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Smart Beta and ESG: Is this a match in heaven ?....

…. has been the title of a recent article on **Funds Europe** (Link). Both have been major trends in investment management over recent years and the article is around **the question, if putting both together might be a next "natural step"**.

"It depends" might be the natural answer - because of several reasons. According to a recent Cerulli report "**Environmental, Social, and Governance (ESG) Investing in the United States"** (Link), responsible investing is implemented in several forms by investors today and each form has one or more value propositions:

1.	Negative Screening	value alignment
2.	ESG Integration	value enhancement
3.	Positive Screening	value enhancement
4.	Thematic Investment	value enhancement + ESG impact
5.	Impact Investment	value enhancement + ESG impact
6.	Active Ownership	value alignment + value enhancement + ESG impact

Negative screening or exclusion seems to be still the most favoured approach by product providers and investors alike, because it delivers the alignment of investors basic principles and beliefs with their investment strategy and it is simple to implement and to communicate. But there are some pitfalls:

- as always, **every seller needs to find a buyer** and as exclusion is a form of active investment if investors continue to use conventional indexes as their benchmarks. That´s why investors should consider basic questions like
    - **Who´s on the other side? and**
    - **What might be the buyer's motivation?**
- a second point to highlight is, that according to Grinold/Kahn´s Fundamental Law of Active Management (performance = skill x breath), **a smaller universe (breath) is equivalent to a reduction in performance potential -** vice versa, for a similar performance a higher information ratio (more skill) is required.
- a pure exclusion-based approach ignores causal links to basic economic principles. As always – **good companies don´t guarantee successful investments** and as long as excluded companies find their customers and earn profits above their cost of capital, it is unlikely, that these companies default or disappear from capital markets.
- and finally: **ESG - exclusion quite often means betting against governments**, as the US withdrawal from the Paris agreement, the unblocking from using landmines or French government's commitment to nuclear power etc. show

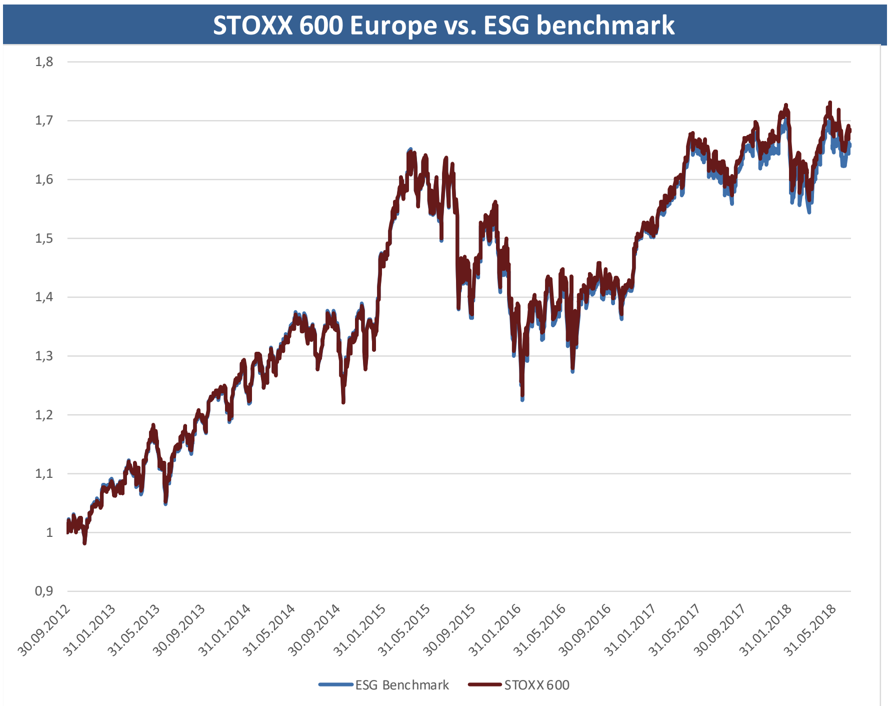
As a result, **investors who prefer exclusion** as their preferred way to implement ESG into their portfolios **might be better off by changing their policy benchmark components to ESG compliant variants**. There´s basically no difference to other decisions on an overall portfolio level, because if an investor doesn´t invest in Emerging Markets, it´s quite unlikely that EM will be part of a portfolio´s policy benchmark. Moreover, new instruments like **EUREX´s new ESG futures** (Link) allow for easy implementation.

For those, who like to stick to conventional benchmarks, we like to come back to our headline, the list of favoured ways of implementation and the question, **if a combination of ESG – implemented via exclusion – and factor investing** can be a convenient way to solve some of the problems above?

