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Investment Analysis

ESG, alpha and risk control can be combined in active portfolios

A broad market index, such as the Russell 1000, is a reference point from which to measure ESG exposure

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ACTIVELY MANAGED ESG EQUITY STRATEGIES

Since the United Nations Principles for Responsible Investment guidelines were issued in 2006, there has been a growing interest from institutional investors to put their funds to work toward meeting environmental, social and governance (ESG) goals. However, asset owners wishing to increase their exposure to sustainable investing face a challenge when considering their public equity portfolios: either target ESG characteristics and risk underperformance, or seek alpha with traditional equity strategies and leave sustainable investments for smaller, specialized mandates.

Here we outline a novel approach for an actively managed ESG strategy that starts by defining a target level for ESG exposure and then fully integrates ESG characteristics into the investment process. The outcome is a portfolio that seeks to deliver alpha with risk control versus a broad market index while providing the desired exposure to ESG characteristics.

BENCHMARKING ESG EXPOSURE

How much ESG exposure is enough? While some is better than none, the best approach is to have meaningful exposure to ESG. Since there is no minimum standard, Quotient Investors looked at the level of ESG exposure implied in some specialized sustainable benchmarks and compared position-weighted ESG scores between these benchmarks and a US market proxy (Russell 1000 or S&P 500). A key insight from this analysis was that the specialty benchmarks, rather than represent a separate asset class or pre-screened universe, represented instead a desired level of ESG exposure.

The distribution of ESG ranks in the Russell 1000 are fairly balanced between positive and negative ranked companies, as shown in Figure 1. In a range of -3 to +3, the mean rank is 0.3, close to the 0.0 rank expected in a Normal distribution. When the ESG rank distribution in the KLD Domini 400 and FTSE Large Cap US Sustainable indices are compared with the Russell 1000 distribution, some interesting differences appear. Both the Domini 400 and FTSE Large Cap US Sustainable benchmarks were created to offer exposure to sustainable and responsible compa-

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Specialized benchmarks provide a target ESG exposure above the market level

nies. When compared with the Russell 1000 index, both benchmarks show **fewer** holdings of lower-ranked ESG stocks, **greater** holdings of higher-ranked ESG stocks, and **higher** mean values. As investment managers, we consider these characteristics to be a quantifiable measure for portfolios aiming to offer ESG exposure. Hence, if a portfolio has a similar distribution of ESG ranks to the Domini 400 or FTSE LC US Sustainable benchmarks and a higher ESG mean value than the Russell 1000, such a portfolio will give investors a good exposure to ESG characteristics.

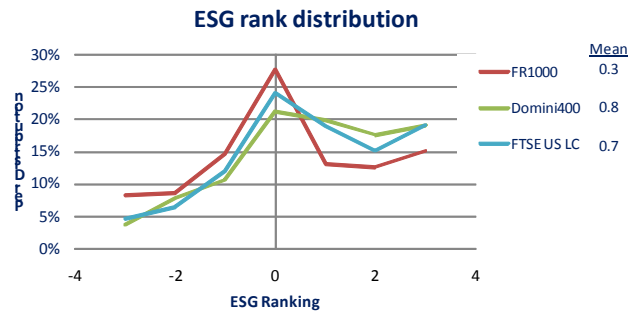


Figure 1

The approach is simple: if an actively managed strategy has the same ESG exposure as a specialized benchmark then the desired level of exposure has been reached. This approach removes the subjective quality of measuring ESG exposure and allows asset owners the ability to identify and assess the ESG characteristics in their portfolios.

IMPLEMENTATION OPTIONS

Until recently, the integration of ESG characteristics into active equity strategies has been hampered by a lack of a valuation framework that relates ESG to stock prices. Instead, the intuitive benefits of investing in ESG have centered on discussions of risk management and quality of a company's management. The initial approach in active strategies used screening methods to avoid investing in the "worst" ESG companies. Other implementation options have used ESG ranks in the following ways:

Negative Screening: This approach involves removing selected stocks from an investible universe. By not investing in the worst offenders, the investor favors neutral or positively ranked ESG stocks.

Positive Screening: This process aims to reward stocks that meet certain criteria by only investing in the higher ranked ESG stocks.

Selective Benchmarks: In this approach, investors select a specialized benchmark that has the desired ESG exposure and then select stocks within the benchmark in an effort to outperform.

