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Funds Unite Do-Gooders and Quants

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Math geeks and altruists are forging unlikely alliances in the quest for better investment returns.

New funds are springing up that blend quantitative investing, using financial data and computer models, with socially responsible investing, a method of picking stocks based on a company's environmental, social and governance practices, known as ESG.

Quotient Investors LLC this year started a $10 million quant fund focused on ESG for the California Public Employees' Retirement System, or Calpers, the biggest U.S. public pension fund by assets. Auriel Capital Management LLP plans to launch an ESG-quant fund next year with seed money from ESG money manager Trillium Asset Management Corp. Quant fund Advanced Investment Partners LLC has seen its ESG portfolio expand to $50 million in assets from $10 million in the past year.

Both quant and ESG managers are seeking to bolster investors' faith. Quants have lagged behind other hedge-fund strategies for the past two years, according to Hedge Fund Research Inc. And ESG proponents have struggled to prove that investing in a responsible way actually improves returns over the long term.

"If we could find the connection, extract it, show it and then demonstrate it, we will change the market," said Matthew Patsky, chief executive of Boston-based Trillium, which oversees about $1 billion for individuals, endowments and some nonprofit groups like Amnesty International and Global Fund for Women.

The early adopters think of the ESG-quant combination as a way to set themselves apart from the pack. One big problem quant managers face is that they often all look at the same types of data and crowd into the same trades.

"This set of data gives a completely new insight into companies that quantitative managers have often not been able to get," said Andre Bertolotti, managing partner at New York-based Quotient Investors.

For Quotient, the strategy has proved successful. The firm's ESG-quant fund gained 9.4% in the first 10 months of this year, beating the 8.5% gain in the benchmark Russell 1000 index.

Jon Quigley, managing director at Advanced Investment in Florida, said the firm's ESG-quant fund is "by far the fastest growing strategy." Auriel Capital is targeting returns of 8% to 9% a year after fees.

The new funds provide a test for ESG investing. For decades, ESG investors have stuck to the belief that companies that pay attention to issues such as board diversity, product safety and access to clean water eventually would have an edge over rivals that don't.

But even as the methods evolved—from shunning "sin" stocks such as makers of tobacco, alcohol and weapons to a method of choosing stocks based on their ESG attributes, like low carbon footprints or strong corporate governance—returns often have been subpar.

Calpers has committed $500 million to ESG investing, mainly by avoiding stocks that rank low on the ESG scale. But the returns haven't been satisfactory, Calpers said.

Calpers was intrigued by the idea of combining quant and ESG strategies and agreed to allocate a small share of its money managed by Quotient to the new fund, Mr. Bertolotti said.

While the amounts are tiny relative to Calpers's $217 billion under management, the allocation was part of a broader plan by Calpers to incorporate ESG investing across all of its funds by the middle of next year.

"One of the biggest things on the radar in the coming year is to incorporate ESG across the board," referring to a more quantitative approach to integrate these factors, said Clark McKinley, a spokesman for Calpers.

The trend also has got the attention of big fund houses. At State Street Global Advisors, a team of analysts is making a renewed effort to gain more insight into quant-ESG strategies.

"Some initial findings are encouraging," said Chris McKnett, vice president of ESG investing at State Street, noting that companies with high ESG scores proved to be more resilient in late 2008 when markets fell apart.

Managers have been trying for some time to feed ESG factors into investment models, but the data weren't easy for quants to tap until recently.

Now, the data are more consistent, and the coverage area is broader and stretches back over a longer time frame. Mergers among ESG data providers also have helped consolidate and standardize the data. But the coverage still is relatively short term, making it hard for managers to go back in time to test results. Also, most of the data are updated annually, while quants typically use data that are updated more often.

Still, the information now "can dovetail fairly straightforwardly into quantitative shops like us," said Mr. Bertolotti of Quotient.

At Quotient, ESG factors are fed into a matrix of about 50 traditional financial measures such as market volatility and growth forecasts.

After dividing stocks into 13 sectors, Mr. Bertolotti found that stocks in industries like basic materials and utilities are more likely to move based on ESG attributes. In contrast, ESG factors don't seem to have a big impact on technology stocks, whose investors are more focused on companies' growth outlook.

Auriel tends to focus on only a few ESG factors for each industry. For example, Auriel sorts auto makers on indicators such as carbon emissions, energy efficiency, research and development, and global sourcing practices.

Other managers found ESG factors could help reduce volatility in their portfolios. Mr. Quigley, of Advanced Investment, said the share prices of companies that rank low on an ESG score card are 25% more volatile than high-scoring companies on average. But Mr. Quigley said they were unable to prove these factors result in outperformance.