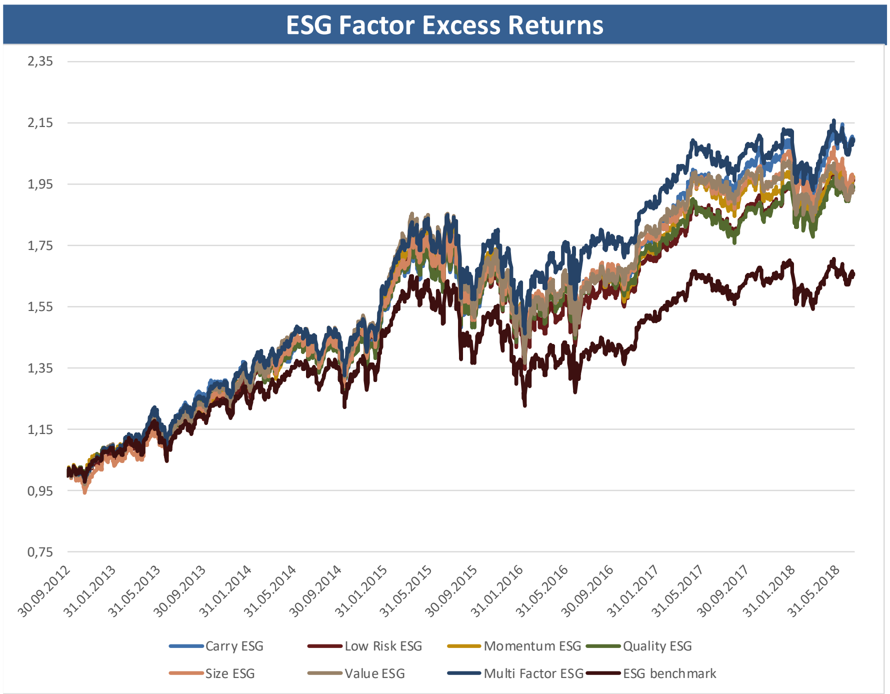
In our first **ESG research project in cooperation with** Southpole´s climate solution group, which is part of **ISS ESG** today and **Prof. Bassen from University of Hamburg** in 2016/2017, we tried to find out, **if climate change has already found it´s way into risk and return of European equities**? In "**The search for climate-smart investments - the case of European equities**" (Link) we elaborated on our research findings and provided ways to deal with the climate change problem in European equity portfolios.

Motivated by an ongoing discussion about the question, **if ESG is able to deliver excess returns** and a FT article in 2017 titled "**ESG investing and smart beta combination grows in popularity**" (Link), we started to investigate in 2018, if a combination of broad ESG plus factor premia can be a useful way to answer the question mentioned above.

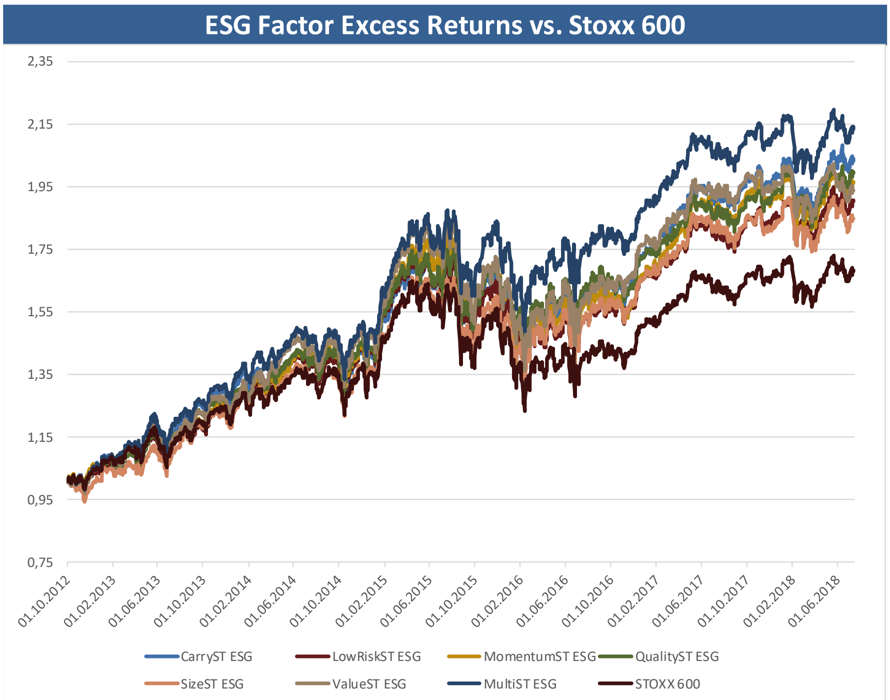
In a first step, we decided to use an ESG – based European equity index, which is **compliant to the UN global compact,** excludes critical companies from the universe and where performance during the relevant timeframe has been more or less identical compared to classic European benchmarks.



