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A "Sweet Investment":

Why ESG Reduces Risk and May Increase Returns

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It's your money, so you can do with it what you want, right? Actually, *not* right – at least, not if you want to use your retirement savings to promote better environmental, social, and governance (ESG) practices. That's because the U.S. Department of Labor (DoL) has recently promulgated a Final Rule that seems intended to eradicate ESG from all investment accounts governed by the 1974 Employee Retirement Income Security Act (better known as ERISA).

The new rule runs to 45,000 words splayed across 40 pages of the *Federal Register*[1], but its essence lies in just a single sentence: "ERISA fiduciaries must evaluate investments and investment courses of action based *solely on pecuniary factors* – financial considerations that have a material effect on the risk and/or return of an investment based on appropriate investment horizons consistent with the plan's investment objectives and funding policy" (emphasis added).

In other words, the *only* relevant considerations are those that directly affect the price, volatility, and time horizon of a possible investment. In case you missed it the first time, the DoL rule also insists that "Fiduciaries who choose investments with expected reduced returns or greater risks to secure non-pecuniary benefits are in violation of ERISA." On the face of it, the DoL rule appears to prevent investment managers from caring about whether a company makes products that are toxic to the environment, promotes social outcomes antithetical to their clients' moral values, or violates human rights conventions.

Likewise, ERISA investors are required to vote their shareholder proxies "solely in the interests of the participants and beneficiaries." ERISA managers can forget about trying to influence management's approach to climate change, or to diversify a board of directors. The only permissible use of a proxy vote is to seek higher profits without incurring undue financial risk.

In short, values-based investing appears to be anathema to DoL. Worse, it seems evident that the DoL hopes to influence non-ERISA funds as well. Yet as the chair of Eastern Bank's employee 401(k) oversight committee, I still endorse this rule. The practice of ESG investing – at Eastern Bank and across the investment community – has grown in sophistication in recent years, such that today investors no longer must choose between market-based returns and social benefits. They can and *should* demand both.

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[1] If you're curious, you can find the rule at https://www.federalregister.gov/documents/2020/11/13/2020-24515/financial-factors-in-selecting-plan-investments. It's possible that the Biden administration may seek to reinterpret or repeal the rule, but doing so does not appear to be a high priority.

The DoL's rule recognizes this reality, inserting a key loophole into the language. The Final Rule says that "fiduciaries are indeed permitted to add … designated investment alternatives that may produce *collateral benefits* or otherwise are viewed by some as socially desirable. But, importantly, these alternatives may be added only if they can be justified solely on the basis of pecuniary factors" (emphasis added).[2]

Here we get to the crux of the matter: If ESG factors can be shown to be "pecuniary" – if they are likely to have a material effect on the risk or return of an investment, and if they are relevant within the investor's time horizon – then they are kosher for ERISA plans. Put simply, the investment manager must "prudently determine" that ESG adds to returns or reduces risk.[3]

For many years, the mainstream investment community considered the assertion that ESG could *add* to returns or could *reduce* risk to be heterodox lunacy. Surely a traditional portfolio already incorporates the manager's best ideas and wisest insights – so the deletion of any individual security because of ESG factors and its replacement by a substitute (lesser) security must inevitably increase volatility or reduce expected returns.[4] Indeed, early research on ESG strategies suggested that simplistic deletion of what were perceived as offensive securities generally did increase volatility or reduce returns.

There was one big problem that scuttles the value of nearly all early research on this topic: The studies were done during a long period when oil prices were rising and when "value" stocks outperformed growth stocks. Tobacco and fossil fuel securities (two classic examples of value stocks) were key contributors to traditional portfolio returns during those years, so their absence from ESG funds negatively affected the performance of those funds. More recently, "growth" stocks have dominated the markets, while oil prices remain well below their historic highs – so it's no surprise that ESG portfolios did *better* than traditional portfolios in recent years.

The early research on ESG focused on funds that essentially swapped divested securities for more palatable alternatives on a one-for-one basis; that was the state of the art through the early 2000s. But in recent years investors have become far more sophisticated in how they construct ESG portfolios, such that stylistic factors and portfolio characteristics could be replicated in ESG portfolios despite the absence of divested holdings. The performance disadvantage in value-tilted markets would presumably disappear.

