Show me the impact: trade-offs between ESG and investment performance

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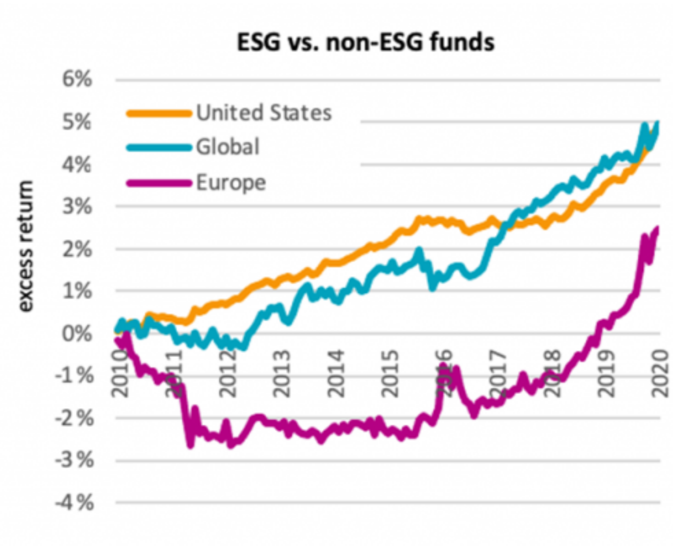
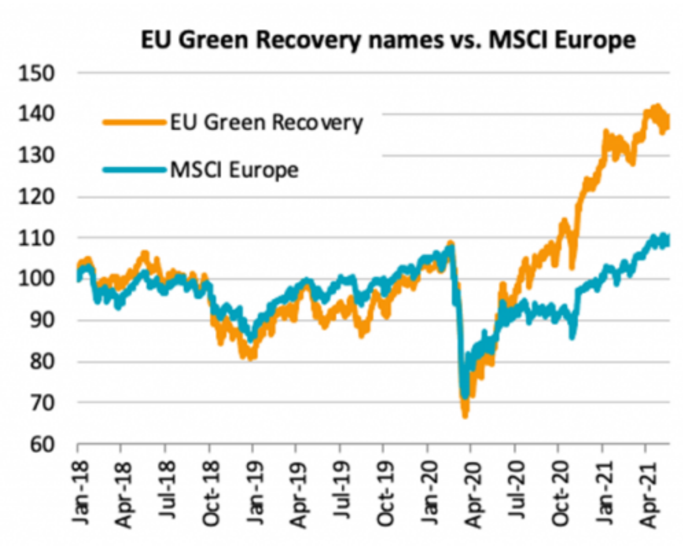
Sustainability investing has been around for a while, yet it seems to have taken off with lightning speed in recent years. The growing appetite for sustainability stems from people believing that their money can have a positive impact on the world. The only caveat being that this should not come at the expense of financial returns. Ideally, we want to create *both* wealth and wellbeing. But is that really possible?

The tipping point

Historically, sustainability investing mainly focused on companies having proper governance practices. Over time, environmental concerns and – on the back of the COVID-19 crisis – social issues, have cemented ESG (environmental, social, governance) as a core part of investment decision-making. We believe this tipping point in favour of ESG investing has sufficient stickiness to enjoy a long-term tailwind.

Recently, much of the debate has centred around the question of whether 'doing good' equals 'losing money', as if there is a natural trade-off between the two. Interestingly, the short answer is *no*. In fact, there is a growing body of academic evidence suggesting a positive relationship between sustainability investing and financial performance. It seems ESG has evolved from being a force to *only* protect against downside risk to one that *also* drives excess performance, or 'alpha'. For example, global ESG funds have outperformed category peers on a three, five and 10-year basis, according to Morningstar.





Source: Morningstar, S&P, Bernstein analysis, Morgan Stanley Research, Robeco

A closer look at ESG performance

Why has ESG fund performance been consistently strong? We can attribute that to a variety of factors. Research indicates that ESG funds tend to be more growth-oriented and quality-biased – approaches that have been rewarded in the past decade. Moreover, excluding secularly challenged industries such as fossil fuels and tobacco has helped over a longer time period. Other evidence points to outperformance for stocks having high ESG scores, a low carbon footprint or that are otherwise well-aligned to key sustainability trends.

Sceptics might argue that ESG is simply loading on so-called momentum or quality factors. However, recent research refutes this view and found that even *after* stripping out differences in such factor exposures, ESG outperformance is still present, albeit admittedly less pronounced. Of course, alpha generation can depend on a host of factors such as fund flows, fundamentals, specific catalysts, and valuation. As always, it remains important to go beyond mere storytelling, stay valuation-disciplined and not overpay for 'good' companies.

