

ESG Momentum Stocks: Sustainable Investing's Diamonds in the Rough

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One of the challenges that confronts retirees and their advisors is how to prevent having to sell their hard-earned retirement assets at the wrong time. We have all heard the age-old investment adage “Buy Low and Sell High,” which tells us to buy assets when they are out of favor but to time the disposition of the assets when the markets are in your favor.

Executive Summary

- A company's efforts to improve its sustainability are often a better gauge of future success than its current ESG (Environmental, Social and Governance) score.
- Numeric ESG scoring doesn't factor in momentum, judgment and perspective, giving active managers a clear edge in the search for long-term outperformance.
- Independent judgment in assessing relative ESG values in companies across regions, industries and market capitalization is crucial for portfolio diversification and risk-adjusted returns.

The old investment maxim “buy low and sell high” has an additional corollary in the fast-growing world of sustainable investing. Companies that strive to improve their environmental, social and corporate governance (ESG) standards, it turns out, may generate market-beating returns for their shareholders. The reasons are simple: first, firms that integrate ESG factors tend to have better risk and return characteristics. Second, for investors who seek to benefit from the improvement in firms’ ESG standards, we believe the best time to invest is before the improvement is widely recognized—and rewarded—by the market.

Contrary to lingering investor concerns that including ESG attributes in the investment research process would undercut risk-adjusted returns, index provider MSCI is providing growing evidence that ESG investing can produce superior returns. At the end of June, the five-year annualized total net return of the MSCI EAFE ESG Index stood at 3.03%, nearly doubling the MSCI EAFE Index’s 1.68% annualized return. Likewise, the MSCI ACWI ESG Index’s annualized net return over the same period amounted to 6.13%, handily outperforming its MSCI ACWI Index cousin’s 5.38% gain. Even the MSCI EM ESG Index showed strik-

“An improvement in ESG scores signals that a company is better equipped to avoid ESG-related risks; this reduction in potential future liabilities is quickly discounted by market participants and built into the share price.”

ing outperformance, with a five-year annualized net return of 0.75%, besting the MSCI EM Index’s negative 3.78% yearly return by just more than four points.

Momentum vs. Tilt

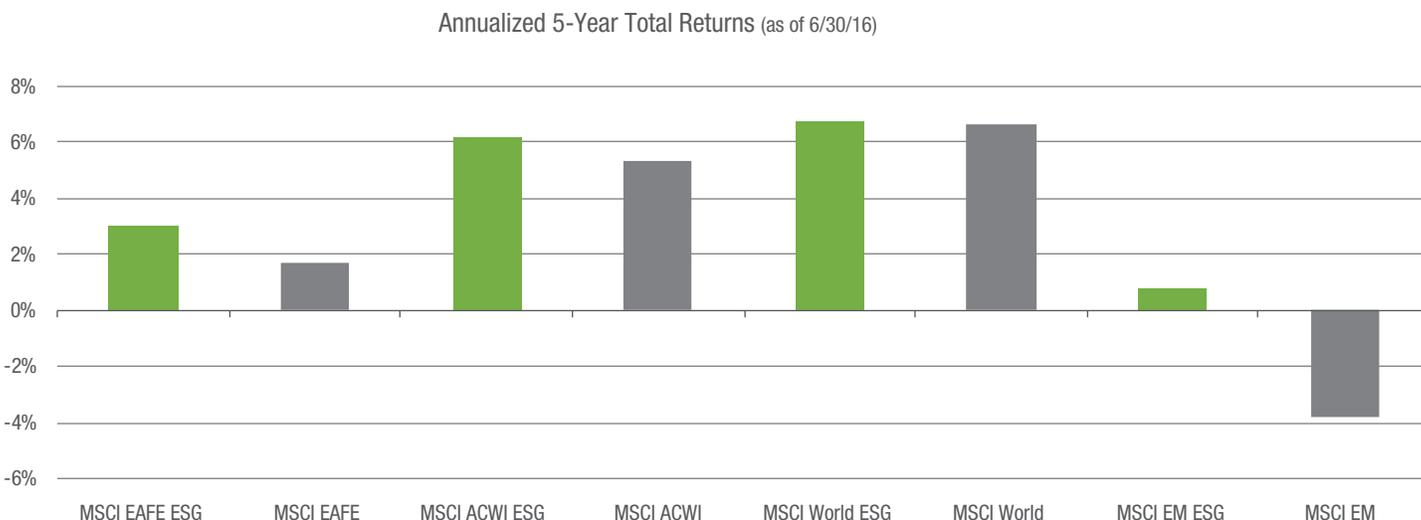
In a study examining stock returns in strategies that focus on ESG “momentum” and “tilt” criteria, MSCI found that both led to outperformance against global benchmarks over seven-year and eight-year periods, respectively.¹ The tilt strategy favored stocks with higher ESG ratings; the momentum strategy focused on stocks that had recently improved their ESG scores. With respect to the latter, “an improvement in ESG scores signals that a company is better equipped to avoid ESG-related risks; this reduction in potential future liabilities is quickly discounted by market participants and built