Each of these implementations has drawbacks that have kept the push into ESG in check. Negative screening, for example, does not provide sufficient ESG exposure

Initial applications of ESG data consisted of simple screens

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since only selected stocks are dropped from the investible universe and the remaining stocks are not differentiated based on ESG exposure. Positive screening does provide a higher exposure to ESG but it eliminates too many stocks, creating sector imbalances and increasing tracking error in the portfolio while not directly providing alpha.

Full ESG integration is the goal set by many asset owners and the UN's PRI initiative

Finally, Selective Benchmarks provide a passive exposure to ESG but introduce a tracking error versus the broader equity market that has not been consistently rewarded by higher returns.

The best solution is to fully integrate ESG data into the investment process and this is the method recommended by the United Nations' PRI 2008 report. But this is also the most challenging because it requires valuing ESG characteristics from an investing perspective and combining this information with a manager's valuation process. Quotient Investors has developed an approach to fully integrate ESG characteristics into the investment strategy to help in stock selection.

FULL ESG INTEGRATION

Lack of formal valuation methods for ESG data has made full integration more challenging

How does an investor fully integrate ESG characteristics into an equity portfolio? This is a difficult question to answer because there is currently no valuation framework that can directly link stock prices with ESG characteristics. Since ESG characteristics are considered non-financial information, classic financial valuation theories cannot be applied. A different methodology is needed to integrate ESG data into the investment process and use ESG to help in stock selection.

We looked to answer the following question: "If a company is improving its ESG profile does its stock perform better than peers in its industry that do not have the same ESG policies?"

Prior studies on the effectiveness of ESG to pick stocks have shown mixed results. In particular, a survey by Russell Research of 45 research papers on ESG found an equal amount of positive and negative results with the bulk of the papers falling in the neutral category. More recently, some new research has focused on combining ESG with other valuation sources. For example, a study by Quantitative Services Group Inc. (QSG), found promising results in combining ESG, Value and Momentum scores into one strategy for picking stocks.

Industry by industry analysis of ESG data provides the best insights

Consistent with our approach of stock valuation within industries, we looked at historical ESG ranks to determine if investors have responded favorably to companies with better ESG ranks than their peers in an industry. ESG data from January 2005 to June 2009 was grouped into 56 industries representing the US market and each industry was evaluated over this period to determine if the

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Industry-level analysis is key for full ESG integration into our active equity strategy

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stock performance of higher-ranked ESG companies outperformed the lower ranked ESG companies. The information ratio was calculated for each industry portfolio, with positive values representing industries where higher ranked ESG companies had higher returns than lower ranked ESG companies. We found that at the industry level results were clearer than across the market as a whole. Surprisingly, we found that ESG exposure is not positively rewarded in all industries: we found 27 industries with positive response, 22 with negative and 7 with zero or missing data. A general finding of this study was that Consumer Cyclical industries, those facing the retail and discretionary market, did better than Energy companies.

The implications from our research were key for integrating ESG data into an active strategy. In industries with positive ESG response, ESG data added value on its own and enhanced the existing stock valuation model. In industries with negative ESG response, however, integration was less straight forward. In these industries, the stock of companies with good ESG characteristics underperformed stocks of companies with poor ESG characteristics so seeking a high ESG exposure come at the expense of alpha. A trade-off needs to be considered between ESG and alpha, and a successful combination will optimize the outcome, preserving as much ESG exposure as possible while still providing alpha.

CONCLUSION

The goal of providing ESG exposure, alpha and risk control in actively managed equity portfolios can be achieved by fully integrating ESG data into the investment process. On one hand, ESG data provide new valuation insights from supplemental company information beyond the common financial and trading data. On the other hand, ESG characteristics allow asset owners to measure and assess the deployment of their funds towards meeting sustainable investment goals.

Asset owners can retain their current equity benchmarks for asset allocation and still obtain ESG exposure. This avoids the introduction of new, specialized benchmarks that may not have the risk/return trade-off sought in the asset allocation process.

Our approach consists of taking an industry-by-industry view of the market, and integrating ESG into our current valuation model. ESG ranks can be used as an additional source of alpha in some industries while in others ESG exposure is a penalty that must be overcome by compelling traditional valuations. A portfolio built with this approach can target a desired risk/return level versus a mainstream equity benchmark while at the same time provide the desired exposure to ESG characteristics.