do not. Retail investors can practice ESG investing without conforming to anyone else's views on performance. Accordingly, the group most likely to drive further growth in ESG investing is not group-A but group-C investors who prefer ESG investing or have an investment creed that does not revolve around performance.

Group-C investors have a handy tool in the form of ESG indexes designed to minimize active share as measured against a conventional market-cap-weighted index. Investors in such ESG indexes can benefit from replication of the market-cap-weighted index's risk-return profile while taking comfort in owning high-ESG stocks. The source of this satisfaction is not investment performance but ownership of a portfolio of companies with small carbon footprints and nondiscriminatory HR practices. This is what Group C is pursuing as the third investment preference.

The asset management industry should offer product strategies, marketing and reporting that meet group-C investors' needs. In particular, it must be able to meet non-performance information needs to keep money flowing into ESG investment products.

Many investors believe ESG investing outperforms and desperately want to prove so. However, it would be more constructive to frame ESG as merely another investment preference. We hope realistic discussions ensue.

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