October 2019

ESG Investing: how smart is a SMARTER Beta™ approach?

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At first blush, the rapid rise of integrating environmental, social and governance (ESG) criteria into traditional financial analysis appears to be a wonderful opportunity for active equity managers. Like a general forced onto the retreat by sheer weight of numbers, only to advance once more with a potent new weapon, perhaps active managers can use ESG to win back ground surrendered to passive investors.

After all, the argument for actively managed investment processes that integrate ESG considerations is that they offer the usual advantages of active management – the possibility of returns above a market-cap benchmark – plus one extra. That 'extra' is the power of active voting and engagement (otherwise known as 'stewardship') to influence business strategy and execution, including specific sustainability issues and policies. Active managers can put pressure on company boards to act in the long-term interests of shareholders, stakeholders and the planet in general. This is helpful for institutional investors who face growing regulatory pressure to incorporate ESG criteria, including recent initiatives from the European Commission, the United Kingdom's Financial Reporting Council and the State of California.

But is active fundamental management unique in offering these advantages? Or is there a third horse in the race that's neither active nor passive?

Smart beta – a pragmatic third way

As everyone knows, no investment manager can guarantee excess returns (or 'alpha'), and active managers' fees tend to be higher than those of passive managers. This reflects the work involved in researching companies and making judgements. Active management can play a useful role for institutions that want to allocate a portion of their investments to alpha-seeking strategies. But active management is not the only way to outperform a market-capitalisation-weighted index.

A pragmatic third option is smart beta: passively implemented, non-market-cap-based approaches to outperforming market-cap indices. These include simple strategies like equal weighting and fundamental indexation, which weights companies based on proxies of economic size. They also include more targeted factor-based approaches that seek to weight companies based on characteristics (or 'factors') that tend to do better than the market over the long term for both behavioural and structural reasons. For example, if a fund followed a 'quality' factor strategy, it would put much more money in companies with historically high returns on equity and low earnings variability. It would avoid companies with the opposite characteristics. The skill here lies not in picking individual stocks but in designing a system that picks stocks with high exposure to the desired characteristics.

Factor investing started with selecting stocks for just a single characteristic, but the market soon saw the birth of multifactor strategies that combine more than one. Ultimately, multifactor investors in equities, including Aberdeen Standard Investments, have tended to opt for the same five factors: value, quality, momentum, small size and low volatility. In the long term, a well-designed multifactor approach tends to outperform conventional stock indices and the index-replicating strategies linked to them. Moreover, smart-beta fees are usually lower than those for active management because smart beta is less labour-intensive. Aberdeen Standard Investments estimates that its proprietary SMARTER Beta™ ESG Multifactor equity index series*, which uses these five factors to select stocks in addition to negative screening and portfolio optimisation on ESG scores, should be able to outperform conventional stock indices by 2 to 4 percentage points over rolling three-to-five-year periods. It is, therefore, a cost-effective way to introduce ESG into an equity portfolio while targeting superior risk-adjusted returns.

Active and activist

But what about the much-vaunted unique role of active fundamental managers as the mouthpieces of concerned investors: activists pushing for ESG change?

Active managers can certainly engage much more effectively than passive managers. Pushing for changes in corporate behaviour sometimes requires negotiating power to overcome reluctance. That power comes from the implicit threat that the negotiator can walk away from a mutually beneficial relationship, leaving the other party worse off. Passive managers cannot walk away.

But this does not mean that only active managers can be successful activists. Smart-beta managers can excel at this too. Activist smart-beta managers have negotiating power against company boards over ESG issues because the board members know that failure to listen and respond may lead to a lower ESG rating. That would compel the smart-beta investor to reduce its holding – making the threat all the more convincing.

If behind-the-scenes engagement with a company board doesn't work, investment managers can always formally protest at shareholder meetings. This is an option open to active, passive and smart-beta managers. Here, investors in all of Aberdeen Standard Investments' strategies benefit from the vast experience of our centralised Stewardship team. This team votes all of its proxies on behalf of clients on issues ranging from the election of the board of directors, ratification of auditors, approval of executive compensation plans and approval of proposed mergers and acquisitions. Over the course of 2018, for example, our Stewardship team cast shareholder votes on behalf of clients at 4,625 meetings. In 52% of those meetings, there was at least one vote against the board or an abstention.

