A Sustainable Strategy for Sustainable Investing

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The hottest dot in asset management right now is not private equity or factor investing; it’s ESG. ESG investing—investing that takes into consideration the environmental, societal, and internal governance impact of an investment—goes by many names: sustainable investing, impact investing, and socially responsible investing to name just three. It rests on two assumptions: first, that an enterprise can profit and grow by advancing the state of the environment, the welfare of all its stakeholders, and the effectiveness of its corporate governance; and second, that the stock market will reward such enterprises.

Lazard has employed ESG in fundamental security analysis over the last two decades and has steadily refined and extended its research on the topic. Over the course of this research, the firm has adapted a flexible ESG approach to its quantitative methodologies. Applied across the broad investment universe, the approach aims for an ESG-optimized portfolio with an attractive risk-adjusted return profile, and it can work equally in constructing optimized portfolios calibrated to client-specified ESG exposures. This paper reviews the principal features of the Global Equity ESG Advantage process and how it tackles the challenge of systematizing ESG data that can vary widely by company size, geography, and data source.
The ESG Phenomenon

According to Matthew Welch, President of the Sustainability Accounting Standards Board,1 $81 trillion in assets, about half the global total under management, adhere to the UN’s “Principles of Responsible Investment” and pledge to “promote ESG issues and incorporate them into investment analysis and decision-making processes.”2 Narrowing the focus to funds specifically dedicated to sustainable investing spotlights the rapidly intensifying interest in the theme. They have grown at better than 50% per annum since 2013, from $4½ billion to nearly $36 billion (Exhibit 1). Among the rising generation of investors, millennials aged 18 to 32, 86% have expressed interest in “… the practice of making investments in companies or funds which aim to achieve market-rate financial returns while pursuing positive social and/or environmental impact.”3 If, then, the reported figures are accurate, ESG may well have such an influence on equity valuation and performance that even unconcerned investors can ill afford to ignore it.

Black/White vs. Total Spectrum

To date, most concerned investors have approached ESG from one of two directions: exclusion or integration. Exclusion eliminates ESG laggards from its investable universe, according to a chosen standard. It is arguably the most transparent form of ESG investing and probably the easiest to work with, which may explain why it is the most common ESG methodology, allocating more than 70% of the ESG assets under management.4 It works best for building portfolios that conform to desired moral or ideological criteria—portfolios that exclude tobacco marketers, for example, or that include only companies that meet a given level of board diversity—but applied rigorously, it can constrict the investable universe and limit returns. Loosely applied, it can lead to portfolios that differ from conventional index funds and ETFs in name only.

In bridging the gap between narrow constraint and excessive latitude, integration takes a more holistic approach—it does not eliminate any stock from consideration ex ante—and changes the nature of the ESG portfolio construction from a qualitative binary screen to a quantitative risk analysis. By crunching the relevant numbers, it might seek to derive a portfolio of companies equipped to cope with the threat of climate change, a portfolio whose assets have little exposure to regulatory impairment, or a broad portfolio with generally favorable ESG characteristics. The challenge in integration, which the paper addresses, lies in determining the relevant metrics and verifying their accuracy.

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Algorithm Architecture

Lazard employs an integrated approach to constructing ESG portfolios that sets out methodically to optimize the tradeoff between stocks that have a strong or improving ESG performance and a favorable risk-adjusted return outlook. The process, which resembles taking a building apart and putting it back together brick by brick so that it looks the same even though something about it has changed, targets two simultaneous objectives: to gain exposure to businesses actively embracing and advancing an ESG agenda, and to attain an annualized risk-adjusted return superior to the relevant non-ESG benchmark over a full investment cycle. The process builds an optimal portfolio based on research which identifies characteristics associated with long-term equity outperformance. As in architectural construction, portfolio construction proceeds from framework to brickwork. The standard economic sectors serve as the framework. The model that determines their relative weights informs the composition of the 157 industry and sub-industry groupings that make up the economic sectors. These in turn drive individual stock selection.
The algorithms operate in a single direction; the output of the industry model cannot affect the composition of the economic sectors. ESG ratings function as an input to the stock model. Therefore, they cannot, and should not, influence sector or industry decisions. At those higher levels, the valuation metrics of the ESG and non-ESG quantitative strategies will closely resemble one another (Exhibit 2).

