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Does ESG really affect performance?

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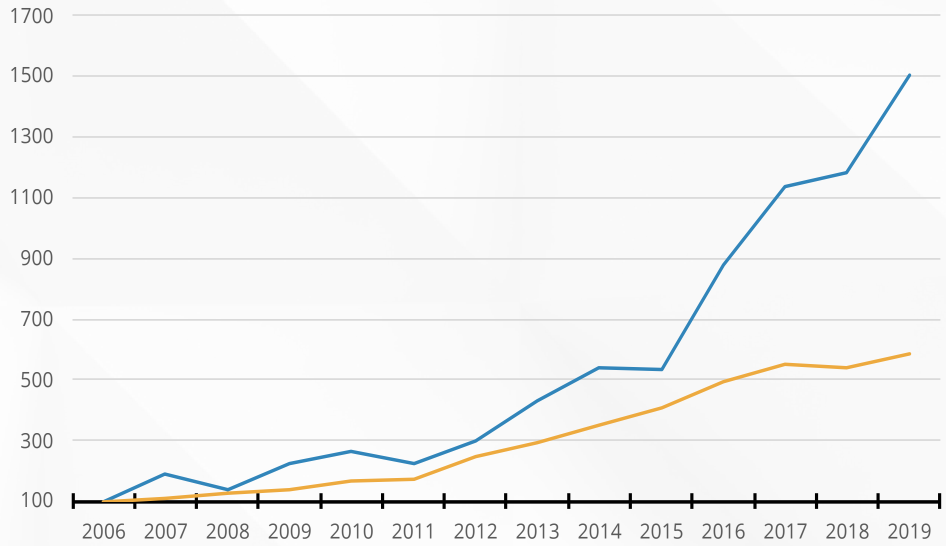
The commitment of the investment industry to ESG (Environmental, Social and Governance) and Responsible investment has been growing steadily in the past few years. However, recently it has become an unescapable theme. The average number of ESG\Responsible funds launched for sale in the UK per year has increased from 3 in the 1990s to 20 a year this decade. However, in the last 3 years alone the average number of ESG/Responsible fund launches rose considerably to 34 fund launches per year. This demand is also evident in the growth of assets under management.

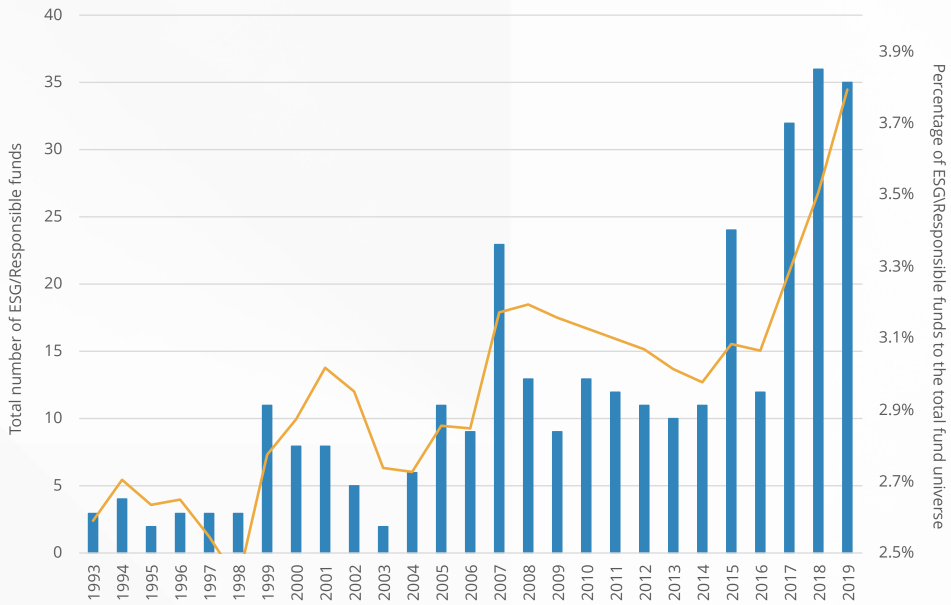
Figure 1: Assets under management growth excluding passives for funds focused on ESG/Responsible (blue) and the rest of the universe (orange).