The usefulness of ESG scores

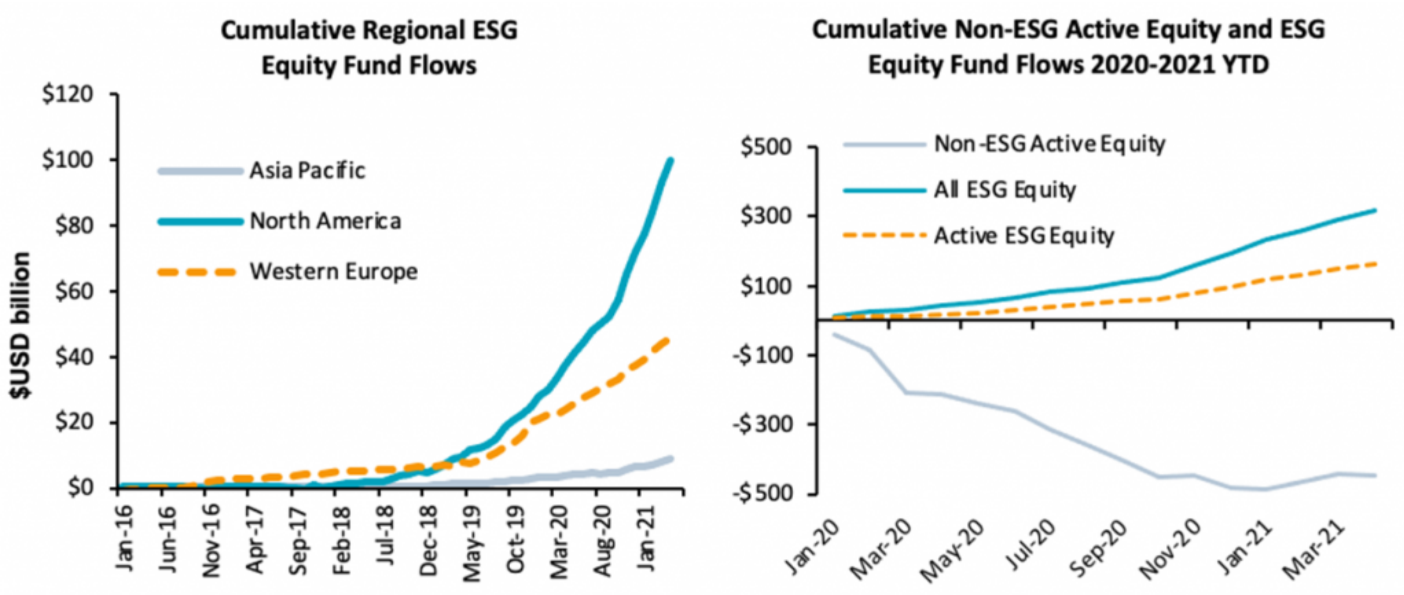
The usefulness of ESG scores is also a source of debate. There are examples where ESG scores have done a good job as a risk indicator. For example, between 2005 and 2015, 90% of bankruptcies in the S&P 500 were companies with poor ESG scores. Yet, as sustainability investing progresses, it will likely become more difficult to base decision-making on widely used datasets or ratings alone. Simply relying on ESG scores is not enough, especially given that the correlation among major ESG rating providers is relatively low. In other words, although ESG scores can be a good starting point, they should always be complemented by fundamental ESG analysis.

Sustainability investing has many flavours, but excess performance stemming from the 'ESG integration' approach, in particular, has fared well. Core to this approach is the integration of financially *material* ESG factors into the investment process. In other words, ESG that directly impacts the financial model of a company, i.e., by altering its growth outlook, profitability, risk profile or overall competitive positioning. For example, if ESG considerations result in a 25% higher valuation of a company, it likely impacts the buy or sell decision of the fund manager.

Our strategy

This same approach is, for example, core to the Robeco Sustainable Global Stars Equity strategy. Over the years, ESG integration has led to better decision making, and more importantly, to *extra* excess returns. For example, in measuring the impact of ESG on investment performance, it turns out that between 2017 and 2020, around 20% of the fund's excess returns can be attributed to ESG. In other words, *without* properly integrating ESG factors into the investment process, excess returns would have been lower.

Fund flows follow performance. In fact, ESG has perhaps been the standout story of equity fund flows in recent years, with robust flows to ESG contrasting sharply with outflows for 'non-ESG' counterparts. Still, as of now, only a few percent of global assets under management are classified as 'ESG' – a number that is poised to increase given where regulatory and societal demand are heading.



Source: EPFR, Bernstein Analysis, Robeco

Of course, ESG investing by itself does not automatically lead to alpha generation. In fact, recent months marked a rare period of softer relative performance for ESG funds. It's normal to have a natural cooling period after such a steep run, but we don't see the market appetite for ESG investing suddenly disappearing. The societal and regulatory pushes for more sustainability investing are simply too strong.

The future of ESG

Every market environment brings new opportunities; ESG improvement stories that are not yet well understood by others may be where the alpha opportunity lies next. As investors move away from simply excluding certain industries or changing their positioning based purely on ESG scores, having differentiated views based on more forward-looking ESG insights will only increase.

ESG has moved beyond the stage of being a nice narrative alone. In uncertain markets, sustainable funds may offer a layer of stability for investors. ESG is also increasingly performance driven in up-markets too. This does come with ups and downs, as returns never show a straight line. Fortunately, we can argue that sustainability as such has proven to be successful in terms of investment performance.

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