This more nuanced approach does not, at the outset, screen out any stock, seeking instead to access the full opportunity set. It blends its ESG ratings with a projection of risk-adjusted returns for every name in its coverage universe. The portfolio blueprints typically hold the variance from each sector weighting in the benchmark index to less than 2%. The restriction in turn limits deviation from the weights accorded to each of the industry groupings covered by the index. It also means that, although clients may choose to screen out specific industries from their own portfolios, industries like oil, armaments, and tobacco, will retain a weight in a broad ESG portfolio similar to the weight in a non-ESG portfolio.

The ESG in the Brickwork

Only at the individual stock level will the portfolio’s composition differ in appreciable degree from the risk-adjusted return portfolio optimized without ESG ratings. (The reassembled building may look the same, but it can have different bricks.) The most recent versions of the ESG blueprints covers 95% of the investment universe, screening out only the bottom 5% by ESG rank in every industry—those companies that have notably poor records or have simply not disclosed their record at all. From there, the process sorts each industry into two groups: the top 50% by ESG rank, designated as “Leaders,” and the next 45%, designated as “Sustainers.”

Holding overall portfolio weights constant, ESG algorithms select stocks among the Leaders in each industry. If the sort cannot identify enough stocks with projected above-benchmark risk-adjusted returns to measure up to the specified industry weight, the portfolio makes up the shortfall from among the Sustainers. In practice, about 85% of the names in the Global Equity ESG Advantage portfolio come from the Leader lists and the balance from the Sustainers.

As of 31 December 2018

Investment characteristics are based upon a portfolio that represents the proposed investment for a fully discretionary account.

Source: Lazard, MSCI
The ESG rank points more often toward resizing than outright elimination (same bricks, different sizes). Two stocks with equal weights in the non-ESG portfolio might tilt to 70/30, say, in one direction or the other after factoring in their ESG rankings. Bear in mind, too, that the model aims to come up with a portfolio optimized for risk-adjusted return as well as ESG. It may accord one stock a greater weight than another, despite a lower ESG ranking, if its projected risk-adjusted return characteristics score sufficiently better. So the process can build a portfolio that differs only modestly from its benchmark weightings but substantially in the stock-by-stock composition of its sectors (Exhibit 3).

The Global Equity ESG Advantage strategy is generally concentrated to a far greater extent than the benchmark—among the Leaders by design. The relative composition of both the portfolio and the benchmark will of course vary over time, but the strategic architecture of closely aligned sector weights and ESG overweights should remain constant. Currently, the top 10 holdings by cap weight in Lazard’s ESG Quantitative Advantage portfolio account for three-quarters of the total in 10 of the 11 benchmark economic sectors and better than 90% in seven of the 11. By way of comparison, the top 10 holdings in the sectors of the MSCI World Index average 43% the total sector weight, with the greatest concentration occurring in communication services at 71%.

Profile of a Top-10 ESG Holding
Galp Energia of Portugal occupies the eighty-ninth spot in the global energy company league tables, according to the authoritative S&P Global/Platts rankings for 2018, and it does not appear at all in the MSCI World Index. Yet it is a top-10 Global Equity ESG Advantage energy position. Investment merits aside, the position testifies to the progress we believe Galp has made in curbing its greenhouse gas emissions and its commitment to a renewable fuel strategy in the near future. Its carbon intensity, a measure of CO₂ emitted per million US dollars of energy generated, stands at 242, well below the industry average of 700, and it has pledged to cut intensity at its two refineries further by 2022. It will devote a minimum of 5% of its annual capital expenditure to low-carbon businesses, and it will rely entirely on renewable energy to fund its domestic operations by 2021.

By other metrics as well, Galp leads the energy sector. Its rate of oil spills, relative to its output, ranks with the industry’s best, and its injury rate has declined steadily over the last three years. Finally, among its peers it boasts the highest percentage of women in the workforce, at 42%.

Do the E+S+G Ratings Really Add Up?
Putting a value on a company’s ESG profile, both for its shareholders and society, is still in its infancy. No uniform measures yet exist, which has not prevented literally thousands of sources from offering corporate “ESG ratings.” Each of these sources has its own definition of the factors constituting environmental and social responsibility and adequate corporate governance. Each source also has its own methodology for measuring the factors, translating the data into standardized scores, and creating peer groups to compare the scores against. The bulk of passive ESG funds and ETFs build their portfolios on the basis of these rankings, even though they lack the objectivity and tested rigor that credit rating agencies apply to a relatively straightforward question: the probability of a security’s default. They compare more closely to the buy/sell security recommendations derived from criteria and methodologies that vary from analyst to analyst. One study found a correlation of 0.32 between the ratings given to 1,200 global companies by two of the more influential ESG rating services, MSCI and Sustainalytics, while correlation between the ratings of the two largest credit evaluators, Moody’s and Standard & Poor’s, came to 0.90.

