

PCA Market Commentary

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The Continued Rise of ESG

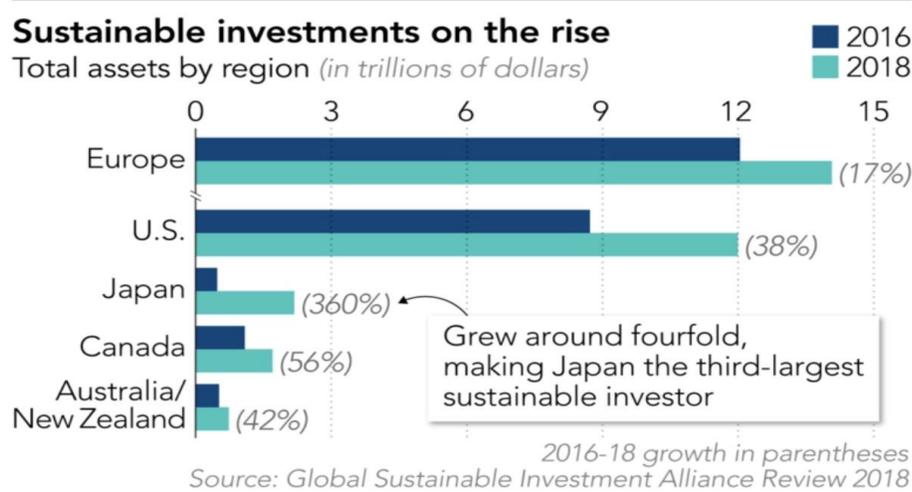
Throughout the investment management industry, an increasingly important topic centers upon ESG, an acronym for Environmental, Social, and Governance impact of corporate policy. Managers of public and private organizations consider the effect of decisions upon broad stakeholders, above and beyond shareholders. This frames their decision process and often includes the firm's impact on the environment and employee welfare.

There are many intangible aspects to incorporating ESG philosophies into investing, stemming from ESG's predecessor, commonly termed as SRI. Socially responsible investing was often implemented by putting exclusionary lenses on a portfolio, by not investing in companies associated with casinos, fossil energy producers, gun manufacturers, and alcohol companies. While this simple and transparent strategy quickly gained popularity, there was never a clear link between performance and such filters. Investors soured on many of these SRI strategies due to their under-performance relative to more traditional counterparts.

ESG, on the other hand, expands the focuses beyond the 'negatives,' but also assigns credit to companies

that demonstrate a clear strategy for enhancing societal benefit. For example, this may include adoption of plans for carbon neutrality, gender parity, and expanded parental leave policy. In addition, governance factors are reshaping management structures to reduce opportunities for self-dealing. These enhancements may include separation of the CEO and Chairman role, avoiding staggered boards, and aligning management compensation with performance.

While the rise of ESG has heralded a new focus for investment managers, as exemplified by the heavy AUM flows moving into such products, it remains unclear whether this investment overlay will be a consistent driver of out-performance. As of year-end 2018, ESG funds in the United States represent around \$12 Trillion in assets, up from ~\$9 trillion in 2016, a growth rate of 38%. In contrast, flows into traditionally actively traded equities have been negative over the same time horizon. The numbers in parenthesis in the chart below denote the growth of ESG Assets Under Management from 2016 to 2018, in each of the respective geographic regions¹.



Past performance is not an indication of future results.

This leads to one of the obvious problems of ESG & SRI investing. It seems that some number of managers are opening ESG funds to harvest a portion of a fast-growing asset class, without having clear conviction within their strategy, nor a complete understanding of the impact upon their investments.

There is a large body of literature that supports the notion that ESG brings no additional benefits to a diversified investments process. Also, there is an equally large body of literature that supports ESG's accretive tendencies. Most of us tend to cheer for the protagonist in movies, where good triumph's over evil. In the back of our minds, we also want the hero to have a secure financial future with an investment portfolio that delivers healthy returns across market regimes.