In a first step, we built factor portfolios, using stocks from the ESG benchmark as a universe and the ESG index itself as a benchmark. The results in the graph below show, that all **factor portfolios outperformed the ESG benchmark**.



In a second step, we tried to find out, if factor portfolios, built from stocks out of the ESG benchmark can outperform a classic benchmark like STOXX 600. **The results look promising as well** and shouldn´t come as a surprise as **factors provide the link to basic economic principles.**



But – the **excess returns are lower compared to non ESG compliant factors** and factors built vs. an ESG compliant benchmark as the summary of results shows:

Factor Excess Returns	Carry	Low Risk	Momentum	Quality	Size	Value	Multi Factor
iSTOXX factors vs. STOXX 600	5,23%	3,40%	5,26%	3,78%	4,45%	2,72%	5,59%
ESG factors vs. ESG benchmark	4,16%	2,90%	2,98%	2,67%	3,01%	2,59%	4,12%
ESG factors vs. STOXX 600	3,61%	2,34%	2,90%	3,20%	1,80%	2,68%	4,55%

On a first look, the arguments of many critical voices with respect to performance potential of ESG seem to be right, but:

- the ESG compliant universe is only 450 stocks compared to the non- restricted universe containing approx. 850 stocks, confirming the "fundamental law of active management"- argument.
- the largest deviation is in Size, which is due to topic no.1 and confirms the findings in many research papers, that larger companies seem to be better positioned with respect to ESG for several reasons
- smaller differences can be found in Quality and Value, and the main reason among others here seem to be, for Quality:
  - that ESG metrics quite often are highly correlated with many Quality characteristics
  - and higher ESG rated companies as well as higher Quality companies are more common within large caps, which removes Size impact

  and for Value

  - that ESG doesn´t really matter in value

So, if investors can invest in a large universe despite exclusions, results should be more in line with non ESG-compliant factors and even **a lower excess return is more valuable than no excess return**. Finally – a combination of ESG and factor investing will be a new category on Cerulli´s list, because **it provides a new value proposition**:

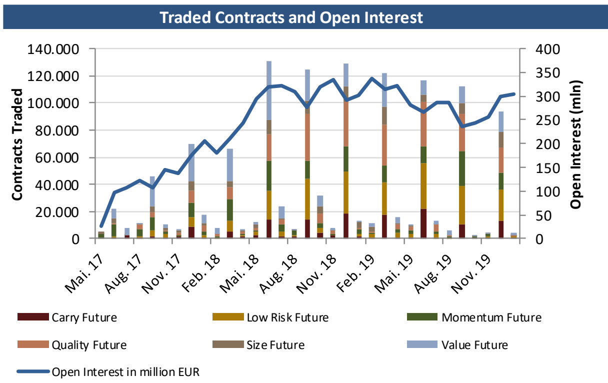
value alignment + value enhancement

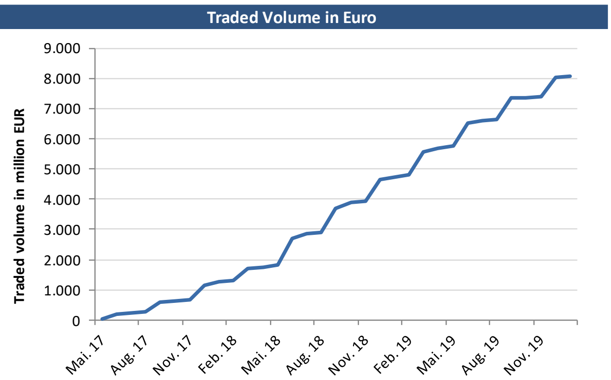
Factor performance

Momentum and Quality lead the table in Q4/2019.Momentum outperformed for a second quarter in a row, delivering +1,04% excess return while Quality outperformed by +0,90%. Carry held the “red lantern” again during the last quarter of 2019, underperforming STOXX 600 by -1,33% while Size delivered -0,58%.

EUREX Futures

Open interest rose for four consecutive months to above 300 mln Euros in January 2020. The tables show developments in traded contracts, open interest and overall traded volumes since introduction in May 2017. The traded volume exceeded 8 bln Euros.





