Does ESG really affect performance?

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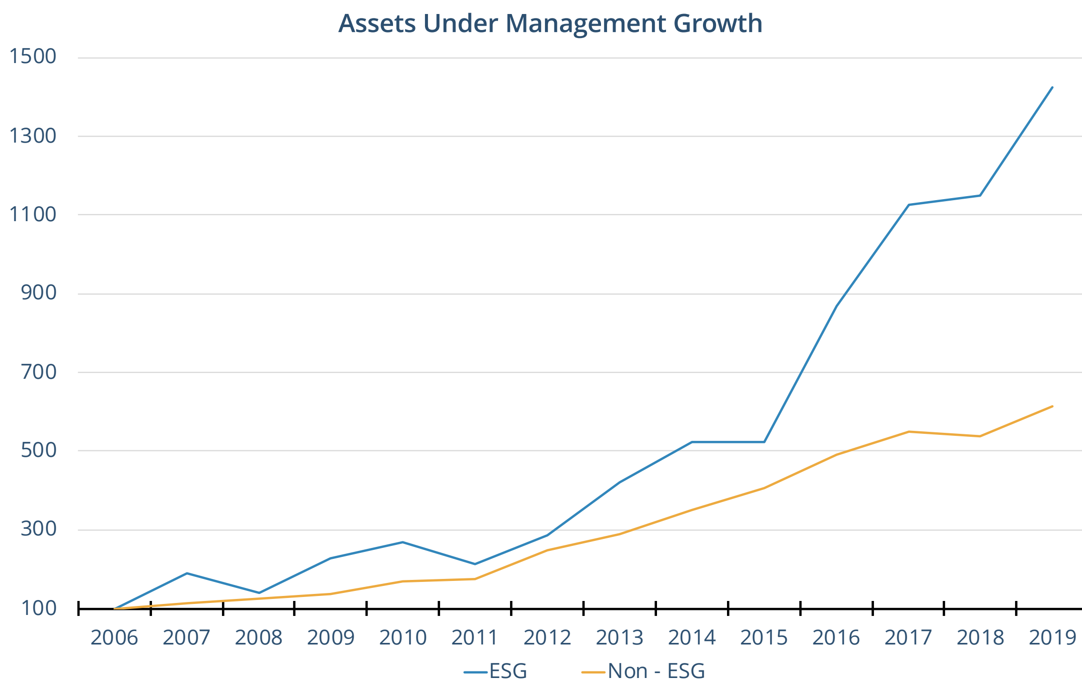
The investment industry's interest in ESG (Environmental, Social and Governance) has grown steadily over the past few years and an increasing focus on wider societal issues like climate change and plastic pollution has spurred on the idea of conscious consumerism.

As a result of this, the average number of responsible funds launched for sale in the UK per year has increased from three in the 1990s to 18 per year in this decade – and in the last three years alone, the average number of responsible fund launches surged to 32 per year. Meanwhile, rising demand for ESG is also evident in the growth of assets under management.



Source: FE Analytics

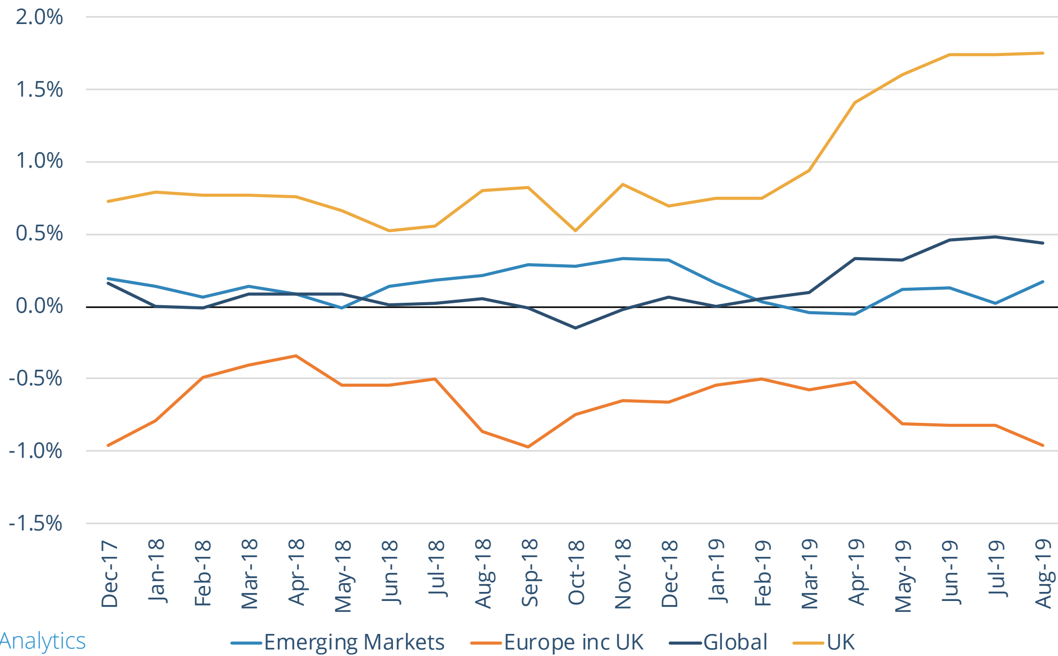
The chart above shows a clear increase in demand for responsible solutions compared with their non-responsible counterparts. Although the size of the universe remains significantly smaller in absolute terms compared to that of funds which do not have a responsible mandate, its growth is attracting attention across the financial industry.

