Busting the RI performance myth

By: Dustyn Lanz | September 10, 2018 | Investment Executive

A growing body of evidence shows that responsible investments perform just as well, if not better than traditional investments.

Despite the outdated yet persistent myth to the contrary, incorporating environmental, social, and governance (ESG) factors into investment decisions is a winning formula for investors. Analyses from leading asset managers, research firms and universities have shown that responsible investments usually meet or exceed the performance of traditional investments at the index, fund and company levels.

On a global index level, the MSCI ACWI ESG Leaders Index, which is composed of 1,251 companies with strong ESG performance, has outperformed the broad-based MSCI ACWI since 2007. And in Canada, the Jantzi Social Index, which comprises 50 Canadian companies with superior ESG performance — has outperformed the S&P/TSX 60 and the S&P/TSX Composite indices since its inception in 2000.

At the fund level, responsible investment (RI) mutual funds in Canada have consistently outperformed. According to data provided by Toronto-based Fundata Canada Inc. for the Responsible Investment Association's quarterly performance report as at June 30, a significant majority of RI funds outperformed their average asset class returns. Nearly two-thirds of RI funds outperformed over three-year, five-year, and 10-year periods. This highlights the long-term benefits of incorporating ESG factors into investment decisions. And yes, this is net of fees.

In addition, an academic study from Carleton University in Ottawa, authored by Dr. Tessa Hebb, found that RI equity mutual funds in Canada outperformed their benchmarks 63% of the time. A report from the New York-based Morgan Stanley Institute for Sustainable Investing found similar results in the United States.

These results at the index and fund levels are made possible by strong ESG foundations at the company level. Make no mistake: well-governed companies that proactively manage their exposure to environmental and social issues are positioning themselves to protect and enhance shareholder value. A growing body of evidence, including the data cited above and more, shows a clear correlation between strong ESG performance and solid returns at the stock level.

But it's not just correlation: a recent report from MSCI provided empirical evidence to identify a causal relationship between ESG and financial performance. The report, Foundations of ESG Investing, found that high ESG-rated companies tend to be more profitable with higher dividend yields and lower idiosyncratic tail risks. It also found that high ESG-rated companies tend to show less systematic volatility, lower beta and higher stock valuations. But, perhaps most important for assessing causality, MSCI's analysis found that changes in a company's ESG characteristics tend to be a leading indicator for future changes in valuation. In other words, tracking the direction or "momentum" of a company's ESG score can help to predict the direction of its future share price.

An analysis from Harvard Business School in Boston found that one of the key links between ESG and corporate performance is the extent to which a company addresses sustainability issues that are most directly material to its business operations. Using the Sustainability Accounting Standards Board's (SASB) materiality standards, the researchers found that "firms with strong ratings on material sustainability topics outperform firms with poor ratings on these topics." The study found there was a nearly 9% difference between the financial returns of companies that performed well and those that performed poorly on sustainability factors that were material to their industry.

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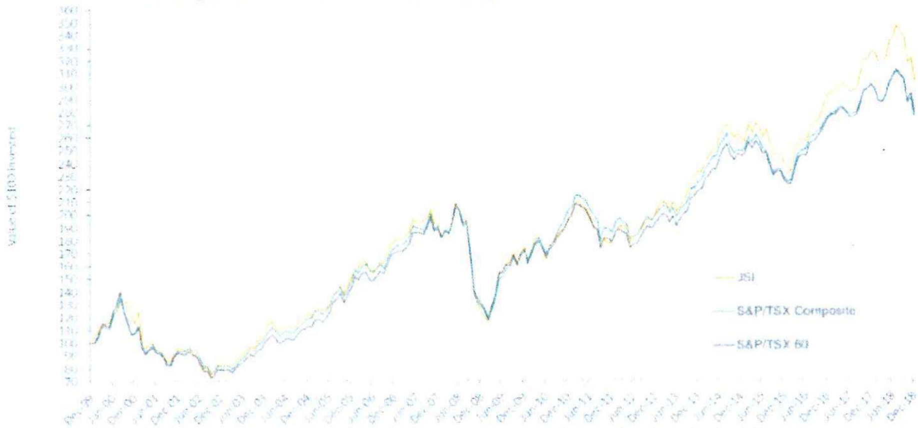
In light of this evidence, investment advisors would benefit from gaining an understanding of which ESG issues are material for companies across sectors. As a starting point, the Responsible Investment Association offers the Responsible Investment Specialist and Responsible Investment Advisor Certification programs to develop foundational knowledge of ESG issues and investing. Those who are interested in gaining deeper expertise in materiality analysis may wish to enroll in SASB's Fundamentals of Sustainability Accounting program. These programs can help position advisors to serve the growing number of investors who want to build their wealth responsibly.

The notion that there is a tradeoff between performance and sustainability is an outdated myth. For advisors, the opportunity to help your clients make a difference while generating strong returns is too great to ignore. And if you can't help them, there is a growing segment of advisors who can.

Responsible Investment Indexes

Jantzi Social Index (JSI)

Comparative Returns: January 2000 - December 2018



MSCI ACWI ESG Leaders Index

CUMULATIVE INDEX PERFORMANCE - GROSS RETURNS (USD) (SEP 2007 – DEC 2018)

RI Performance Resources

[Corporate Sustainability: First Evidence on Materiality]
Harvard study

[ESG and financial performance: aggregated evidence from more than 2000 empirical studies]
Academic paper

[Financial performance of ESG integration in US investing]
PRI report

[Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk and Performance]
MSCI report

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RIA
Responsible Investment Association

About the RIA

The Responsible Investment Association (RIA) is Canada's industry association for responsible investment. RIA members include fund companies, financial institutions, asset management firms, asset owners, advisors, research firms, consultants and others who practice and support the incorporation of environmental, social and governance (ESG) factors into investment decisions. Learn more at riacanada.ca