



ESG integration: value, growth and momentum

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This study provides finer-grained results on the financial effectiveness of ESG integration for mainstream active investment styles. We account for firm size, industry and country effects within ESG scores and introduce the concept of ESG risk materiality. Empirical evidence shows that US and European investors can raise their portfolio's ESG level and increase risk-adjusted performance at the same time. Therefore, we add to the growing demand for sustainable products in the traditional investment industry and overcome the notion of ESG integration being a burden to traditional investment strategies.

Introduction

The status of sustainability issues for corporate management and the investment management industry is ever increasing. While only 20% of S&P 500 listed companies published sustainability reports in 2011, the number has increased to 81% as we entered in 2016 (Coppola 2016). The increased awareness to account for the sustainability performance of a firm partially rests on the empirical evidence that the relation between ESG—the three central factors for measuring the sustainability of an investment: environmental, social and governance—and corporate financial performance is largely positive and stable over time, as documented in a recent meta-analysis of over 2000 empirical studies by Friede et al. (2015). Their study concludes that “the orientation toward long-term responsible investing should be important for all kinds of rational investors...[and] requires a detailed and profound understanding of how to integrate ESG criteria into investment processes in order to harvest the full potential of value-enhancing ESG factors.” (Friede et al. 2015, p. 227). However, they also recognize the fact that both the aggregation of ESG sub-criteria and the universal application across countries and industries are difficult and not likely to result in a clear picture. In this fashion, Warren Buffet—arguably one of the most prominent and successful fundamental value investors of our time—supports this notion by stating that there is no easy way to attaining a sustainable competitive advantage; thus, businesses must invest in the three key components of profitability: its people, communities and the environment (Arbex 2012).

Hanson and Fraser (2013) state that non-financial issues including governance, corporate culture and employee satisfaction play an integral part for fundamental investors to determine the value of a business and derive an investment decision. In their view, the ESG framework might be new; however, the underlying concept and issues addressed are well known to business value investors. Yet, the debate on sustainability in investment management often seems decoupled from traditional investment practices.

van Duuren et al. (2016) document that the practical implementation of ESG criteria is generally not on the basis of a distinct investment strategy, as most academic studies implicitly assume in their setup, but rather acts as an add-on for conventional fund managers by adopting criteria of responsible investing to their existing investment process. Yet, the expectations from sustainable investment (short- vs. long-term returns, risk reduction, diversification, etc.), the strategic implementation (screening, best-in-class, activism, engagement, etc.) and the factors identified as relevant (social, environmental and corporate governance) vary strongly. In particular,




US investment managers are more skeptical about the benefits of sustainable investment with respect to the financial performance compared to European or UK managers and consequently less determined to incorporate ESG criteria in their investment process. Thereon, the consensus between fundamental (value) investors and ESG investors is prevalent in Europe and the UK with respect to: (1) a low rebalancing frequency of portfolios, (2) preference for individual firm over industry analysis, (3) long-term investment horizon and (4) an active management understanding of their investment approach in terms of generating excess return over passive benchmarks (van Duuren et al. 2016).

We address the impact of ESG integration on value, growth and momentum strategies. For this purpose, we rely on multidimensional passive screens in order to identify value, growth and momentum stocks. On the other hand, we categorize stocks along their sustainability characteristics by means of ESG ratings and separately account for their degree of environmental, social and corporate governance performance. We closely follow the methodology by Asness et al. (2013), who conduct an analysis of value and momentum returns across alternative asset classes. Besides a close alignment of the theoretical underpinnings of value and sustainable investment, which will be discussed in more detail in the course of this paper, both styles also show commonalities in their implementation through screening procedures and more recently through shareholder activism. Furthermore, the term sustainable—meaning to be able to continue over a long period of time—is a central concept for value investors with regard to businesses' long-term success. Thereon, we examine this proclaimed entanglement in more detail.

As for the case of an alignment between momentum and ESG investing, we build on the demand-driven growth of sustainable investments in the asset management industry. According to a report by Morgan Stanley (2016), the dominant drivers for an adoption of sustainable investment practices on behalf of asset management firms are: client demand (29%), financial return potential (15%) and personal values of leadership (10%). Segmenting client demand reveals the driving forces to be millennials with 81% of respondents being interested in ESG investing and 76% of women, whereas slightly over 60% of the financial advisors express “little or no interest” in ESG investing (Hale 2016). Based on this current gap in demand and supply, we can expect stark buying pressure from institutional investors going forward as to meet their clients demand. As such, the current impressive growth figures for sustainable products may just be the beginning of a longer journey. Consequently, if we are currently only at the beginning of this sustainable growth path, then highly rated ESG stocks may still show low levels of price-return momentum and consequently make an alignment more challenging for momentum investors. Hence, referring back to the findings by van Duuren et al. (2016) on the higher adoption rate of ESG criteria among European compared to US investors, this should be reflected in higher average levels of aggregated sustainability ratings of momentum portfolios in the case of the European market.

Conclusion

Evidence provided in this study, on the impact of ESG integration on mainstream active investment styles, yields valuable insights for both investors, portfolio managers and firms alike. In fact, the corporate relevance is not to be neglected. Businesses in general and in particular firms with the aim of improving their ESG performance seek long-term shareholders, such as value investors, given relatively high short-term sustainability innovation costs vis-à-vis long-term benefits (Whelan and Fink 2016). Thereon, understanding the impact of a firm's ESG performance on valuation metrics commonly considered by value-based investors can have a material impact on the shareholder structure. At the same time, the increased attention by private and institutional investors toward ESG criteria is likely to result in a momentum effect for stocks fulfilling a high ESG standard. However, based on the documented negative relation between value and momentum stocks (Asness et al. 2013), the beneficial inclusion of ESG criteria should be mutually exclusive to either value or momentum investors.



This paper provides empirical evidence on the effect of integrating ESG information into mainstream active investment styles. We build on a US and European sample and consider three types of investment styles: value, growth and momentum. Against the common notion, we show that the inclusion of ESG information does not inevitably result in a performance drag. After adjusting ESG ratings for size and industry/ country effects, portfolios demonstrate higher ESG ratings and improved risk-adjusted return characteristics. Besides, we introduce an approach to systematically derive ESG risk materiality and report favorable portfolio performance for an integration thereof.

Overall, findings show a consistent reduction in portfolio risk from the inclusion of ESG information in the portfolio formation, which supports the risk mitigation hypothesis for the case of ESG-based investment management. Previous discussions on the risk mitigation hypothesis in the field of corporate social performance (CSP) have provided evidence in the same direction including higher equity cost of capital for low CSP firms (Heinkel et al. 2001), a decrease in idiosyncratic risk for equities alongside an increase in CSP (Lee and Faff 2009), a decrease in the cost of debt (Goss and Roberts 2011) and lower capital constraints (Cheng et al. 2014). We identify on average higher ESG ratings for firms with value characteristics, whereas growth and momentum stocks show on average lower ESG ratings. We argue that differences between the US and European sample are due to a higher adoption rate of ESG in Europe, which leads to such information being more efficiently priced in the market. As such, US value investors can benefit most from integrating ESG information, both in terms of decreasing risk and realizing return potential.

Full Paper and References are available here:

<https://link.springer.com/journal/41260/onlineFirst>



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