It's not just carbon

The pattern of these votes illustrates another tenet of Aberdeen Standard Investments' SMARTER Beta™ ESG Multifactor equity index approach not held by most smart-beta ESG investors: that it is as important to remember the S (social issues) and the G (governance) in ESG policy as it is to remember the E (environment). A company with poor governance is more likely to make damaging decisions in every field; social issues, such as the mistreatment of workers in the supply chain, are more likely to damage corporate reputations. This is because of both the higher levels of expectation from government and public, and the oxygen of social media.

Aberdeen Standard Investments' understanding of the need for a broad approach is shown in the high frequency with which we discuss material ESG issues with our invested companies. During 2018, for example, we did so with more than 400 companies. Of these discussions, 7% were about environmental practices, but 11% were about labour practices, with 26% about issues to do with the board and 12% about senior executive remuneration. Many of our Stewardship team's highest-profile votes against boards have been over governance.

This wide range of ESG criteria that we use is somewhat at odds with what surveyed investors revealed in a recent research report. This was published by Aberdeen Standard Investments, Sustainalytics and the University of Oxford's Smith School of Enterprise and the Environment, and is entitled *Smart Beta and ESG: Promoting Sustainability in Smart Beta Investment Strategies*. Asked which ESG issues they believed were most suitable for inclusion in a smart-beta investment strategy, investors' top three answers were all related to the environment: carbon, at more than 45%, followed by water and then waste.

Some smart-beta ESG portfolios dispense altogether with anything unrelated to climate change: in the survey, 8% of the smart-beta ESG investments blended smart-beta and ESG information through a climate tilt. This is where the final weights of companies in a factor index are adjusted using various climate-change-related metrics, such as carbon emissions. The social issues of gender diversity, health and safety, and product quality and safety came fourth, fifth and sixth, with interest at 15% to 20%. Governance scored under 10%.

However, the work by Sustainalytics and other specialist ESG research and ratings firms suggests that all these issues can be included in smart-beta strategies, because they are all measurable. For example, Sustainalytics has 34 measures that, if taken together, can give an accurate picture of the quality of governance. These measures range from whistleblower programmes to board diversity to whether the chair and CEO roles are separated.

Investors warm to ESG smart beta

Some investors might be more interested in some aspects of ESG than others – and Aberdeen Standard Investments can accommodate this. But whatever their interest and motivation, many have become quietly convinced that ESG can be applied effectively to smart-beta investing. To give an idea of how widely adopted this has become, about a quarter of investors surveyed on smart beta and ESG said they were running smart-beta ESG programs. This move benefits from two separate tailwinds: the increasing shift to ESG among institutional investors and their waxing enthusiasm for smart-beta. Thirty-seven percent of investors who were surveyed expressed dissatisfaction with market-cap indexation and said they planned to reallocate assets to smart-beta over the next year or two.

The power of negative ESG screening

Negative screening – excluding companies that have poor ESG practices, or that sell goods and services which investors oppose, such as weapons, tobacco or gambling – is the most common form of smart-beta ESG investment at the moment. Sixty-two percent of those investors in the survey that were using smart-beta ESG techniques used negative screening, which is also known as 'socially responsible investing'.

All of Aberdeen Standard Investments' proprietary SMARTER Beta™ multifactor equity indices employ negative screening to exclude companies that produce controversial weapons (cluster bombs, landmines, depleted-uranium weapons and chemical and biological weapons) and those facing severe ESG controversies, based on ratings by Sustainalytics. These so-called Category 5 companies rated by Sustainalytics face ESG risks that may be severe, and impacts from poor ESG may be irreversible. Cases may be recurring and not addressed adequately. One such company is G4S, the British security company attacked for revelations about abusive behaviour by staff and for overcharging the UK government for the electronic tagging of prisoners, some of whom had left the country or even died.