into the share price,” MSCI reported. Importantly, the momentum strategy wasn’t focused on lifting “the ESG profile of the resulting portfolio because stocks with the largest increase in ESG scores are not necessarily the best-rated stocks at the time.”

During the seven-year sample period, the momentum strategy produced yearly benchmark-beating returns of 223 basis points, of which stock-specific return amounted to 132 basis points (*Figure 2*). As MSCI pointed out, “overall, most of the portfolio’s risk and return came from picking the right stocks, but factor tilts also played a role.” Moreover, both the momentum and tilt strategies “experienced very low tracking error with respect to a global benchmark,” MSCI noted.

¹ *Can ESG Add Alpha?* MSCI, June 2015

Figure 1 | Green is the New Black



Source: Morningstar

Figure 2 | Active Return, Risk in ESG Momentum Strategy

Source of Return	Active Return (%)	Active Risk Contribution (%)
Style	0.72	0.08
Industry	0.44	0.35
Country	-0.28	0.14
Currency	0.03	-0.05
Stock Specific	1.32	2.07
Total Active	2.23	2.59

Decomposition of the active return and risk of the ESG Momentum portfolio, annualized figures, February 2007 – March 2015.

Source: MSCI

Limitations in ESG Scoring

The MSCI ESG study largely parallels our own research and decade-long experience managing socially responsible separate accounts, and, since September 2015, running our own Thornburg Better World International Fund and, for institutional investors, International Equity ESG Strategy. However, we would highlight important caveats. While investment and market research firms provide some helpful data on a company's ESG integration, we believe judgment and perspective are crucial for assessing any company's day-to-day application of expanding ESG standards, particularly in the case of ESG momentum investing. ESG momentum prospects are, almost by definition, initially tagged with low ESG scores by research firms, which don't have much choice. As MSCI indicated, companies are scored on their current ESG levels, not the potential outcome of their nascent efforts to improve their ESG characteristics. As a result, ESG mutual funds that employ a momentum strategy typically receive lower "sustainability scores" by the research firms, even as portfolio stocks progress toward higher ESG marks and, potentially, returns.

Due to a lack of resources, the research firms can also generate an unintentional bias against mid- and small-capitalization stocks simply by not rating them, even if they have solid ESG attributes. That unrated status counts against them and, by extension, drags down the ESG profile

score of multi-capitalization ESG mutual funds. Likewise, companies may be rated against industry peers without a social overlay, meaning those in socially dubious sectors (say, firearms or tobacco) might receive a higher relative scoring. Research firms generally try to adjust for this by assigning a "controversy" score. But even then, an ESG rating may not reflect a company's true ESG profile. For example, Korea Zinc might get a "controversy" knock against it for its mining sector classification, even though it sources much of its zinc, which is indispensable for human, animal and plant life and a necessary ingredient in a huge spectrum of consumer goods and appliances, through environmentally friendly recycling.

On the flip side, ESG funds angling for high sustainability ratings by research firms may end up with insufficiently diversified portfolios, leading to higher correlations between portfolio holdings, with greater risk and return volatility.

ESG Investing: More Than a Score

It's difficult to over-emphasize the necessity of sound judgment and perspective in constructing an ESG portfolio. At Thornburg, we employ fundamental financial analysis coupled with ESG research, which we derive partly from third-party research firms but mostly from direct engagement with companies.

