

# The impact of ESG on passive management performance

Investors have a number of reasons for integrating Environmental, Social and Governance (ESG) factors into their portfolios. Some are motivated by a desire to be more responsible investors. While others believe it could help to enhance the performance of their portfolio.

There have been sound arguments for positive benefits of incorporating ESG factors as it allows investors to avoid, for example, risks associated with climate change or poor governance.

These characteristics also help investors to weight their portfolios in favour of higher quality stocks, which have been shown to perform better over time than less well-run companies.

But while the possibility of a relationship between a high ESG score and better performance sounds plausible, unless there is data to support this thesis, it remains a theory rather than an empirical fact.



Amundi recently published **“The alpha and beta of ESG investing”** Discussion Paper to bring new insight to the topic, with three focus on active, passive and factor investments.

For more information, please consult [Amundi Research Center](#)

## Data quality: the key for ESG investing analysis

It has been hard, until now, to ascertain if there is a relationship between ESG factors and performance as it has been difficult to find information which is sufficiently robust.

**For an analysis of the relationship between ESG and performance to be statistically significant it requires a high-quality, consistent dataset.**

The data has long been inconsistent because analysis of these characteristics is relatively new and some metrics are not clearly defined, making interpretation a subjective process.

But **the amount and quality of data has improved dramatically over the last five years.**

Amundi can address these data quality issues because its long history of responsible asset management gives it a greater awareness of the relationship for a particular ESG risk at a company and its long-term financial consequences.

That involves giving more weight in the rating process to those issues which will be associated with a higher level of ESG risk sector per sector.

For example, managing carbon emissions will be a key concern for a utility company while

governance issues will be at the forefront of the ESG analysis of a bank.

**Amundi has used this process to build data going back to 2010, which covers 5,500 global companies. This research awards a mark for each individual ESG characteristic, which is then combined to give a composite score.**

Analysing this information showed that, between 2010 / 2013, tilting a portfolio towards stocks with a high ESG rating had a slightly negative impact on performance, whatever the region. ■

## Positive relationship between ESG factors and performance

In contrast to the period 2010 / 2013, **ESG factors were a source of outperformance in 2014 / 2017 in Europe and North America.**

For example, if an investor had bought the top quintile ESG stocks and sold the bottom quintile, they would have generated an annualised

return of 3.3% in North America and 6.6% in the Eurozone during this period. But between 2010 / 2013, the respective underperformance would have been -2.7% and -1.2%.

The data also showed the environmental factor was most responsible for outperformance in North America and the governance characteristic performed the strongest in the Eurozone.

**In general, ESG characteristics were a greater contributor to outperformance in the Eurozone than in the US.**

The shift away from a negative contribution to performance in 2010 / 2013 towards a positive one in 2014 / 2017 raises some interesting questions: is this performance driven by investors recognising that ESG characteristics are a way of choosing quality stocks?

Annualized excess return of index portfolios with ESG tilt (Global Dev Market universe)



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Or is it driven by the increased popularity of stocks with a high ESG score?

The analysis shows ESG has become a risk factor, particularly in Europe. In other words, those companies with high ESG score tend to

also be characterised as ‘high quality’ stocks. Over the long-run, these stocks tend to deliver excess returns.

At the same time, there has been increased allocation of capital in recent years to equities

with a high ESG score so this could also help to explain the strong performance of these stocks. ■

## Integrating ESG into a passive portfolio ...

With the evidence now showing a positive relationship between a high ESG score and performance, this will provide additional incentive for investors to integrate these factors into their portfolios.

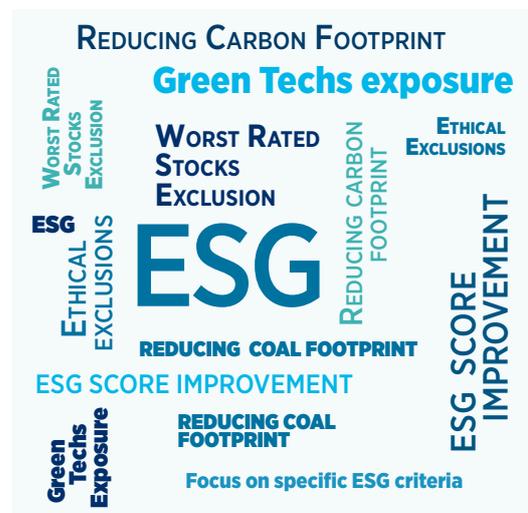
While investors have often preferred an active approach as they believe it is better at selecting these investment characteristics, research from Amundi shows a passive approach can be just as effective.

There are two options available to investors. They can either buy a product which tracks an index that includes ESG factors. Or they can ask their to integrate ESG when replicating a standard index.

In other words, the index manager will tilt the portfolio towards a specific ESG outcome. This allows the client to take a bespoke approach to these factors.

For example, it could exclude certain stocks to reflect the investor’s stated philosophy, when replicating the index.

Or it could have a more complex objective such as improving the overall ESG score while also reducing the carbon footprint of the portfolio and improving the overall exposure to green technologies for instance. ■



## ... implies navigating tracking error

Investors need to be aware that the more complex they make their requirements, the greater the tracking error will be. If the goal of the passive portfolio is to match the performance of a particular index, then investors will want to match the benchmark as closely as possible.

It is, however, possible to achieve a significant improvement in the ESG characteristics of a passive portfolio, including improving overall scores, reducing carbon footprint and increasing access to green technologies with limited additional budget of tracking error.

Some investors are willing to take on this difference in performance because they believe, for example, carbon risk is not accurately reflected in current share prices. And others might have to take this position because of the demands of their members or investment committees. ■

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