Sustainable investing

Education primer: ESG improvers equities

Chief Investment Office Americas, Wealth Management | 01 August 2018 | 02:08 am BST
Rachel Whittaker, CFA, Analyst; Melissa Spinoso, Andrew Lee, Head of Sustainable and Impact Investing, andrew.lee@ubs.com; James Purcell, Analyst

- An ‘ESG improvers equities’ approach provides exposure to companies that are demonstrating improving performance in employing strategies to minimize environmental, social and governance (ESG) risks, as well as take advantage of ESG opportunities, and that their momentum in this area is expected to continue.
- ESG improvement is an emerging SI indicator for identifying potential stock price outperformance relative to the broader market.
- In practice, ESG improvement strategies are often combined with an ESG leaders approach (active or passive), as market for funds focused purely on ESG improvement and momentum is new and still limited.

Our view

Sustainable investing (SI) is an investment philosophy that can be applied to a wide range of asset classes. It seeks to achieve competitive portfolio risk/return characteristics comparable with a traditional approach while also having a positive effect on the environment and society and/or aligning investors’ portfolios with their goals and values.

ESG improvers are companies that are demonstrating positive momentum in addressing ESG risks and opportunities. This concept of ‘ESG momentum’ is relatively new, as sustainable investors expand their focus from ESG leaders to seeking new ways of generating alpha through an SI approach. Robust empirical evidence gathered over 40 years points to a correlation between ESG leadership and financial performance, so the rationale for the ESG improvers strategy is that if this potential for improved performance can be identified before it happens and is priced in by the market, there may be potential for investment outperformance.

There is a small, but growing, body of mainly academic evidence that improvements on ESG metrics can be an indicator of potential stock price outperformance compared to the broader market. The signal appears to be variable across sectors, styles and regions, with those where companies have not yet reached their optimal levels of ESG performance show particular promise such as emerging markets.

However as the approach is still new and relatively unproven, it is currently implemented mainly in combination with other SI approaches such as ESG leaders and in a global approach for conviction and diversification. Both active and passive approaches are possible, and ESG improvement indicators can also be used.

This report has been prepared by UBS Financial Services Inc. (UBS FS) and UBS Switzerland AG. Please see important disclaimers and disclosures at the end of the document.
as an additional source of information in conventional portfolio management.

What are ESG improvers equities?

ESG improvers are companies that are demonstrating positive momentum in addressing ESG risks and opportunities. They are not yet ‘leaders’ but their performance on various ESG criteria shows signs that they could become leaders in the future. Momentum is a well-known strategy in the investment industry that consists of buying stocks that have an upward trending price, and selling those that have had poor returns in the past few months, based on the tendency of the price to move in the direction of the trend.

This approach integrates ESG related information into the investment decision to construct a portfolio of improving companies, rather than companies that are already leaders from an ESG perspective. Investment portfolios adopting this strategy are therefore likely to contain a higher proportion of companies with below-average ESG ratings (see also Fig. 1) as this is, by definition, the opportunity set. In practice, many existing funds or indices that consider ESG improvement actually do have higher ESG profiles than conventional ones, largely because there are not yet many pure-play improver strategies and they are usually combined with an ESG leaders type approach (see also Fig. 2). One example is the MSCI ESG Universal Indices, in which a ratings trend multiplier is applied to company ESG scores (x1.25 for upward trend in ratings, x0.75 for a downward trend) to reward improvement. Yet because the underlying company ESG scores are higher for better-rated companies (2 for AAA/AA; 1 for A/BBB/BB; 0.5 for B/CCC), the overall index weightings still favor leaders by absolute score.

Identifying ESG improvers

While traditional investment momentum strategies are based on a universally understood and accessible indicator – the stock price – ESG momentum indicators are not standardized. There is no universally accepted standard for defining ESG leaders, and similarly there is no universally accepted standard for defining ESG improvers. In the ‘ESG leaders equities’ report in this series of educational primers we describe the various methodologies that are available to investors and fund managers for evaluating corporate performance on ESG criteria. ESG improvers strategies can use these same data sources and rating methodologies to try and identify which indicators signal improvement. For example, a trend of upward changes in overall sustainability ratings (either from one ratings provider or several), or a trend of strong performance on some key issues (e.g. better environmental management policies) that are likely to be followed by improvements in other areas (e.g. implementing energy efficiency measures) and ultimately lead to value creation (costs savings to the company and reduced emissions to the environment).

---

Fig 1: “Pure” ESG improvement universe
Focus on stocks with positive momentum. The exact definition depends on the strategy/research (e.g. “10% improvement or more within 2 years”, or “two consecutive upgrades”).

Source: UBS, adapted from NKI (2017)

Fig. 2: Universe combining ESG improvement and leading ESG
Combining stocks that have positive momentum with stocks that have leading ESG strategies improves the ESG profile but dilutes the momentum strategy.