Underlying the large ESG differences are three systemic shortcomings: a built-in large-cap bias, a European skew, and industry classifications so broad and so vaguely defined that they obscure company-specific focus. In the first place, larger companies as a rule have more resources to devote to ESG policymaking and
reporting than smaller companies have. Not surprisingly, they
tend to fare better in the ratings. That same paperwork premium
confers an advantage on heavily regulated companies that already
have a reporting infrastructure in place and on companies that
are not allocating resources to revenue expansion or fending off
competitive threats. ESG merits aside, the limitations imply a
large-cap, low-volatility portfolio versus the benchmark that may
exclude high growers and value opportunities. In itself, this kind
of portfolio may or may not align with investor objectives, but it
suggests that ESG considerations can overly influence and even
undermine risk and return targets.

The tendency to overweight Europe stems from the fact that
Europe’s ESG requirements and reporting standards exceed
those found elsewhere in the world. As a consequence, European
businesses tend to score higher on ESG measures than their
non-European counterparts, giving ESG portfolios a European
overweight relative to their non-ESG benchmarks. The unintended
overweight introduces, again, an element of unforeseen risk—
currency risk—which can as easily enhance as detract from returns,
but which in either case complicates the calculation of ESG’s
contribution.

**The Tesla Wrinkle**

The stickiest systemic complication of all we might call the
Tesla wrinkle. Depending on how a rating service classifies the
automaker, it is part of the environmental solution or part of the
environmental problem. MSCI places Tesla at the head of its class
for good reason: the vehicles it manufactures emit no carbon.
Sustainalytics, on the other hand, rates Tesla as an environmental
laggard trailing such old-school standard bearers as Ford and
General Motors for equally good reason: the factories where it
manufactures all those non-polluting vehicles run on massive
amounts of fossil fuel.7

The difficulty stems from the shortcoming in the ratings
themselves. The ratings gauge more or less randomly designated
peer groups against broad industry exposures, not company-
specific ESG exposures. In its 2017 white paper, “Foundations
of ESG Investing,” MSCI emphasizes the point. “In each of 157
GICS® sub-industries, the MSCI ESG Rating model incorporates
only a handful of key issues that it determines are the most
financially significant for the specific industry. That is, not all
ESG issues are considered important; those that are not deemed
significant do not carry a weight in a company’s rating.”8 Thus
a company’s ESG rating depends to a large extent on what peer
group a rater decides to place it in and by what criteria the rater
measures the peer group. It also means that an ESG-optimized
portfolio, based on MSCI scores (or the scores of any other rating
service for that matter) may not be as optimized as it seems.

**Solving for ESG**

The Global Equity ESG Advantage strategy derives industry
ratings from the output of five widely recognized ratings services:
MSCI; Bloomberg; Trucost, a division of S&P Dow Jones;
Sustainalytics, a long-established independent ESG ratings
service that provides Morningstar’s sustainability ratings; and
RobecoSAM, a sustainability investment advisor. It does not
incorporate the ratings from those of the five providers directly
but rather sources the fundamental supporting data gathered by
the first three services. MSCI has amassed the most wide-ranging
data set: corporate ESG policy statements, board makeup and
the background of its independent directors, the state of labor
relations, and records on environmental controversies and fines.
Bloomberg tracks public ESG disclosures. Trucost compiles
company carbon emissions and water usage records in its role as
consultant to corporations on environmental impacts. Two of
the most established and comprehensive ranking systems serve as
a reality cross-check: the Sustainalytics 450 peer-group coverage
universe and RobecoSAM’s annual Corporate Sustainability
Assessment, drawn from the self-reported responses to industry-
specific questionnaires mailed out to corporations worldwide.

We believe Global Equity ESG Advantage explicitly addresses
each of the three systemic shortcomings. It corrects for the size
bias inherent in ESG ratings by emphasizing the hard numbers
in the supporting data—actual carbon emissions and water
usage reporting required by regulators, for instance, or employee
turnover rates at companies too small to conduct satisfaction
surveys—while discounting announced policy. (The notorious
practice of “greenwashing,” misrepresenting a firm’s ESG
commitment, tends to find its way into policy pronouncements.
According to one authoritative critic, the former CEO of the
Sustainability Accounting Standards Board Jean Rogers, the
pronouncements fail to deal with 90% of the typical company’s
“known negatives.”)9 We correct for the Europe skew by staying
typically within two percentage points of the MSCI World’s
Europe cap weight.