As active managers, we find that we have to make judgment calls that are often at odds with the ESG scoring of investment research firms, given the limitations of their methodology or resources for scoring a wide array of companies globally, especially international small- and mid-capitalization stocks. We also believe that rating companies versus industry peers and assigning a "controversy" score often doesn't accurately capture the social benefits of some companies, such as Korea Zinc, or the social detriment of others, say tobacco and gaming companies.

Moreover, quite apart from the obvious shortcomings of scoring on ESG momentum strategies, portfolio diversification and reduced correlation between portfolio holdings can only be achieved by accounting for relative differences in context. Should culturally distinct Northeast Asian firms be held to the same disclosure standards as North American companies? Should Latin American firms be held to the same gender diversity standards as Scandinavian peers? Relative differences in context matter when assessing the strength of the trend toward ESG integration in momentum names, or the extent of ESG values integration in companies that already exhibit strong ESG factors.

Correlations within a portfolio can be reduced without sacrificing adherence to ESG principles. For example, Thornburg's ESG strategy shuns hydrocarbon and certain types of metals producers, but we can compensate for those exposures by investing in firms with strong ESG standards and high return on capital in countries whose economies and currencies benefit from cyclical uptrends in the commodity complex. That partly explains our recent investments in South African hospital group Life Healthcare, Norwegian seafood producer Marine Harvest, and Chilean water utility Aguas Andinas. All three have improving or strong ESG attributes, strong financial characteristics and offer indirect exposure to commodities and energy via the

rand, the krone, and the peso, helping offset the lack of direct exposure to oil and materials.

Alongside an attractive share price with a good margin of safety, these are the sorts

of synergistic financial and ESG characteristics that we like in our portfolio holdings. Such attributes also offer real downside protection, which can deliver higher portfolio returns over time by establishing a higher base off which to

rebound following bouts of market volatility. And financially strong companies that don't yet enjoy high ESG scores but that demonstrate a concerted effort to achieve them can also in time produce increasingly attractive, sustainable returns. ■

Important Information

Thornburg Better World International Fund Top 10 Holdings (as of 5/31/16)

Holding	Percentage
ING Groep N.V.	3.0%
Thermo Fisher Scientific, Inc.	3.0%
Europris ASA	2.8%
Telenet Group Holding NV	2.8%
Empiric Student Property plc	2.7%
AIA Group Ltd.	2.6%
Novartis AG	2.6%
Brenntag AG	2.5%
Nippon Telegraph & Telephone Corp.	2.4%
Nokia Oyj	2.3%

The views expressed by the portfolio managers reflect their professional opinions and are subject to change. Under no circumstances does the information contained within represent a recommendation to buy or sell any security.

Past performance does not guarantee future results.

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assumed that any of the referenced securities were or will be profitable or that the investment decisions we make in the future will be profitable.

Active Return – The differential between the portfolio return and that of the benchmark.

Active Risk Contribution – The total percentage contribution to active risk (tracking error).

The MSCI EAFE (Europe, Australasia, Far East) Index is an unmanaged index. It is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas developed markets on a U.S. dollar adjusted basis. The index is calculated with net dividends reinvested in U.S. dollars.

The MSCI EAFE ESG Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social and Governance (ESG) performance relative to their sector peers. MSCI EAFE ESG consists of large and mid cap companies across developed markets countries around the world, excluding the U.S. and Canada.

The MSCI All Country (AC) World ex-US Index is a market capitalization weighted index representative of the market structure of 45 developed and emerging market countries in North and South America, Europe, Africa, and the Pacific Rim, excluding securities of United States' issuers. The index is calculated with gross dividends reinvested in U.S. dollars.

The MSCI ACWI ESG Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social and Governance (ESG) performance

relative to their sector peers. MSCI ACWI ESG consists of large and mid cap companies across 23 developed markets and 23 emerging markets countries.

The MSCI World Index is an unmanaged market-weighted index that consists of securities traded in 23 of the world's most developed countries. Securities are listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated with net dividends reinvested in U.S. dollars.

The MSCI World ESG Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social and Governance performance relative to their sector peers. The parent index is MSCI World Index, which consists of large and mid-cap companies in 23 developed markets countries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The MSCI Emerging Markets (EM) ESG Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social and Governance performance relative to their sector peers. MSCI EM ESG consists of large and mid cap companies across 23 emerging markets countries.

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