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Search for ESG alpha continues

But experts still think using ESG criteria key for long-term results

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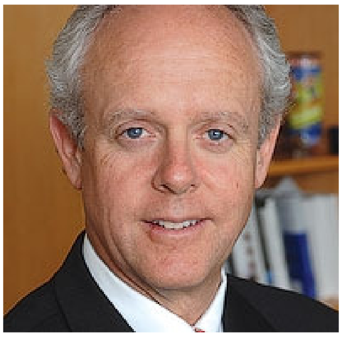

Lawrence E. Kochard: "The challenge is finding managers who are good investors. They have to firstly be good investors in addition to being capable of effecting (corporate governance) changes in a non-hostile way."

There is some evidence that ESG alpha does exist in certain pockets of portfolio management, but whether managers can consistently deliver such alpha remains to be proved, according to recent research papers.

"In isolation, (environmental, social and corporate governance factors) are not going to dramatically improve returns," said Andrew Howard, London-based head of the GS Sustain research team within the Global Research division of Goldman Sachs Group Inc. "But if you combine (the data on) how these signals can have a significant effect on financial results with other factors on how the company's financial results are achieved, then yes, I think ESG can be an important element in long-term outperformance."

The GS Sustain focus list is Goldman Sach's concentrated global equity strategy that uses ESG factors along with other drivers to obtain outperformance.

"ESG is an ingredient in the recipe to identify future leaders" in a particular sector or market, Mr. Howard said. "If the sole selection criteria is ESG, then the strategy is not going to generate outperformance."

However, opinions vary widely when it comes to isolating that ingredient and replicating the recipe. Chris McKnett, vice president and head of ESG Investing at State Street Global Advisors based in Boston, said while it is accepted that ESG factors can add alpha, "there's still a need for proof."

Much of the available research has not been able "to conclusively establish a link between a company's ESG profile and stock price," according to a recent State Street paper titled "Sustainable Investing: Positioning for Long-Term Success," which was co-authored by Mr. McKnett. But as the quantity and quality of ESG data improve, Mr. McKnett believes the understanding of the link between ESG and performance can only strengthen. State Street's own research shows that share price might be correlated to ESG factors, but the degree of correlation varies across different countries and sectors. In additional research due to be published early this year, there is some preliminary evidence that companies with better ESG ratings offered some downside protection during the financial crisis, Mr. McKnett added. "These companies offered more stability during the worst period of the bear market in 2008," he said.

Good governance, for example, may offer more downside protection by better aligning investor interest with that of the company's.

Lawrence E. Kochard, new CEO of the University of Virginia Investment Management Co. — which manages the $4.6 endowment fund, said he sees opportunities to unlock company value through collaborative, active engagement. The university endowment portfolio does include a portion dedicated to active engagement in which money managers work with public companies to exploit inefficiencies that will maximize value. Mr. Kochard, who started as CEO on Jan. 1, declined to specify the amount and the managers of the endowment's strategy. (He was previously CIO at Georgetown University's $1 billion endowment, where he also had invested in active engagement strategies.)

"This is an approach in which I have a lot of conviction," Mr. Kochard said. "The challenge is finding managers who are good investors. They have to firstly be good investors in addition to being capable of effecting (corporate governance) changes in a non-hostile way."

Oil spill spotlights role of ESG

Separately, the Gulf oil spill in 2010 also helped to highlight the role of ESG factors in share prices. Following the largest oil spill in U.S. history, BP PLC shares lost about 55% of their value to close at £2.96 per share in London trading on June 25.

Avoiding BP because of ESG concerns helped managers such as London-based F&C Asset Management PLC outperform for the year. The firm's Stewardship International fund returned 16.51% compared with a 15.87% gain of the MSCI World index.

“BP definitely drove home the importance of looking at companies through (an) ESG lens,” said Karina Litvack, director and head of governance and sustainable investments at F&C based in London.

Elsewhere, ESG equity strategies received mixed reviews from clients and consultants in their ability to consistently outperform broader non-ESG strategies. While the evidence for ESG alpha remains unclear, ESG strategies nevertheless are attracting new asset inflows at a record pace, according to data from industry sources globally. “A lot more pension funds are starting on that journey to integrate ESG factors into the investment process,” said Emma Hunt, senior investment consultant in the sustainable investment team at Towers Watson & Co. in London.

Mr. McKnett said: “I think where we're at right now (in our understanding of ESG) is the point in which we need to put down the telescope and take up the microscope.” SSgA had about $86 billion in ESG assets under management at year-end 2009, the most recent data available.

A separate paper published last year took a different path and examined how environmental factors affected corporate bond ratings. (Most research papers on the subject focus on equity markets.) In “Corporate Environmental Management and Credit Risk,” authors Rob Bauer and Daniel Hann concluded “environmental management practices have become increasingly relevant to bond investors over the recent decade.”

Mr. Bauer is professor of finance at Maastricht University's School of Business and Economics and Mr. Hann is a Ph.D. researcher at the same university based in Maastricht, Netherlands. Mr. Bauer is also formerly head of research for what is now APG Asset Management, Heerlen, Netherlands.

By analyzing information on the environmental profile of 582 U.S. public companies and their associated cost of debt, the authors concluded that companies with weak environmental performance ratings pay as much as 64 basis points more than their peers for cost of capital. “Firms that engage in environmental misconduct can incur costly penalties and evoke strong negative reactions from both financial and non-financial stakeholders, each of which affects their default risk and thus impairs the value of their fixed-income securities,” according to the paper, which was published by the European Center for Corporate Engagement at Maastricht University, Maastricht, Netherlands. The paper won the 2010 Moskowitz Prize, which is awarded by the Social Investment Forum and recognizes outstanding research in socially responsible investing.

Similar returns

Even if ESG alpha exists, managers — even those running specialist strategies — might not be delivering it, according to other research papers. Several have statistically shown that sustainable investment funds basically mirror the returns of non-sustainable funds at a higher cost to investors. Furthermore, a research paper published last year concluded that many SRI funds aren't any more “sustainable” than non-SRI funds.

A study conducted by the University of Zurich that sifted through data from RepRisk AG, which gathers reputational risk information on about 16,000 companies globally, found no statistically significant differences between investment funds that are labeled as sustainable compared with those that weren't. Furthermore, when examining what was in the respective portfolios, researchers found the holdings were very similar.

“Many (money managers of the sustainable funds) are trying to beat the same benchmarks” as those of mainstream managers, and they are unwilling to take the additional risk of straying from those benchmarks, said Philipp Aeby, CEO of RepRisk based in Zurich. “Investors don't want the same thing for a higher price.”

Rob Lake, head of sustainability and governance at APG Asset Management said while different pension funds might reach different conclusions about the evidence for ESG alpha, he believes the factors themselves are “financially relevant enough so that if ignored, investors run the risk of missing something very important in financial terms.”

Mr. Lake added: “Have ESG factors improved performance of the overall portfolio? I don't think it's possible to answer that question because there are just so many moving parts.”