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Mark Nicholls: The rise of the responsible quant

How quantitative investors are tapping ESG for an information advantage

by **Mark Nicholls** | February 20th, 2014

For some in the responsible investment world, it's the Holy Grail: hard-nosed quantitative investors plugging environmental, social and governance (ESG) data into their models to help generate above-market returns. And, with recent improvements in the quality, coverage and supply of corporate ESG data, and emerging evidence that analysing this data offers an information advantage, it's a Holy Grail that is increasingly within reach. "There's been a surge in interest from quants in ESG data," says Andre Chanavat, consultant at Thomson Reuters' ESG arm in Switzerland. "We're talking to pretty serious quants, dedicated companies doing algorithmic trading, who are looking for standardised ESG data. "There is growing interest in seeing if ESG is an alpha generator." "We're seeing inbound enquiries from very mainstream players, dipping their first toe in the ESG water," says Michael Jantzi, CEO of research and analysis firm Sustainalytics. "They're looking for predictive signals." To some degree, this is simply part of the onward march of responsible investment, says Noel Friedman, executive director, ESG product management at financial information firm MSCI in Boston. "ESG is branching out from large-cap equities … the quant world is the latest frontier." And, with asset owners increasingly asking questions of their managers about ESG integration across the range of asset classes, "it's about asset retention", he adds. But as quants are encouraged to explore – or revisit – ESG analysis, some are also finding investment advantage in the data. "Quants are pretty resistant to things that impact their models negatively, and the traditional view is that ESG will negatively impact portfolios. That view is changing," says Friedman.
He gives the example of a California-based quant shop – which he declines to identify – with a request for proposals from an asset owner that required ESG integration. "They wanted the mandate, but didn't want anything to do with SRI," he says, as they associated it with negative screening. However, with some encouragement from Friedman's team, they found that incorporating ESG data provided risk reduction, and also found some positive signals from the data. "They wound up incorporating it across all their models," he says. That experience is increasingly common. Last year, Deutsche Bank's North American quantitative strategy analysts produced a landmark report – the Socially Responsible Quant – prompted by "a significant increase in client demand among quant funds, hedge funds, mutual funds, and pension funds for SRI performance metrics and products". Their starting point was the contention that "the ESG dataset contains an overwhelming number of unique data points that are typically not previewed by traditional investors." The report found that a series of long-only, optimised US and global ESG portfolios

outperformed their benchmarks. And last month, Hermes Fund Managers published research arguing that, contrary to many investors' prejudices, "focusing on ESG factors can enhance returns". Specifically, the fund manager looked at companies in the MSCI World from the end of 2008 to the end of 2013, using Hermes' own data, as well as that from external providers including Trucost, Sustainalytics, Bloomberg and FactSet. The research found that companies with high governance scores outperformed poorly governed companies by an average of more than 30 basis points per month over the last five years.

"Capturing this consistent source of value can enhance the returns of equity strategies," the report said. "ESG has historically been seen by many investors as a 'benchmark-minus' sort of product," where good ESG outcomes came at a cost to investment performance, says Geir Load, head of Hermes Quantitative Equities in London. "If we're able to show that [ESG data] can be used to identify good management, we can turn it into a 'benchmark-plus' product." What Hermes' research didn't show, however, was any relationship between environmental or social factors and financial returns. "Governance is the easiest of the three to change," says Load. "You can change the board structure, introduce an independent chairman, etc. If you're a polluting business, it takes a long time to change it." "You will see social and environmental scores become more important over time – we just don't have the statistical evidence for it at this time." The point is to use ESG data to come to an objective assessment of the quality of management. "We've been thinking about this for six or so years, looking at various data sources, and integrating it on the subjective side," says Lewis Grant, a portfolio manager at Hermes Quantitative Equities. "Only in the last couple of years has the data become good enough." "This is a function of the greater availability of ESG data" and improvements in its quality, agrees Andre Bertolotti, chief investment officer at Quotient Investors, a New York-based investment firm that is backed by California pension giant CalPERS. "It's become more consistent through time, and consistent across assets and industry sectors," he adds. Non-existent or inadequate data has long held back the use of ESG factors by quants. And even now, because most ESG data is provided by companies on a voluntary basis, without the standardisation that regulation tends to bring, its use remains challenging. One drawback is that the data – much of which is derived from voluntary corporate social responsibility reporting, or periodic regulatory disclosures – is typically only updated once a year. "It's not easy to use," says Bertolotti. "However, it gives really, really important insights into a company that aren't available elsewhere."

"Without ESG, my portfolio would look like that of many other managers," he says. "We all like cashflow, earnings … But when you bring ESG into the picture, I end up buying a different set of stocks." Bertolotti declines to name individual companies, but he says that applying ESG information – weighted differently depending on the industry sector – has led him to invest his US equity fund, which is benchmarked to the Russell 1000 index, more heavily in mid-caps. "Basic materials, healthcare, they're responding well to ESG," he says. And Quotient claims significant outperformance from its strategy. Its Sustainable Alpha strategy has delivered annual alpha (outperformance) of 4.88 percentage points over three years compared with the Russell 1000. It's a story which Dutch pensions giant APG has subscribed to, making perhaps the biggest commitment to quantitative ESG integration among pension funds. In 2011, it hired Andy Moniz from Macquarie as senior quantitative portfolio manager, with a mandate to research and backtest the impact of ESG signals on stock performance. Last year, it added a member of staff to its governance and sustainability team dedicated to quant ESG. "Quantitative strategies rely on the accuracy of reported data," Moniz says. "And there are lots of challenges with ESG data." The lack of consensus among ESG ratings providers meant that APG had to do much of the research from the ground up. However, the conclusion was clear: "ESG data does enhance risk-adjusted returns," Moniz says, although he stresses that "you need to take a very tailored approach", controlling for "corporate hypocrisy" – the gulf between corporate ESG policy and behaviour – and acknowledging that different ESG factors weigh differently depending on the sector, country and even the company involved. "In the end, we need to look at the individual company's behaviour." "Quantitative ESG integration doesn't stop at the stock selection model," he adds. APG insists that portfolio managers 'know your company', he adds, to ensure they systematically monitor their companies, and related newsflow, to assess which ESG issues are likely to affect earnings, and whether the market has accurately priced those in.

"Having dedicated ESG quantitative resources means we can really delve into these issues," says Claudia Kruse, APG's managing director of governance and sustainability. APG has been applying its proprietary approach to its portfolios for around a year, although Moniz prefers not to disclose a figure for the effect on portfolio performance. And the effort is ongoing, adds Kruse. "We are constantly innovating our approach. We're not stopping here." But some responsible investment veterans urge a note of caution. "By definition, quantitative investing is based upon historical numbers and correlations – this is a limitation of the approach, period," says Matthew Kiernan, the founder of Inflection Point Capital Management and of Innovest Strategic Value

Advisors,
a pioneering sustainable investment analysis firm that is now part of MSCI. “The only way you can claim 100% predictive usefulness is if the future is going to be a mirror image of the past” – which, given the emergence of environmental, demographic and resource ‘megatrends’ is unlikely. “This should at least condition one’s enthusiasm for incorporating ESG factors.” “It’s at an early stage in terms of quants looking at this data,” agrees Friedman at MSCI. “But with asset owners ratcheting up their expectations, it will drive more thoughtful and sophisticated responses from quants. “The more research there is in the marketplace that provides evidence that there are interesting signals from ESG, the broader will be the uptake,” he adds.