28th September 2020

Having your ESG cake, whilst eating your expected performance

- Indices codify a criteria-based approach to ESG investing
- Index methodology means screen, score and weight each company
- ESG indices enable similar performance, but with ESG compliance

Defining terms

With a growing range of ethical investment propositions available to portfolio designers, we first of all need to define and disambiguate some terms.

- **Ethical investing:** this is an established investment approach that considers investors' social and moral preferences, and typically relied on exclusions (typically excluding companies with exposure to "vice" – for example armaments, gambling or alcohol). Traditionally the approach of religious charities, this approach is becoming mainstream.
- **Environmental, Social and Governance ("ESG"):** the index provider, MSCI, rates companies based on their approach to Environmental issues (such as Climate change, Natural resources, Pollution & waste and Environmental opportunities); Social issues (such as approach to Human capital, Product liability, Stakeholder opposition and Social opportunities); and Governance issues (such as Corporate governance and Corporate behaviour)[1].
- **Socially Responsible Investing ("SRI"):** using MSCI's definitions, this approach incorporates ESG ratings as for ESG, but goes one step further to exclude companies whose products have negative social or environmental impacts; removing companies involved in Thermal Coal mining and power generation; and exclude companies involved in controversies.

Criteria-based approach works well for indices

Applying ESG criteria to a universe of equities acts as a filter to ensure that only investors are only exposed to companies that are compatible with an ESG investment approach.

Creating a criteria-based approach requires a combination of screening, scoring and weighting.

Looking at the MSCI World SRI 5% Capped Index, for example, means:

1. **Screening:** removing companies with exposure to Nuclear Power, Tobacco, Alcohol, Gambling, Military Weapons, Civilian Firearms, GMOs, Thermal Coal and Adult Entertainment.

[1] For more on this ratings methodology, see https://www.msci.com/esg-ratings

2. **Scoring:** means only including companies that score above a certain level on their MSCI ESG Rating and MSCI Controversies score.
3. **Weighting:** to make sure the final index has similar risk-return exposure to the parent index (so as not to impact portfolio construction parameters such as risk, return and correlation); index methodology can target similar sector and region weights as the parent index. Furthermore to ensure that, as a result of all this screening and scoring and weighting adjustments, single-stock exposure (which creates systematic risk) does not become too concentrated, a 5% cap restricts the allocation to any single stock.

Indices codify criteria

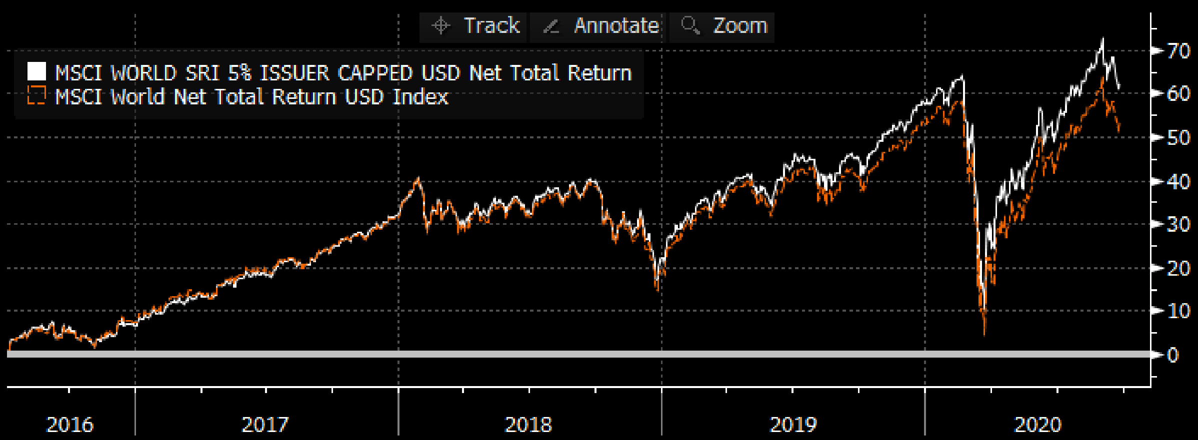
An index is "just" a weighting scheme based on a set of criteria. A common, simple index is to include, for example, the 100 largest companies for a particular stock market. SRI indices reflect weighting schemes, albeit more complex, but importantly, represent a systematic (rules-based) and hence objective approach. However, the appropriateness of those indices is as only as good as their methodology and the quality of the screening, scoring and weighting criteria applied.

Proof of the pudding

To mix metaphors, the proof of the pudding is in the making of performance that is consistent with the parent index, whilst reflecting all the relevant scoring and screening criteria. This allows investors to have their ESG cake, as well as eating its expected performance characteristics.

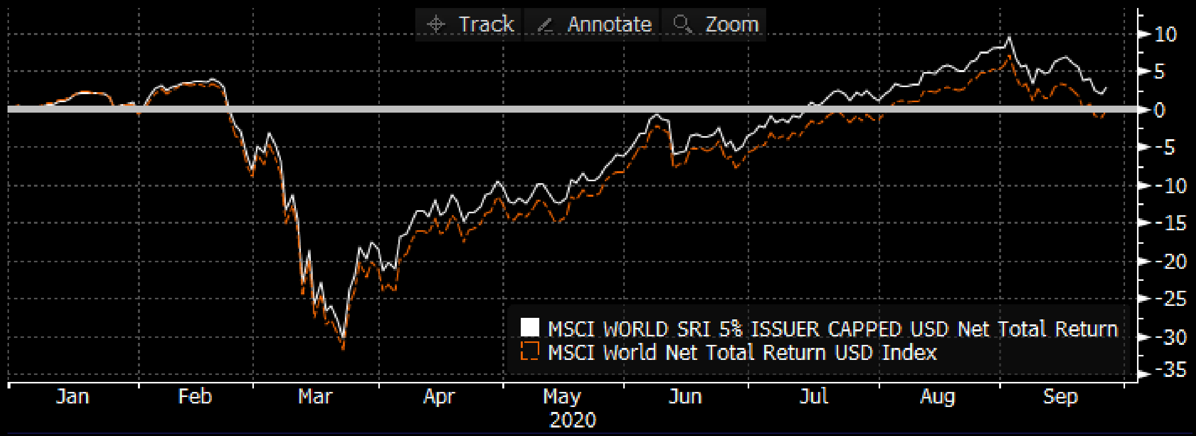
Contrast, for example, the MSCI World Index with the MSCI World Socially Responsible Investment 5% Issuer Capped Index. The application of the screening and scoring reduces the number of companies included in the index from 1,601 to 386. But the weightings adjustments are such that the relative risk-return characteristics are similar: the SRI version of the parent index has a Beta of 0.98 to the parent index and is 99.4% correlated with the parent index.

Fig.1. Comparative long-term performance



Source: Bloomberg data

Fig.2. Year to Date Performance



Source: Bloomberg data

Focus on compliance, not hope of outperformance

Indeed pressure on the oil price and the performance of technology this year (technology firms typically have strong ESG policies) means that SRI indices have slightly outperformed parent indices.

However, our view is that ESG investing should not be backing a belief that performance should or will be better than a mainstream index. In our view, ESG investing should aim to deliver similar risk-return characteristics to the mainstream index for a given exposure but with the peace of mind that the appropriate screening and scoring has been systematically and regularly applied.

Find out more

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