Some investors are tempted to use responsible mandates in a quest for additional performance, as well as for the benefit of improving society. This trend has led to a revival in academic research investigating links between ESG considerations and stock performance as investment professionals seek to gain a clearer understanding of the factors in play. Some would argue that when an investor restricts their investment universe, they also limit their opportunity set, increasing the risk of weighing down long-term performance. On the other hand, it could be argued that, by focusing on ESG factors – and governance in particular – an investor may avoid company "blow-ups", not only achieving positive performance over the longer term, but also benefiting from a lower level of absolute risk.

In the following paragraphs, we examine the performance characteristics of responsible mutual funds in the UK market relative to their non-responsible peers. The responsible funds were identified using their name, objective and description; there was no differentiation based on the depth or method of responsible implementation used, nor whether the responsible mandate is included for strategic or altruistic reasons.

The chart below shows the relative average performance of responsible over non-responsible funds in four regional sectors from November 2012. It suggests that if a five-year investment into a responsible UK fund peer group ended in August 2019, it would have produced an average annualised return of 1.6% greater than the same investment in a non-responsible fund. In this way, the success of a five-year investment can be traced over time for each asset class considered.

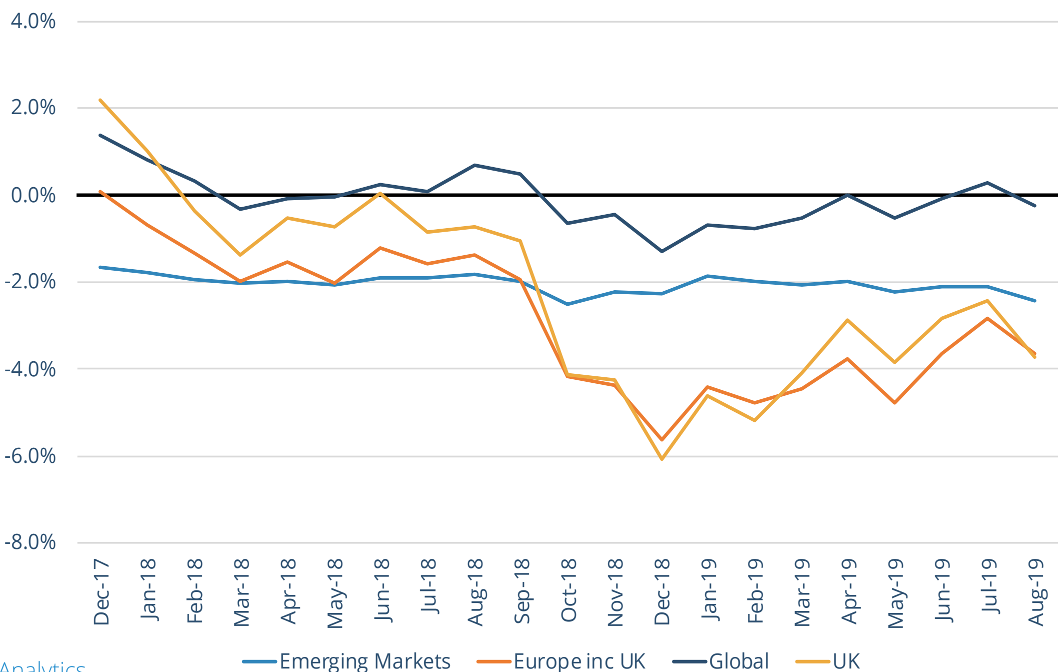
Historically, it has often been assumed that any performance benefits resulting from ESG factors were likely to be cancelled out by the cost of investment implementation. We also note that ESG factors may have a more pronounced effect in some regions than others. In some cases – such as the UK peer group – it may also result in a strong outperformance. However elsewhere, in Europe Ex-UK for example, it may result in underperformance.



Source: FE Analytics

In summary, ESG has either a strong or a minor effect on outperformance. Practitioners in this space may observe an ESG-related time effect in which greater awareness of responsible investment, complexity of implementation strategies and change in the cost of investing would affect performance in this sector.

The theme of protection offered by responsible funds is clearly highlighted when comparing average annual volatilities of a five-year investment in responsible peer groups relative to their non-responsible counterparts. In the chart below, all negative values show that less risk, expressed by volatility, was taken by responsible funds over non-responsible funds.



Source: FE Analytics

This result would suggest that, despite the potential limitations imposed by a fund's investment universe, investors are not exposed to additional levels of risk. On the contrary, as demonstrated here, through their focus on sustainable and stable businesses, ESG factors can potentially result in a reduced level of risk.

Ultimately, we found that any disadvantageous impact on a fund's performance from responsible investing was minimal at most. In fact, the opposite was shown to be true: ESG can have a positive impact on performance, both in terms of absolute return and overall risk taken during the investment period. Therefore, the enhanced risk-adjusted returns support the growing interest into ESG from the perspective of financial benefit. Furthermore, as ESG evolves into a more defined investment strategy, its impact on performance is likely to change over time.

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