Recently, the Financial Analyst Journal (FAJ) published research showing that measures of ESG could be drivers of investment out-performance within context of global equity selection. Interestingly, the researcher found that the (G)overnance component of ESG was about twice as relevant as the (E)nvironmental and (S)ocial components. Also, the overall ESG composite score was also deemed to be a statistically significant driver of performance, where each component was accretive.

What was striking about the result was that the researcher ran a horse race between E, S, & G components against more traditional financial metrics such as valuation and price momentum. While these traditional factors remain significant drivers of performance, the ESG composite score and the Governance component, individually were also strong predictors of company success, and a source of alpha.

Although these results are encouraging, we should be mindful of the limitations of the research. First, the study covers a brief period and doesn't span a full market cycle (2013-2017). Even when a study spans several market cycles, there is no guarantee that results are robust. Also, correlated factors such as investment flow can mask relevant factors within a given study. In this case, we wonder if demand imbalance is pushing pricing upwards for ESG related assets, and concurrently buoying performance.

Nonetheless, the paper suggests that an innovative implementation of ESG, and one which makes intuitive and economic sense, may represent the foundation for investing in the coming decade. While still in its infancy, we are optimistic about the possibilities to use a growing body of environmental, social, and governance data to improve our investment decision process.

Percentage Performance as of 10/25/2019

		Month to Date	Quarter to Date	Year to Date
SPY	SPDR S&P 500 ETF Trust	1.52	1.21	21.86
USMV	iShares Edge MSCI Min Vol USA ETF	-0.28	-0.51	23.40
IEFA	iShares Core MSCI EAFE ETF	2.85	2.90	16.55
VMBS	Vanguard Mortgage-Backed Securities ETF	0.10	-0.03	5.45
HYG	iShares iBoxx \$ High Yield Corporate Bond ETF	0.40	0.58	11.97
IEF	iShares 7-10 Year Treasury Bond ETF	-0.65	-0.43	9.12
TIPX	SPDR Bloomberg Barclays 1-10 Year TIPS ETF	-0.20	0.16	5.93
BSV	Vanguard Short-Term Bond ETF	0.17	0.23	4.67
IAU	iShares Gold Trust	-1.98	1.91	16.92
SUSA	iShares MSCI USA ESG Select ETF	1.74	0.66	22.16
SUSL	iShares ESG MSCI USA Leaders ETF	1.19	0.74	
ESGS	Columbia Sustainable U.S. Equity Income ETF	3.00	2.00	21.56
USSG	Xtrackers MSCI USA ESG Leaders Equity ETF	1.31	0.77	
NULC	NuShares ETF Trust Nuveen ESG Large-Cap ETF	1.84	1.21	
NULG	Nuveen ESG Large-Cap Growth ETF	1.79	1.39	28.35
NUSC	Nuveen ESG Small-Cap ETF	0.90	1.16	19.73
ESGD	iShares ESG MSCI EAFE ETF	2.86	3.06	17.32
EASG	Xtrackers MSCI EAFE ESG Leaders Equity ETF	3.29	3.13	18.37
ESGN	Columbia Sustainable International Equity Income ETF	3.31	3.56	12.26
ESGE	iShares ESG MSCI EM ETF	2.89	3.97	11.15
ORG	Organics ETF	-4.98	-4.61	-1.25
FAN	First Trust Global Wind Energy ETF	1.08	2.71	20.21
TBLU	Tortoise Water Fund	7.04	5.73	30.10
PHO	Invesco Water Resources ETF	1.46	0.38	30.69
SUSB	iShares ESG 1-5 Year USD Corporate Bond ETF	0.27	0.34	6.49
BGRN	iShares Global Green Bond ETF	-0.86	-0.73	9.95
GRNB	VanEck Vectors Green Bond ETF	0.01	0.14	5.32

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Sources

¹<https://www.ussif.org/files/US%20SIF%20Trends%20Report%202018%20Release.pdf>