Finally, by closely adhering to benchmark weights, dispensing with
screens, and applying the most relevant standard, the strategy seeks
to smooth the distortions of the Tesla wrinkle. Competitors in the
same industry must obviously cope with the same environmental
and workforce issues, and as supply chains grow increasingly more
complex and global, they must take similar responsibility for
conditions at suppliers and end users. It treats governance—the
“G” of ESG—on a regional basis, however. Just as it makes little
sense to compare a pharmaceutical manufacturer’s environmental
record with a utility’s, it makes little sense to compare a Japanese
automaker’s regulatory compliance with a German automaker’s.
Good Returns on Good Intentions

The ESG-optimized portfolio is a portfolio with largely the same risk-adjusted return potential, according to our model, as the standard Global Equity Advantage portfolio. The difference between the two, insignificant at the portfolio level, lies in the algorithms directing stock selection. They steer the algorithms designed to capture alpha, above-market returns, toward the ESG Leaders identified by our fundamental research.

Put another way, the quantitative ESG approach does not pursue broad societal welfare at the expense of adequate risk-adjusted returns but rather seeks to build an alpha-seeking portfolio with positive ESG characteristics. Over the last decade, the approach has managed to deliver alpha while moderating exposure to harmful business practices. A comparison on environmental measures between the portfolio and its MSCI World Index benchmark indicates the extent of the “ESG effect.” The portfolio’s cap weight exposure to the bottom quintile on four critical measures—the worst corporate offenders in the investable universe, in other words—ranges from a tenth to nearly one-half less than benchmark exposure (Exhibit 4).

DIY ESG

But the quantitative methodology should not limit the most committed ESG investors, in our view. In place of qualitative exclusion, it provides a systematic means for those investors to determine for themselves how much ESG they want for their portfolios and generates a solid estimate of its cost—or contribution. A comparison of returns between stocks in the Global Equity ESG Advantage portfolio and those of a standard benchmark provides a measure of the ESG effect on returns. To illustrate with the ESG portfolio’s carbon footprint over the past 10 years, the low carbon overweight within its sectoral construction blueprint cost returns in 63 of the 120 months but had a net neutral effect over the period as the greater benefit from the additive months balanced out the cost of the negative months (Exhibit 5).

The same attribution enables investors to take a precisely calculated step forward (or backward) from the Global Equity ESG Advantage portfolio. If they want to construct from the full investment universe a custom portfolio that restricts their carbon exposure more than the standard ESG portfolio, for example, they can size the impact of their choice using its quantitative ESG attribution. They can project the cost or benefit to returns of a reduced carbon footprint against the broad index and isolate its alpha contribution against a custom low-carbon benchmark carved out from the broad index. This capability frees committed investors from reliance on idiosyncratic, arbitrarily defined, and often inconsistent portfolio models that can only approximate their return targets and ESG objectives. Applying the most advanced techniques, they can aim directly and calibrate their investment and ESG performance precisely.
A Portfolio That Aligns with Investor Priorities

To judge from investor interest, media coverage, and both the meteoric growth in investment vehicles and “sustainable” assets under management, ESG considerations have come to weigh in investment decision-making on a scale approaching risk-adjusted return itself. ESG may have arrived by that measure, but calculating actual ESG impacts is still very much a work in progress, lacking generally accepted definitions and uniform standards. The lack makes room for and gives value to quantitative ESG with its construct of algorithm architecture on a foundation of fundamental ESG research. It transforms ESG investing from a laudable object to a practical strategy that may be suitable for the individual investor and the institutional fiduciary, who must concern themselves with return and risk as well as social responsibility, and adaptable for committed ESG investors, who wish to measure the impact of their investment alongside its return.

As of 31 December 2018
Carbon allocation effect is the portion of portfolio excess return attributed to having different carbon group exposures versus the benchmark. Stock selection effect is the portion of portfolio excess return attributable to choosing different securities within carbon groups from the benchmark.
Source: Lazard, MSCI
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Notes
1. The SASB was founded in 2001 under the auspices of professional asset managers and large institutional investors to bring a measure of uniformity to sustainability reporting metrics.

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Published on 15 February 2019.

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