Source: FE Analytics

The chart above shows a clear increase in the demand for ESG/Responsible solutions, where the size of assets under management for these starts to grow at an increasing rate compared the rest of the fund universe. Although in absolute terms the size of the ESG/Responsible universe is magnitudes smaller, as seen in figure 2, with respect to the total fund universe size. Less than 4% of funds are dedicated to providing exposure to either ESG or Responsible investment.

Figure 2: Number of ESG\Responsible fund launches excluding passives relative to the rest of the universe (right axis) and in total (left axis)



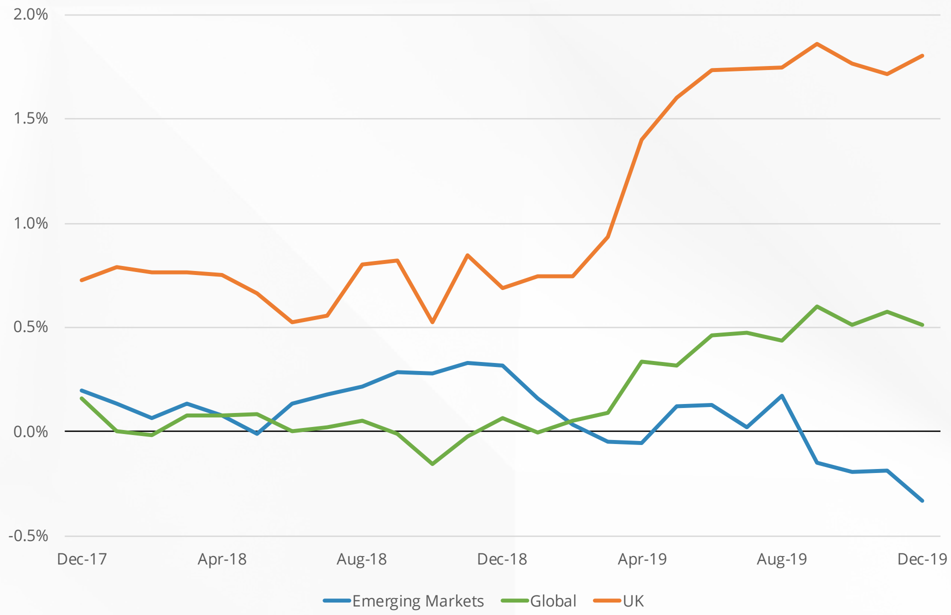
Source: FE Analytics

Recently, the research investigating links between ESG factors and stock performance has been revived as investment professionals are looking for a clearer understanding of the factors in play. Some would argue that when the investment universe is limited, like in the case of exclusion based methodologies, the result be manifested by a reduced performance over the longer term. The counter-argument would be that by focusing on the ESG factors, Governance in particular, an investor should avoid company "blow-ups", therefore achieving both positive performance over the longer term and a lower level of absolute risk.

In the following paragraphs we focus on the performance characteristics of ESG and Responsible mutual funds in the UK market relative to their peers. No differentiation has been made made based on the depth or method of ESG implementation used, nor whether the ESG mandate is included for strategic or altruistic reasons.

The chart below shows the average return of a 5 year investment in ESG\Responsible funds relative to the rest of the universe in the three main equity asset classes from December 2012 to December 2019. The chart can be interpreted as follows: if a 5 year investment into an ESG\Responsible UK fund peer group ended in December 2019 it would produce on average an annualised return of 1.8% greater than the same investment in a non ESG\Responsible fund. In this way, the success of a 5 year investment can be traced over time for each asset class considered.

