Key Findings | CROSS ASSET Investment Strategy

ESG Investing & Equity Asset Pricing: Key Findings

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Amundi ASSET MANAGEMENT

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Responsible Investing & Performance: Results from our 2018 Study

The responsible investing landscape is evolving extremely rapidly, as more investors integrate ESG into their processes, initiatives reshape investment frameworks, and regulators increasingly step in to cement the role of Environmental, Social and Governance-related criteria. In a short timeframe, ESG has gone from being a "nice to have" to a "must have".

Acting as a responsible financial institution is a core commitment and a founding pillar of Amundi. This commitment is reflected in our responsible investment processes, and expressed in the range of solutions we have developed for investors.

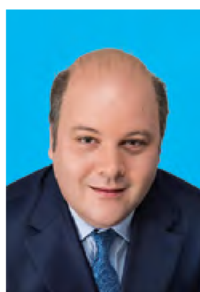
In order to best serve our clients in this rapidly evolving environment, we believe that gaining a deep understanding of the various facets of ESG is absolutely critical. Therefore, ESG has been a top priority for Amundi research teams. In 2018, we published a seminal paper exploring the impact of ESG investing on asset pricing in stock markets for the periods 2010 to 2017. We found that:

(i) ESG investing tended to penalize both passive and active ESG investors between 2010 and 2013.

(ii) Contrastingly, ESG investing was a source of outperformance from 2014 to 2017 in Europe and North America, and was even becoming a beta strategy in the Eurozone.

(iii) We took note of two success stories: the Environmental pillar in North America and the Governance pillar in the Eurozone.

Given the speed at which ESG investing is reshaping the investment landscape, we decided to update our findings with new data from January 2018 to June 2019, and while we confirm most of our findings from the previous period, some new interesting trends have appeared, reflecting a growing complexity and diversity in responsible investing.



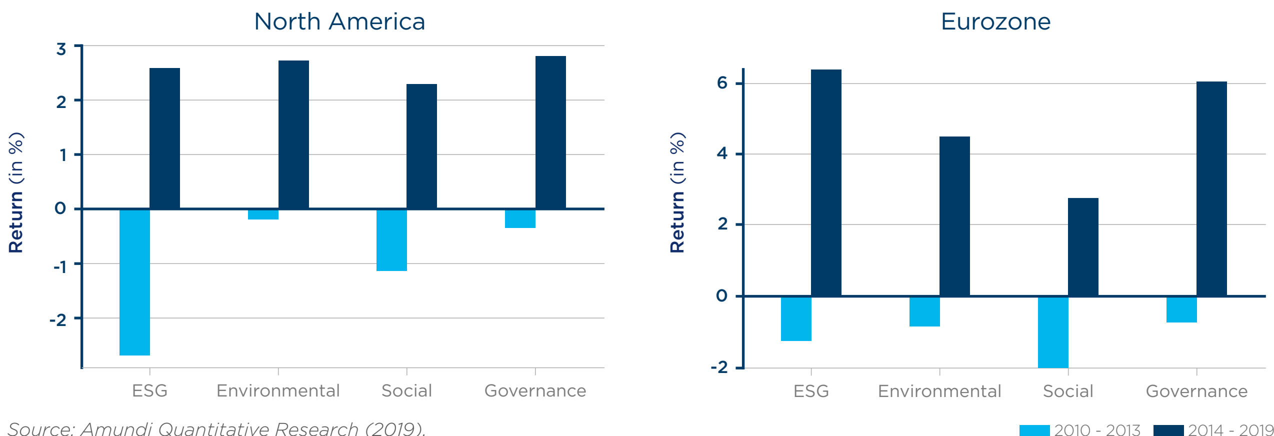
"As a responsible asset manager, it is our duty to constantly take the pulse of ESG investing dynamics, to ensure that we remain at the forefront of responsible investing. Indeed, these findings show that investing with an ESG lens is a complex but ultimately rewarding process."

Vincent Mortier, Group Deputy CIO

The 2014 Break

If we consider a long/short strategy between best-in-class and worst-in-class stocks, returns were negative on ESG and each individual pillar for North America and the Eurozone between 2010 and 2013. However, they are positive between 2014 and 2019. We also notice that alpha generation is more important in the Eurozone than in North America.

Fig. 1: Annualized returns of best-in-class vs worst-in-class long/short portfolios



Source: Amundi Quantitative Research (2019).

How to explain this break? We have observed a massive mobilization of institutional investors on ESG. This has impacted the supply/demand mechanism with a subsequent effect on stock prices. Even though this concerns European investors more than their American counterparts, North American stocks have also benefited from this high demand because of the significant exposure of some large European institutional investors to North America.

ESG Investing in Recent Years: a Transatlantic Divide

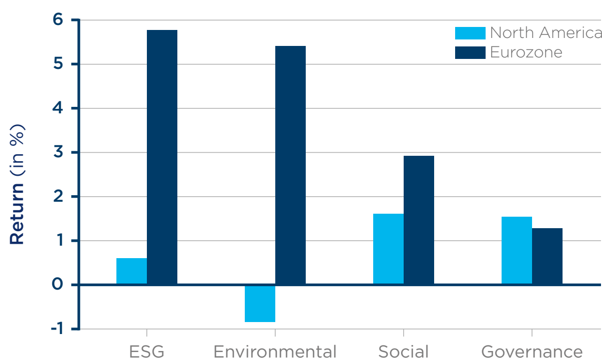
The 2018-2019 period seems to be a continuity of the 2014-2017 period we had previously studied, rather than another distinctive phase. Indeed, when integrating 2018-2019 into the former analysis, returns remain positive for the two regions, with the exception of Environmental in North America that posted a negative performance. Nevertheless, the gap between North America and the Eurozone has grown.

