Avoid sustainable equity exposure pitfalls

ESG

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ESG strategies can introduce unintended factor biases, which can affect overall risk-return objectives if not managed correctly

KEY POINTS

Active portfolio management is necessary to fully exploit sustainability

Most investors are unaware of the full implications of their sustainbility preferences

Sustainable investing cannot be defined statically – and a static definition would, in any case, not make economic sense. So to exploit the full potential of sustainability in the context of modern portfolio construction, active portfolio management aimed at strengthening performance potential and controlling associated risk concentrations is required.

Yet the financial industry provides insufficient information about the latter in particular and most asset owners are unaware of the fact that sustainability preferences tilt portfolios a certain direction.

This is problematic because unintended tilts can lead to erratic outcomes with respect to a portfolio's risk-return profile – especially when sustainability strategies underperform against broader market benchmarks as they did in the first quarter of 2021 when value exposure celebrated a comeback on the back of rising inflation expectations.

Portfolios that unaligned with best practice sustainability aspects can affect risk-return profiles

Despite significant cash inflows to financial products labelled 'sustainable', there are still reservations among asset owners. Sustainable investing is said to restrict portfolio managers too greatly and thus lower their potential to generate excess returns over benchmark indices.

However, this is only true if portfolio managers exclude stocks from their investable universe to an extent that is no longer reasonable from an economic standpoint based, for example, on normative concerns. When this happens, the potential of modern portfolio construction cannot be exploited.

Beyond an economically reasonable degree of exclusions (that strengthen portfolio returns without stretching the tracking error too much), the consideration of financially material sustainability aspects in the investment process, most frequently referred to as ESG integration, is indispensable in order to improve risk-return profiles further.

But there is some disagreement as to which 'E', 'S', or 'G' topics have the greatest impact on a portfolio. Our own analysis shows that good governance and social issues have been the most positive contributors in the past 10 years, while environmental issues have not been a reliable component (figure 1). However, that could change with the rising momentum towards carbon-neutral portfolios in accordance with the Paris Agreement that limits global warming to 1.5°C above 1890-1900 pre-industrial averages.

"Most investors are unaware of what implications the sustainability preferences in portfolio strategies can have for other investment levels"

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When considering sustainability criteria in the investment process, asset managers primarily focus on exclusion lists, ESG ratings, climate-risk models and economic activities that comply, for example, with the UN sustainable development goals (SDGs) or the upcoming EU Taxonomy regulation.

Investment decisions that asset managers base on such defined preferences change the aggregate demand for financial securities and influence their price setting. The more popular a security is due to its advantageous ESG characteristics, the more liquid it is to trade. This translates into rising valuation multiples and hence contributes to excess returns compared to securities not rated as sustainable.

Rising valuation multiples enable more attractive refinancing compared to peers. This increases capital productivity and boosts revenue growth – a structural competitive advantage.

By contrast, for issuers of capital not rated as sustainable, declining aggregate demand makes trading their securities more illiquid and prices more volatile. Increasing volatility burdens the risk profile of a portfolio. It can therefore be concluded that portfolios not aligned with best practice sustainability standards burden risk-return profiles.

Concentration risks in portfolios

Most ESG investment approaches applied by asset managers can be implemented using the ESG data outlined above. Two main consequences catch the eye. First of all, the characteristics of these datasets correlate positively with one another (figure 2)

Secondly, this favours a very specific company profile. In terms of fundamentally-based risk premiums, this translates into a preference for quality stocks while value stocks are often excluded (figure 3) . This is a key factor when stocks with already comparably low valuations continue to get cheaper instead of being viewed as attractively valued – a structural pitfall for investment strategies with a value tilt.

Why does this matter to portfolio risk management? Because such preferences can lead to concentration risks if ESG data is applied without reflection. Three factors in particular could exacerbate this:

- first, stricter regulation of sustainable investments that narrows the consensus further around sustainability aspects;
- second, more uniform financial reporting by companies;

PORTFOLIO STRATEGY
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● third, ongoing consolidation among ESG data providers. The latter, in particular, leads portfolio managers to rely on less and less data to differentiate between sustainability indicators.