Figure 3: Average annualised total return of a 5 year investment in ESG\Responsible funds relative to the rest of the universe



Source: FE Analytics

A common assumption is that any ESG\Responsible factor related performance benefit would probably be cancelled out by the cost of investment implementation. Analysis of the performance over long investment horizon reinforces this point. It shows that an ESG\Responsible focused investment would not cause a severe underperformance compared to a conventional fund management. We also note that ESG factor influence can be region specific, where the ESG factors would have a more pronounced effect. In some cases, like in UK peer group it may also result in a strong outperformance.

In summary, ESG\Responsible has either a strong or a minor effect on the outperformance. It is possible that with the increasing demand for training, as well as, competition driven cost cutting, the performance of these funds will continue to improve. Therefore, a practitioner in this space would observe an "ESG\Responsible time effect" where an increasing awareness of Responsible investment would lead to increasing complexity of ESG implementation and a reduction in the cost of investing resulting with positive increase in performance across this topic.

The theme of protection offered by ESG\Responsible funds is clearly highlighted when comparing average annual volatilities of a 5 year investment in these funds relative to their counter parts. On the chart below all negative values indicate less risk was taken by funds implementing ESG or Responsible funds compared to the funds which did not.

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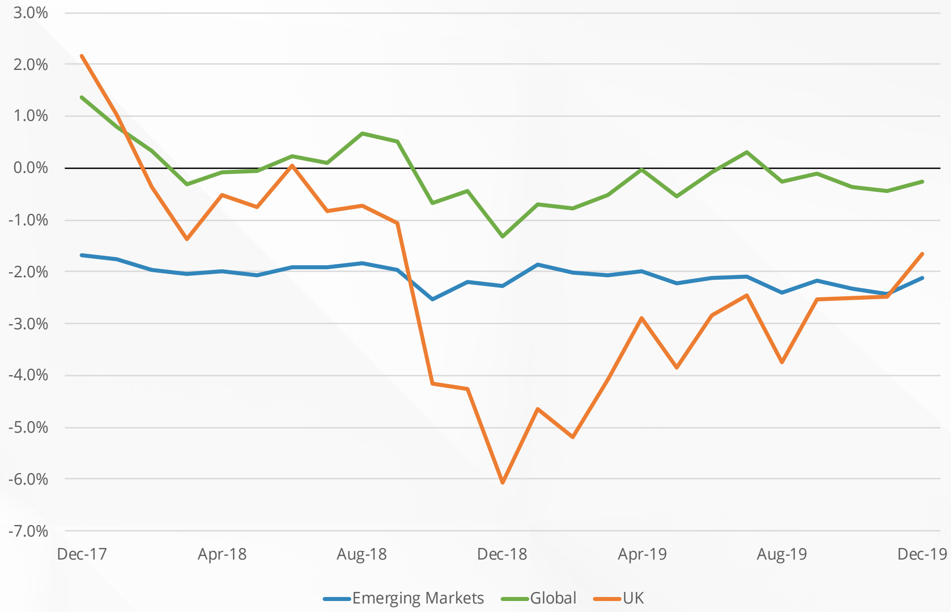
Figure 4: Average annualised volatility of a 5 year investment in ESG\Responsible funds relative to the rest of the universe



Source: FE Analytics

This result would suggest that despite the potential limitation of a fund's investment universe, investors are not exposed to extra levels of risk. On the contrary, it is shown here that funds focusing on ESG factors and responsible implementation have achieved reduced level of risk through their focus on sustainable and stable businesses.

In summary, we showed that ESG and Responsible investment can have a minimal, if any, disadvantageous impact on a fund's performance. In fact, the opposite was shown to be true, these factors can have a positive impact on performance, both in terms of absolute return and the overall risk taken during the investment period. Therefore, the enhanced risk-adjusted returns justify the growing interest into ESG from the financial benefit perspective. Furthermore, as ESG\Responsible investment evolves into a more defined investment strategy, its impact on performance will change over time.

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