The mobilization of institutional investors, however massive it may be and especially in Europe, is not always enough to write a success story.

Indeed, sustainable investing is at the crossroad of investing and policymaking. Investors affect the supply and demand of securities when they act on their views, but governments can gear financial outcomes by regulating ESG-related fields. Thus, the U.S. withdrawal from the Paris Climate Agreement might have influenced regional asset pricing on the Environmental pillar.

Moreover, we have yet to see a massive mobilization from American institutional investors. Although the two regions benefited from the 2014 breakthrough, we hypothesize the possibility of transatlantic divide in the sustainable investing space given the latest developments.

Fig. 2: Annualized returns of best-in-class vs worst-in-class long/short portfolios (2018-2019)



Source: Amundi Quantitative Research (2019).

Social under the Spotlight

After indicating that the Social pillar's integration was lagging compared to Environmental and Governance between 2010 and 2017, Social is the winning pillar since 2018. For instance, a portfolio being long 20% best-ranked stocks and short 20% worst-ranked stocks would have yielded 2.9% in annualized return in the Eurozone and 1.6% in North America. Similarly, tilting MSCI capitalization-weighted indices would have created an excess return of about 60 and 40 bps in EMU and North America for a tracking error of 50 bps. While it is speculative to state why Social is the winning pillar, we believe it was helped by developments in Social narratives and by sustainable investors exploring ESG's latest frontiers.

ESG Investing: Growing in Complexity

It would be a mistake to consider ESG as following one clear path. Indeed, as ESG investing becomes more mature and integrated by a growing diversity of investors, it is also becoming more complex.

For one, as illustrated previously, we have noticed divergent trends across geographies, with European actors and regulators pushing ahead at greater speeds, and less so on the other side of the Atlantic.

Second, while the past five years have placed climate change as the number one priority for responsible investing, new themes are emerging rapidly, and among them the social pillar. Therefore, we are seeing cycles, meaning that as the market increasingly prices in certain ESG criteria, these cease to outperform and are replaced by newer ones, not yet priced. Past results are no guarantee of future results, and this holds in the responsible investing landscape. Therefore, it is important to identify the adaptive price discovery process based on the market's feedback loops in order to capture the value of ESG integration.

Third, ESG investing goes beyond the exclusion of worst-in-class stocks. Today, a comprehensive integration of ESG in stock picking processes is a reality. In particular, we noticed that the increasing relationship between ESG ranking and performance is sometimes disturbed, and second-to-worst in class stocks[1] may perform well. We hypothesize the seemingly abnormal performance of these stocks as the emergence of forward-looking strategies, with some investors betting on improving companies rather than well-scored companies.

The emergence of ESG momentum strategies and this shift towards a dynamic view are still a positive development, as this increase in complexity of ESG integration demonstrates that sustainable investors might better understand underlying issues and are moving beyond a binary black and white view of corporations.

"Traditional ESG fundamentals are still present with best-in-class and worst-in-class approaches functioning in some areas. However ESG investors have integrated dynamic approaches seeking value added from ESG improvements as well. The ESG integration has therefore become more complex and diverse in its time horizon."

Thierry Roncalli, Head of Quantitative Research

1. Second-to-worst in class stocks: This research divides the stocks in 5 quintiles according to their ESG score. Those in the worst-in-class category – or 5th quintile – being the 20% stocks with the lowest ESG score. Second-to-worst in class stocks are those in the 4th quintile.

Key Findings

Using the same methods as for our previous research, we study the period from January 2018 to June 2019 and find some interesting new patterns compared to the 2014-2017 period. Some were predictable, but others are definitely more surprising.

1 The Transatlantic divide

After eight years of similar development, we observe a contradictory trend in ESG investing between North America and the Eurozone since 2018. In North America, we notice a decrease in alpha generation on all dimensions, and even a loss on the Environmental pillar, whereas in the Eurozone, the same positive dynamic still operates, with the E and the S pillars over-performing. We do see a slowdown on the G pillar, but this is natural given it was the most dynamic of the three pillars over the last period.

2 Moving from static to dynamic

We observe a new development in ESG integration, with a surprising finding for some pillars. The second-to-last quintile of our sorted portfolios (having ESG scores in the fourth quintile) performs surprisingly well, meaning that there is more to the story than a linear approach to ESG investing. We interpret this as a shift towards forward-looking strategies, with investors betting on improving companies as well as well-scored companies. This means that ESG investors have gone beyond worst-in-class exclusion or best-in-class selection policies and have implemented more active strategies by integrating a dynamic view of ESG scores.

3 Passive strategies: not as easy as before

On the passive management side, we note a slight reduction in the excess return, which is the consequence of better integration of ESG pillars in market pricing and a more dynamic approach as noted above. On the other hand, tracking error costs of integrating ESG are stable compared to our previous period, implying that active budget risk is necessary to implement ESG policy.

4 Social: from laggard to leader

From 2014 to 2017, we noticed that the S pillar was clearly the lagging pillar, with delayed results. This is no longer the case: we observe very strong performance both on the active and passive side for 2018-2019, most likely as a result of growing investor concern for social themes such as rising inequalities.

5 All quiet on the factor front

Finally, our factor analysis remains unchanged for this period: ESG remains an alpha strategy in North America, whereas in the Eurozone, it is the best explaining single-factor of stock returns. This means that even if the ESG contains some information in North America, it offers little diversification benefits in multi-factor framework, whereas it improves the diversification in a portfolio that is already well-diversified in the Eurozone.

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