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ESG and Alpha: Concession or Contribution?

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Many investors still ask the question, “Do environmental, social and governance (ESG) factors create alpha?” We ask a slightly, but meaningfully, different question, “Does ESG integration contribute to higher risk-adjusted returns over time?” We think the answer is yes.

ESG Integration

Determining whether the incorporation of ESG factors enhances alpha[1] depends significantly on the definition of the “factor” and the timeframe over which the impact is tracked. E, S and G considerations are sometimes inter-related, overlapping and mutually re-enforcing. However, they might also be distinctly different in terms of relevance, materiality and magnitude for a given security.

In addition, there is a market component to alpha. Specifically, efficient markets—that is markets where information is widely known and incorporated into security pricing—will exhibit less alpha than inefficient markets. Therefore, if an ESG factor is readily available, reliable and known to be correlated with positive financial performance it will be less likely to create alpha because its effects will be priced in. This is why our research on ESG topics is intended to discover and apply insights that the market has not yet incorporated. This is also why ESG insights are most often expressed as a component of our investment thesis rather than an input to a financial model.

The Volkswagen auto emissions scandal is a good example of the compounding effect of E, S and G issues. Most obviously, this was an environmental problem; vehicles were causing more pollution than was legally allowed. However, the issue became a governance concern when it became clear that the company had deliberately manipulated emissions tests to appear compliant. The financial impact will come directly from significant fines and indirectly from damage to the brand name. Although the stock didn’t immediately plummet with the news of the problem, the scandal was a drag on the stock’s performance and fines further eroded support for the share price.

A more positive example of the overlap between E, S and G issues is one of our mining stocks. This company encountered issues with the opening of a mine in South America when a local non-governmental organization (NGO) contested the mine’s pollution controls and alleged a lack of protection for nearby indigenous people. Our research discovered that the company had engaged with both the local community and the local government to address land usage, possible pollution of water and air, and employment concerns. In fact, it collaborated with authorities to enact regulations that both held them to a workable standard and created barriers to entry to anyone unwilling to exert the same level of care. While these concerns are all directly related to E, S and G issues, the expected outcome is an increase in stock price when the market realizes the company has built a competitive advantage.

Whether in fixed income or equities, our success as fundamental active managers relies on our ability to recognize those issues that will influence the way a company or issuer behaves or the contexts in which it works. When we apply this expertise, including considerations that can be classified as E, S or G, we expect to generate alpha. As with other factors or considerations, however, neither over- nor underperformance is assured through the inclusion of E-, S- or G-related information.

Certainly, if a portfolio differs from the benchmark for whatever reason, the return stream will differ as well. While fundamental analysis does not guarantee alpha, the effort, including that related to ESG, is undertaken with the goal of delivering better risk-adjusted returns to clients over time.

Arguments against the connection between ESG integration and alpha often reference a few assumptions:

1. “doing ESG” means merely eliminating certain securities, industries or revenue generators from the investable universe
2. there is insufficient ESG-related data to evaluate material ESG issues
3. investor behavior, including proxy voting and engagement, does not influence corporate or issuer behavior

In our view, these arguments are too simplistic.

Socially Responsible Investing (SRI) and Screens

Socially responsible investing, or screened portfolios, restrict the investment universe, and many have argued that this constraint leads to lower financial returns. Performance depends on the weights of the remaining names, additional “bets” in the portfolio such as size, style or duration, whether or not the portfolio is optimized and over what timeframe the results are measured. For example, many fossil fuel-free portfolios exalted in their outperformance between 2013 and 2015. These same funds would have severely underperformed from 2005 to 2007. These results have very little to do with the emissions of the companies affected, their reporting protocols and practices, or the reserves they own. Rather, the bulk of these results were driven by the price of oil. This is one example of why it is important to resist the temptation to attribute either positive or negative performance to only one factor, especially those as imprecise and often qualitative as E, S and G factors.

When a client asks us to screen out certain names or categories, we seek to re-optimize the portfolio to minimize any additional investment risk that the restriction introduced. In some instances, we may look for another security with the same risk and expected return characteristics to replace the prohibited investment. These additional steps are taken to dampen any affect the change in universe might have on the investment outcomes and enable investors to achieve both their financial and beliefs-based objectives.

Data

The availability, reliability and relevance of data remains the biggest hurdle to ESG incorporation, and consequently, ESG-attributable alpha generation. Challenges cited in the use of ESG data include lack of measurement and reporting standards, unwarranted conflation of metrics and outcomes, differing terminology or definitions, applied timeframes, and assessment of materiality and relevance. As the amount of ESG data grows, these challenges become issues of implementation rather than an absence of information. Instead of waiting for perfect data and maximally informative relative frameworks, we apply our expertise about individual issuers, sectors and geographies to determine what information is material and relevant. In this way, we position ourselves to develop meaningful insights in the present as the availability of quality information evolves.

There are several vendors that aggregate public data, apply some measure of materiality, evaluate it through a predetermined lens and then determine an aggregate ESG rating. None of these services is perfect, in part because of the challenges with the underlying data. However, these services are our best chance of applying a consistent framework around ESG issues across sectors and peer groups. Often, complementary sources are needed to complete an ESG picture.

As with any other third-party research, reported ESG metrics and vendor-provided ratings are only a component of our robust research analysis. It is incumbent on us to critically evaluate the information and apply it appropriately in our investment process. Our expertise in recognizing material and relevant information is what leads us to the assertion that our integration of ESG considerations is supportive of alpha generation.

Proxy Voting and Engagement

Mellon considers both proxy voting and issuer engagement to be important components of our investment management responsibility. These efforts are supported by outside data vendors as well as the expertise of our investment professionals.

A specific proxy vote or engagement conversation rarely, if ever, leads to the outperformance of a stock or bond. That said, these tools are the best we have to alert a company or issuer to those elements of their strategy, governance or operations that we believe need improvement.

Through the BNY Mellon Proxy Voting and Governance Committee and the BNY Mellon Proxy Voting and Governance Research Team which supports it, we have direct access to management teams and corporate boards to discuss important issues such as board structure, shareholder access and executive compensation. Each of these has a meaningful impact on the way a company operates. For example, done well, we can expect companies with better management and strategic vision to perform better than their peers. Likewise, companies with outsized compensation plans or plans not tied to performance, essentially transfer value away from shareholders to individuals.

In addition, our active equity analysts have access to senior corporate management and, consequently, easy access to ESG information. Because analysts and portfolio managers are responsible for identifying material, relevant ESG considerations and applying them appropriately, these meetings are valuable sources of information.

Our Conclusion

If we:

- focus on past rather than future risks
- do not acknowledge the challenges of current ESG data
- fail to recognize the risks and opportunities presented by a changing world

Then no, the integration of ESG considerations will not help our investment outcomes.

However, when we:

- incorporate material and relevant ESG considerations that the market hasn't already priced in
- expertly and appropriately employ our expertise
- apply our ESG analyses to our investment mosaic

Then yes, we expect ESG integration to contribute to higher risk-adjusted returns over time.

Endnotes

1. Defined as excess return over the benchmark.