Combined with the power of ESG optimisation

But there's a compelling case for smart-beta programmes to go beyond this negative screening by increasing investment in stocks that, at the portfolio level, provide a higher aggregate ESG score than the equivalent market-capitalisation-weighted index. This is achieved through portfolio optimisation, which optimises ESG scores in aggregate above that of the equivalent index and so rewards good behaviour at board level. This high-level approach of pressing for better ESG policies could be an extremely effective way of facilitating change because of the huge global footprints of many companies in portfolios subjected to ESG screening and optimisation. Just 100 companies have been the source of more than 70% of the world's greenhouse gas emissions since 1988, according to the NGOs CDP and the Climate Accountability Institute.

It's also sound investment sense to back winners and reject losers. A striking statistic from MSCI highlights the combined power of negative screening and ESG optimisation in reducing risk. It finds that companies in its lowest ESG rating category are three times more likely to suffer a catastrophic 95% fall in share-price value in the following three years. This chimes with what we know intuitively: a company with bad ESG can become a shadow of its former self very quickly, because ESG touches everything. This is supported by a McKinsey study[1] suggesting that "sustainability issues" – environmental and social factors alone – can be as high as 70% of EBITDA. If you included governance, it would be fair to put this at 100%.

A smarter future

What might the future hold for ESG smart-beta investing? Multifactor investing informed by ESG considerations, along the lines of Aberdeen Standard Investments' approach, is quite rare at the moment. But it is likely to become more common. Another possibility is that more investment managers will treat ESG as a risk-premium factor in its own right, like value, quality and so on. One asset owner surveyed for the smart-beta ESG report said they were already doing this, and several revealed that they were researching ESG as a factor.

But this 'new' factor should be treated with caution. The investment-management industry has a history of devising new factors – some investors have used as many as 20 or more. However, most of these look pretty similar to others, like the stereotypical heroines in Mills and Boon romantic novels or handsome princes in fairy stories. Cynics decry the rise of the 'factor zoo', inhabited by all manner of weird and wonderful factors, competing for investors' attention with various exotic growls and squeaks.

After considering the advent of ESG as a factor from every angle, Aberdeen Standard Investments has emerged as a sceptic – for now. ESG fails our factor test, in that each factor should be **RIPE: robust, intuitive, persistent** and **empirical**. Specifically, ESG falls at the empirical hurdle: each factor should be supported by empirical academic research. There is not enough data to support this, quite yet. One problem is that the data on past ESG performance is qualitative, as opposed to the quantitative data, such as price-to-earnings and financial leverage, called into service for the five factors we currently use. Because analysis of ESG performance relies on qualitative data, it is perhaps especially vulnerable to a common risk of backtesting past performance to predict future performance: the arbitrary use of one measure that shows better performance in the past, rather than another that does not. Because of this lack of a hard evidence base, the time is not ripe for adopting ESG as a new factor. In the meantime, our approach of ESG exclusions and ESG optimisation makes the most sense.

* Aberdeen Standard Investments' SMARTER Beta™ ESG Multifactor equity index series includes: Global (in USD, GBP, EUR), Developed Markets (in USD, GBP, EUR), International (in USD), Europe ex-UK (in USD and EUR) and US (in USD).

[1] Sheila Bonini and Steven Swartz, "Profits with purpose: How organising for sustainability can benefit the bottom line, McKinsey & Company, 2014.

About the Author

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David Wickham is the Global Head of Quantitative Investments Solutions at Aberdeen Standard Investments in London. In this role, he is responsible for the development, marketing, and specialist sales of the firm's equity, fixed income, and multi-asset quantitative capabilities.

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David holds a Master's degree in International Relations from the University of Cambridge and an MBA with Distinction from the University of Oxford. He is also a former Fellow of the Brookings Institution in Washington DC and Adjunct Professor of the University of Oxford's Saïd Business School, Fellow of the Oxford University Foreign Service Programme, and Practitioner-in-Residence with the Skoll Centre for Social Entrepreneurship at the University of Oxford's Saïd Business School.

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