Source: UBS, adapted from NKI (2017)
The key question, particularly with quantitative and rules-based approaches, is how to identify the companies that are positioned to improve. For example, how do investors decide whether a rating upgrade indicates a positive trend or is merely a random upward movement due to changes in ESG rating methodology? Fig. 3, for example, shows an initial slow upward momentum. Ideal ESG performance development could rise over time along curve a. Point no. 1 may therefore be the best time to invest, as much of the improvement is still expected, but is not priced in yet. However, the initial improvement may not have been an indication of a clear trend, and the company could also follow curve b. Waiting until point no. 2 to be sure of improvement, however, would mean failing to capture the improvements that may have already been priced in.

Whether using external ratings frameworks or their own proprietary fundamental research, fund managers pursuing an ESG improvers strategy should provide clear guidance to investors on their framework for evaluating ESG improvement, and ideally also regular reporting to investors on the incremental improvements that investee companies are achieved from a social/environmental perspective. Such reporting could be based on company disclosure or on the fund manager’s assessment, but either way it should explain the link between investment decisions and the environmental or social impact of the company for the strategy to have credibility from an SI perspective.

Performance considerations
A typical investment strategy incorporating ESG momentum uses it as a tool (perhaps one among several) to identify undervalued equities either in an active approach or as an enhancement to a benchmark approach. As such, we believe that the risk and return expectations for such strategies should be no different to our expectations of conventional equity investing. Evidence – either academic or observations of actual investment strategies – on the performance of an ESG improvers strategy is still limited, reflecting the newness of the theory. However, a key assumption of the ESG improvement strategy is that future stock performance is correlated with the change in the ESG management and performance of a company, and to date the empirical evidence suggests that this may often be the case.

- A study by Truvalue Labs (2017) found that “companies with strong information flow, good overall ESG scores on its proprietary rating scale, and positive ESG momentum outperform the S&P500 over a five-year period, adding approximately 3%-5% of alpha annually.”
- MSCI ESG Research (2015) showed that an “ESG Momentum” strategy results in outperformance of the standard benchmark while improving the ESG profile of the portfolio. The strategy tested over-weighted companies that had improved their ESG ratings during the previous 12 months, and under-weighted companies with declining ESG rating over that period. They hypothesized that this is due to the market reacting to a change in rating in a relatively short time period; i.e. the signal that the company is now better equipped to avoid ESG-related risks is quickly priced in by the market.
• The Principles of Responsible Investment (PRI, 2018) evaluated the efficacy of a momentum strategy (i.e. overweight stocks whose ESG score has improved) vs a tilt strategy (i.e. overweight stocks with higher ESG ratings) across the world and three geographic regions (USA, Europe and Japan), finding an alpha advantage coming from integrating ESG information in the construction of optimal mean-variance equities portfolios across all regions when compared to their respective benchmarks. However, the investment signal derived from ESG momentum may not be consistent across sectors and regions. The PRI study observed that World, U.S. and Japan portfolios benefited more from the momentum strategy, whereas a European portfolio benefited more from the tilt strategy. A UBS study (2017) also came to the same conclusion, though also finding that a combination of both ESG momentum and tilt were successful for all regions except Asia excluding Japan. One hypothesis for these mixed findings is that momentum strategies may be more effective in markets where companies have not reached high levels of ESG performance or where there is less strict regulation or enforcement of regulation regarding ESG issues, while tilt strategies may be better suited for regions where standards are already high, such as Europe (see Fig. 4). A recent study by NN Investment Partners (2017) on the correlation between ESG factors and share price supports this thesis, finding that that in emerging markets, high absolute levels as well as positive changes in ESG ratings (used third party provider Sustainalytics) correlate highly with relative stock outperformance. See Fig. 5.

We expect further evidence of the performance of ESG improvers to emerge in the near future, examining other applications of the ESG momentum theory, e.g. so-called “fallen angel” stocks that have faced an ESG crisis, such as a corruption scandal or an industrial accident with significant environmental and health impacts, and how the company and the markets respond to this. However, a clear takeaway from the current body of research is that combining the ESG improvers signal with other established approaches, such as ESG leaders or conventional equity strategies, is the optimal way to access this strategy at present.

How to invest in ESG improvers equities
Although there are currently few investable products that place significant or even sole emphasis on ESG improvement, we observe an increasing level of interest in this strategy and expect more products to come to market, particularly as more data becomes available which can be used to evaluate “momentum” on ESG factors.

