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Investment viewpoint

Quant ESG is still doing well

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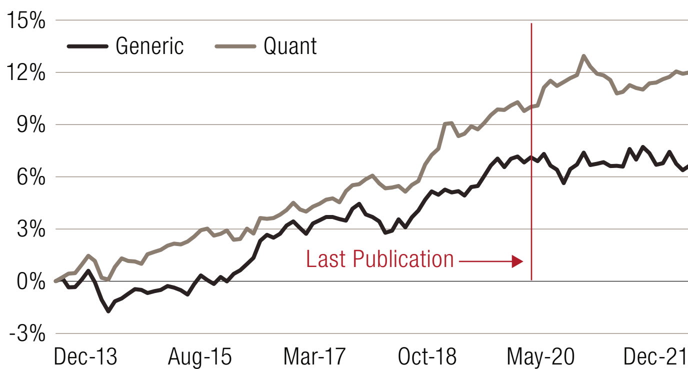
Two years ago, we published the paper "ESG alpha: doing well while doing good". In it, we described our views on how to enhance portfolio returns with ESG data. Since then, ESG thematics have gained further popularity both in the investment community (global sustainable assets have quadrupled[1]), and in academia marked by the launch of a dedicated Journal of Impact and ESG investing.

The general consensus is that incorporating ESG considerations into the investment process is a "good" thing. However, there is still no agreement on whether this will bring performance. In fact, taking into account the rise of responsible investment, ESG risks might be already fully priced by the market, therefore, "good" companies could be expensive. A recent study from Morningstar suggests the possibility, showing that indeed "bad" companies trade at discount to their fair values, while "good" companies command a premium.[2]

In our original publication, we stressed that getting performance out of ESG requires a prudent approach to portfolio construction. A naïve ESG integration tends to introduce various systematic biases (regional, sectoral and style) that will explain most of the portfolio returns. These biases will result in a variation of performances depending on the portfolio construction approach, and could result in misleading conclusions about ESG alpha. In our study, we chose to neutralise our ESG portfolio to all of those biases, which allowed us to confirm that integration of ESG indeed brings performance. We further proposed a quantitative scoring methodology that enhanced ESG alpha through a dynamic weighting of various ESG themes.

1 Global Sustainable Fund Flows: Q3 2021 in Review, Morningstar.
2 What's the Cost of Buying Good ESG Companies?, Morningstar.

FIG. 1 BACK-TEST OF A QUANTITATIVE ESG PORTFOLIO



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Does ESG alpha still exist? Figure 1 provides an update on the performance of the global quant ESG strategy. The back-test reported in the original publication ended in November 2019, which we extended here over to November 2021. For comparison, we showed the performance of a "generic" strategy that was based on an equally-weighted score.[3]

The quantitative portfolio continued to perform since the last report, however, its path was not always smooth. The portfolio experienced a notable drawdown in the second half of 2020. Nevertheless, the strategy managed to quickly adapt to new conditions and recovered well in 2021. The quant portfolio also outperformed the generic one, which had been mostly flat over the last year. The inability of the generic portfolio to generate any alpha evidences the importance of a selective approach to ESG scoring.

Since the last publication, the quant ESG score has been implemented in the range of our long-short and long-only equity solutions, where it was combined with other sources of alpha. In all the cases, its performance contribution has been positive, and we are confident about its ability to generate alpha in the near future.

[3] We performed exactly the same neutralizations to make tow strategies comparable.

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