Key Questions

Will Outperformance in ESG Investing Last?

May 11, 2020

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ESG investing is not a fad. Sustainability of the approach is strong and good performance should continue. Embracing its benefits to portfolios and society overall, positions you well within our new world.

Environmental, Social, and Governance (ESG) investing combines the goals of doing well and doing good. How a company treats the environment and its employees and manages its governance is considered to be valuable information in evaluating a company's risks and growth opportunities. The thesis is that incorporating ESG factors in the investment process leads to better decisions and better outcomes along with enhanced sustainability for the environment and society overall. Although this investing approach has increased in popularity over the years and research that supports the ESG thesis is growing, the investment community continues to debate ESG's value and whether performance data supports or undermines it.

Looking at the last quarter when markets declined dramatically due to the COVID-19 pandemic, both active and passive ESG funds (also called sustainable funds) were the clear winners, providing strong relative outperformance versus traditional funds. While ESG funds were down for the quarter during the severe market decline, they did not fall as much as other funds. According to Morningstar, 70% of US equity sustainable funds ranked in the top half of their category this year with 44% finishing in the top quartile. Also, nearly all ESG index funds outperformed their closest market-cap weighted index fund. While one quarter does not constitute a trend, this result along with research over longer periods provides evidence that ESG investing can deliver competitive performance in all types of markets.

ESG managers tend to hold stocks of higher-quality companies, those with well-capitalized balance sheets, low leverage, and low ESG risk. Because of this, it is not surprising that they provide capital protection in a downturn. Attribution analysis also reveals that stock selection was the primary reason for outperformance, a desired factor in active strategies. It is worth noting that many ESG funds are underweight the Energy sector due to its negative environmental impact. Since Energy was the worst-performing sector last quarter, that underweight contributed positively to performance as well.

Skeptical investors may grudgingly acknowledge one quarter of good results for ESG funds in a difficult market, but they may also ask if the solid performance of sustainable funds is itself sustainable. Will outperformance persist during the COVID-19 recovery phase? Is ESG worth considering or is it just an investing fad?

We can't predict performance outcomes with precision. But we can make a strong argument that ESG and sustainability factors in the investment process will continue to grow and evolve and become more important as we grapple with our new reality.

ESG managers have always considered a company's employee policies and practices in investment decision-making. Given the drastic impact of COVID-19 on our health, the economy, and our world, awareness of the importance of such practices has only increased. While environmental and governance factors remain critical, issues that fall into the social category of ESG have become more relevant.

The thesis is that the companies that are easing the burden on their stakeholders, taking good care of their employees, expanding benefits, protecting workers and customer safety, addressing supply chain challenges, and implementing continuity plans will likely be the leaders going forward. The goodwill that such actions evoke with employees, customers, and investors can have long-lasting impacts.

In terms of ongoing performance, many ESG managers have been active in this downturn, buying stocks that fit their criteria at attractive valuations and looking for those firms that are positioned to perform well in the new environment. ESG managers are often overweight the Healthcare sector; with the current focus and government support on the development of vaccines and pharmaceuticals, this allocation should be positive for returns in the recovery.

At a macro level, the nature of the pandemic has pushed companies to expand their focus beyond shareholders to employees, customers, and communities. This is a trend that ESG managers cheer as they support a move toward a durable stakeholder-centric model of corporate behavior for purposes of long-term profitability and alignment of values. This brings us back to the twin goals of doing well and doing good.

ESG managers have been ahead of the pack in supporting corporate practices that have gained traction in this crisis; as a result, they may have an advantage over traditional managers here. Keep in mind that not all ESG managers are created equal, and ESG evaluation is just one part of a manager's fundamental investment process.

In conclusion, we submit that ESG investing is not a fad, that the sustainability of the approach is strong and good performance should continue. Investors who embrace the information value that ESG can provide and the benefits to investment portfolios and society overall are well-positioned in our new world.

For more information, please contact your Key Private Bank Advisor.

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Publish Date: May 11, 2020