Harnessing the power of ESG risk premia in systematic investing

By Jessica Phalafala

3 Sep 2020

Socially responsible investing (SRI) has undergone a profound evolution since its origins in colonial America, where religious groups abstained from investing their endowment funds into anything associated with the slave trade. Centuries later, it transformed into mutual funds screening out investments that were directly or indirectly associated with gambling, alcohol and tobacco.

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SRI was further used as a tool to express the moral values of institutional investors and their support for historical movements. As a case in point, during the apartheid regime in South Africa, many global mutual funds screened out companies that were engaging in business in the country.

At the dawn of the 21st century came a heightened global awareness of the myriad of acute challenges we face as a planet, ranging from climate change, socio-economic inequalities, and the rise of unjust and exploitative institutions. This heightened the awareness of the need to introduce responsible investing methodologies that were significantly more extensive and far-reaching than the traditional screening approach.

The term environmental, social and governance (ESG) investing was first coined by the United Nations Global Compact in 2004 and involved the systematic integration of these factors into the investment processes of financial institutions. ESG investing has since gathered significant momentum and continues to gain traction in line with the fundamental shift in investor perceptions as they recognise the material impact ESG factors can have on investment returns.

Risk premia strategies

Risk premia strategies have been used for decades in systematic investing as a method for harvesting excess returns. This is achieved by investing in factors that have been proven academically and in practice to provide the investor with a positive payoff for undertaking the risk associated with each factor.

Commonly used risk premia include the value risk premium, which is the excess return derived from companies that are trading at a low price relative to their fundamental value; the momentum risk premium, which favours stocks that have displayed a sustained positive return trajectory over a given period; and the market risk premium, which is the differential between the market yield and the risk-free rate of return.

These factors have all been proven to yield higher long- term risk-adjusted returns. The overwhelming evidence confirms that using ESG factors in the portfolio construction and security selection process based on factor analysis and risk premia strategies allows investors to yield additional risk-adjusted returns.

The logic that value-creating ESG-related practices contribute to company outperformance upholds the thesis. For instance, a well-managed company that adheres to environmental and social regulations is less likely to face litigation, the higher costs associated with the management and disposal of hazardous waste and elevated employee injury rates.

Therefore, ESG factors may provide better insight into the probability distribution of company returns in the same way as the traditional risk premia incorporated in classical asset pricing frameworks. Also, ESG factors are strong candidates for inclusion in long-term factor investing. They display strong explanatory power over a wide range of securities, offer a positive payoff over reasonably long horizons, have a significantly low correlation with other factors and, above all, they make intuitive and economic sense.

In identifying ESG factors as risk premia, the systematic investor needs to move beyond traditional screening methodologies and policy implementation towards a rules-based, scalable and measurable ESG integration strategy. To do so requires practical, quantifiable metrics that can be readily integrated into an existing investment process, together with other strategies to construct a well-diversified portfolio.

The last decade has seen ESG find a permanent place in everyday investing. Its rise in popularity has shown no signs of slowing down, with Bank of America forecasting a “tsunami of assets”, as much as $20trn, flowing into ESG funds in the US alone over the next two decades.

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