Analysing risk exposure

Owing to their trustee function, asset managers are obliged to be aware of concentration risks, that is, to identify imbalances in portfolios and actively compensate for them if necessary. Most investors are unaware of what implications the sustainability preferences in portfolio strategies can have for other investment levels – for example, risk premiums or allocation according to sectors or regions. If they knew, they probably would not tolerate them.

An analysis of how individual sustainability preferences affect the various other investment layers of the portfolio can help here. For example, a simple CO_2-neutral positioning of a global equity portfolio implicitly bets on an increase in the euro/dollar exchange rate. However, this positioning may not line up with the economic assessment of a portfolio manager, so factor-neutral balancing can be applied.

This means that extreme characteristics of the unintentional currency bet can be limited to a maximum value without changing the exposure of the portfolio in other investment layers. At the same time, the primary goal of CO_2 neutrality is met. This is achieved through an actively managed optimisation process that, in addition to portfolio rebalancing, also minimises the tracking error compared with a given benchmark.

Conclusion

As sustainable investing is constantly changing, ESG integration in asset management must also be adapted to create added value for portfolio construction. Active management of concentration risks will have to make a significant contribution in the future. This is the only way that sustainable investing can persist and avoid going down in investment history as a 'giant with feet of clay'.

Jan Rabe is co-head of the sustainable investment office at Metzler Asset Management

1. EU equity universe: long-short portfolios that differentiate between best (quantile 1) and worst (quantile 5) stocks on the back of E, S and G scores

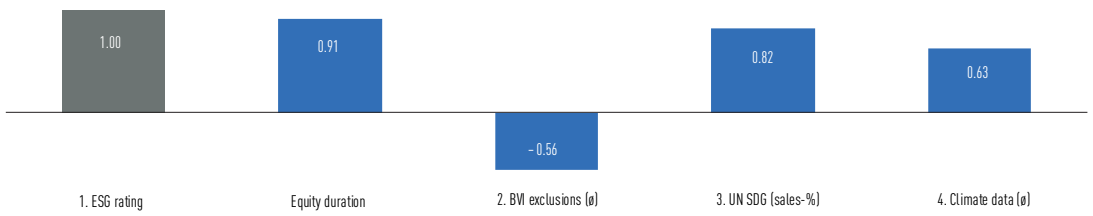
(Total returns in euros: quantile 1 vs. quantile 5, Q1 2007 = 0)

Note: An industry-specific ESG rating is used. The calculations are based on a monthly rebalancing of the portfolios which are based on long-short strategies. These strategies invest quantile 1 and short quantile 5

Sources: MSCI, Refinitiv, Factset (Alpha Testing), Metzler

2. A homogeneous alignment of ESG data (MSCI)

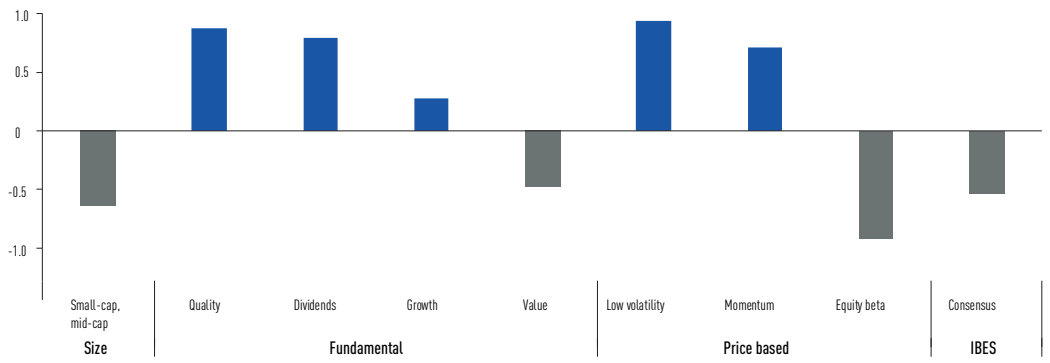
EU equity universe: correlations of ESG ratings with...



Sources: MSCI, Refinitiv, Factset, Metzler

3. Risk premium tilts of ESG ratings versus ...

Correlations within the European equity universe



Note: the definition of risk premiums is based on MSCI's methodology
Sources: MSCI, Refinitiv, Factset, IBES, Metzler