Alpha Centauri Indexing - Data as of 31.01.2020

<u>Description:</u>

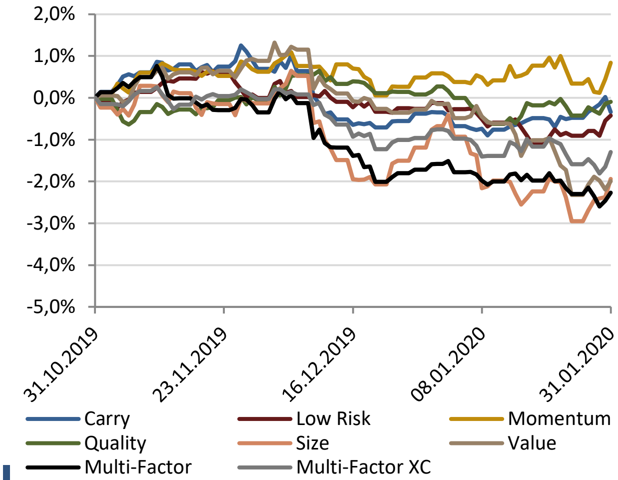
The iSTOXX Europe Single Factor index family developed by STOXX in collaboration with Alpha Centauri offers investors a unique and very innovative way to target and capture premia.
It consists of six single factors that aim to capture well-known risk premia and one multi-factor that aims at simultaneously capturing premia from the aggregate of all single factors rather than from just one source of risk alone.
All indices are constructed to maximize the exposure to their particular factor and minimize unwanted risks. While constructing the final indices the FIS APT risk model is used to measure and restrict risk.

For more information go to **www.alpha-centauri.com** or www.stoxx.com

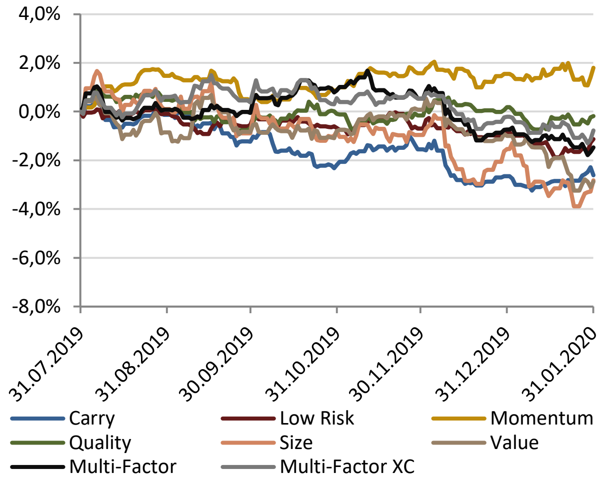
Performance and Volatility Breakdown

Name	Ticker	Return 3 Months	Return 6 Months	Return 12 Months	Return Live (1.4.)	Vola pa	Vola pa Live (1.4.)
Carry	ISECFER Index	3,4%	4,7%	11,9%	44,6%	13,9%	12,8%
Low Risk	ISERRER Index	3,4%	6,1%	16,4%	44,1%	12,7%	11,8%
Momentum	ISEMFER Index	4,6%	9,1%	16,3%	36,3%	13,5%	12,5%
Quality	ISEQFER Index	3,7%	7,1%	17,3%	35,6%	13,6%	12,6%
Size	ISEZFER Index	1,8%	4,5%	5,6%	30,7%	13,8%	12,9%
Value	ISEVFER Index	1,8%	4,4%	7,4%	24,3%	14,4%	13,2%
Multi-Factor	ISEXFER Index	1,5%	5,8%	13,5%	28,0%	13,2%	12,2%
Multi-Factor XC	ISEXFCR Index	2,5%	6,5%	12,9%	31,8%	13,3%	12,2%
Benchmark	SXXR Index	3,8%	7,3%	17,9%	37,2%	13,7%	12,6%

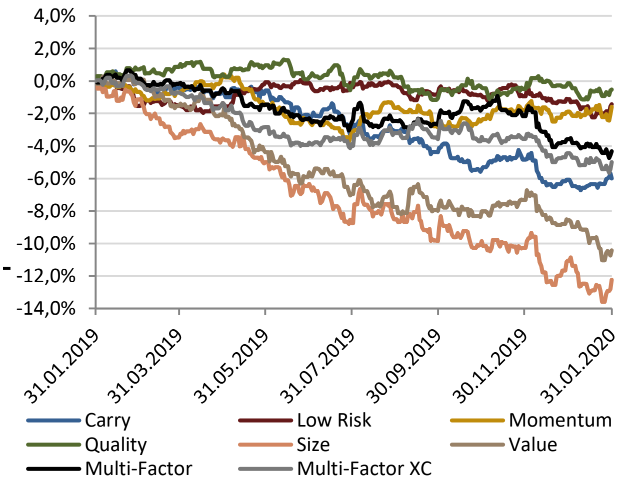
Excess Return 3 Months



Excess Return 6 Months



Excess Return 12 Months



Excess Return since going Live (1.4.2016)