Size and region focus
ESG improvement can be played in any market. To have a balanced portfolio and enough choice of truly improving companies, most managers seek global exposure. Similarly, the existing indices that incorporate ESG momentum focus on global developed markets. As such, the strategy is currently likely to be most suitable as part of a global equity allocation or as a replacement for a conventional global equity approach. However, the apparent regional variation in strength of the momentum signal suggests that this could also be an interesting strategy for emerging market fund managers to pursue in the future.
Active versus passive

In principle, ESG improvement lends itself to active and concentrated strategies. Identifying improvement that could yield operational and reputational gains requires deep knowledge of a company’s fundamentals, their ESG management and how improving ESG practices could affect the company’s value drivers. This ability to perform an integrated analysis of both ESG and financial information is still not widely encountered among asset managers today, but availability of these capabilities continues to improve as asset managers acknowledge the relevance of ESG analysis.

MSCI ESG Research showed that momentum can also be played with passive approaches, based on indices built on rules around improving ESG ratings. Notably, the approach in the MSCI ESG Universal Indices, which play ESG momentum, is not focused solely on ESG improving companies. It is based on investing in the whole market, but tilting the index toward overweighting improving companies and underweighting deteriorating companies. This is typical of current practice, where an ESG improvers approach is often combined with an ESG leaders approach. This increases the investable universe, and usually improves the overall ESG standard in the portfolio compared to pure ESG improvement strategies (see also Fig. 1 and 2).

Fig. 6 contains a short list of questions that can provide support when selecting ESG improvers equities funds.

Key Risks

The ESG improvers strategy is not as well-established a sustainable investing approach as ESG leaders, hence a key risk is that this theoretical concept ultimately proves not to add value from a fundamental valuation and return perspective. The prevailing approach that combines the improvers signal with other approaches helps to mitigate this risk. Other ESG improvers risks include:

- **Sub-par sustainability standard**: In an extreme case of focusing on improvement from the bottom, the ESG profile of an ESG improvement portfolio could be lower than a “conventional” equivalent. Should a fund manager not succeed in outperforming over a sustained period of time, the investor may be exposed to an underperforming portfolio of companies that have sub-par sustainability standards.

- **Wrong timing and scope of ESG momentum**: A good ESG improvers strategy would identify ESG momentum early and focuses on the right area of ESG improvement. This either requires very deep knowledge of the company’s fundamentals in the case of a focused active strategy, or good rules to identify true ESG momentum in a scores and rules-based strategy. It is possible that improved ratings and scores may not be due to real improvements, but simply be the result of revised rating methodologies, such as shifts in weighting or change of criteria, or deterioration of sector peers’ ESG performance.

- **Lack of diversification and sector or country biases**: In an ESG leaders approach there is usually a defined percentage of companies that are considered “best in class” within each industry or sector. This is not the case for ESG improvement. It may be the case that one sector improves much more than

---

**Fig 6: Checklist for ESG improvers equities funds**

Questions to support fund selection

- Does improving performance on E, S or G issues form the basis of the investment thesis and strategy? Does the fund manager provide transparency over criteria and investment process?
- Can the fund manager show how s/he links ESG performance with expected outperformance?
- Do I understand what investments this methodology results in? For example, do I accept sub-par sustainability performance if a company is showing true improvement?
- Does the fund manager apply negative screens in addition to the ESG improvement approach that fit with my values?
- Does the fund manager have a policy of active ownership that could support and strengthen the ESG improvement trend?
- In case of an ETF on an index: Is the ESG improvement index based on solid rules? Do the rules result in large unintended over- or underweights in single stocks or sectors which might drive performance?

Source: UBS Chief Investment Office
others. This may lead to overweights in specific sectors or countries and underweights in others, which could lead to unintended deviations from benchmark performance if not managed properly.

Social and environmental contribution

This strategy may be considered to be placing more emphasis on investment returns than on aligning investments with personal or ethical values, and exposure to companies that are not already considered ‘sustainable’ may be a problem for some investors. However, the strategy offers investors deliberate exposure to companies making material improvements on ESG issues that can lead to greater potential positive incremental social/environmental change than companies already demonstrating high performance in these areas.

Owning these securities enables investors to signal to corporations the importance of continually improving their ESG performance. Just as with ESG leaders equities, the potential to intentionally drive or measure impact through the liquid underlying securities owned is limited.

References


Appendix

Research publications from Chief Investment Office Global Wealth Management, formerly known as CIO Americas, Wealth Management, are published by UBS Global Wealth Management, a Business Division of UBS AG or an affiliate thereof (collectively, UBS). In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. This report is for distribution only under such circumstances as may be permitted by applicable law.

Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Deutschland AG, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS Securities Japan Co., Ltd, UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. UBS Financial Services Incorporated of PuertoRico is a subsidiary of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the “Municipal Advisor Rule”) and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.

UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS. UBS accepts no liability whatsoever for any redistribution of this document or its contents by third parties.

Version as per April 2018.

© UBS 2018. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.