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[2] Actually, there are two loopholes. The second allows investment managers to choose an ESG-themed investment over a traditional alternative if the two options are identical in all other respects (including projected risk and return) and provided that the investment manager document the analysis in writing. That burden is unrealistic to ask of ERISA managers fearful of potential lawsuits, so this "tie-breaker" provision is likely to be useless in practice.

[3] This being the government, the phrase "prudently determine" is used many times in the Final Rule, and it has a specific meaning: The investment manager must use a reasonable standard of care, incorporate forward-looking expectations, and consider the specific risk profile and time horizon of the client (retirement plan participant).

[4] See, for example, Milton Friedman's anti-ESG philippic, "The Social Responsibility of Business is to Increase Its Profits," in The New York Times, September 13, 1970. More recently, his University of Chicago colleague (and fellow Nobel laureate) Eugene Fama attacked ESG funds from an efficient-markets perspective; see "Efficient Capital Markets II" in the Journal of Finance, May 1991.

The evidence powerfully supports this proposition. Study after study shows that modern ESG techniques don't detract from performance, and may even produce better returns than traditional approaches. To take one example, BlackRock examined a series of traditional and ESG stock market index returns over a seven-year period, and found almost no differences (Chart 1).[5]

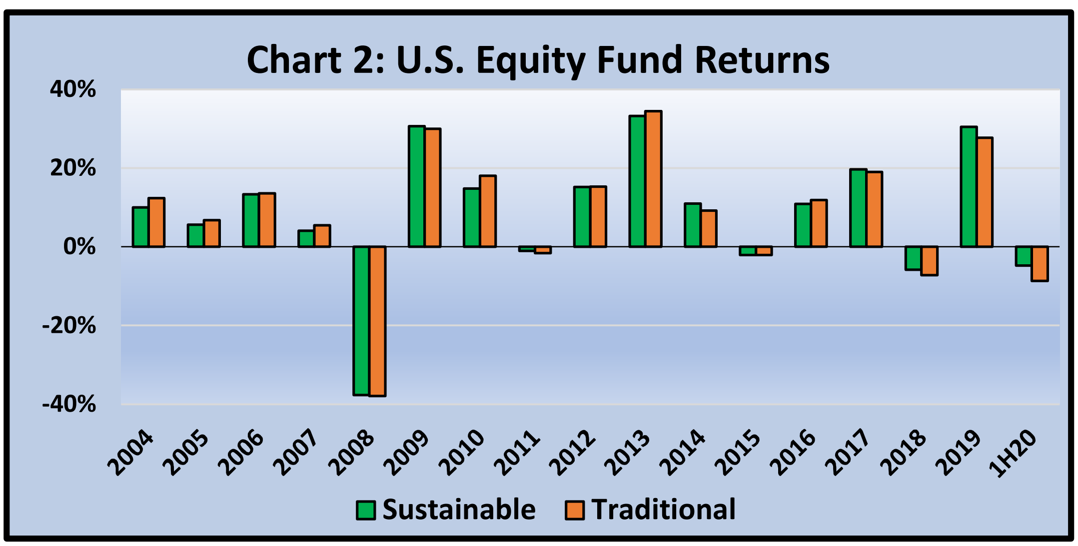
Chart 1: Traditional vs. ESG Index Characteristics

	Traditional	ESG Focus
Annualized Return, 1994-2018	9.86%	9.94%
Volatility (Standard Deviation), 2012-2018	9.5%	9.6%
Sharpe Ratio (return per unit of volatility)	1.62	1.60
Maximum Monthly Loss	-13.9%	-13.8%
Price/Earnings Ratio	19.4x	19.5x
Dividend Yield	2.1%	2.1%
ESG Score	5.2	6.6

Source: BlackRock

The data in Chart 1 is quite remarkable: Across every relevant financial characteristic, there is almost no difference between the traditional and ESG indices. The only meaningful difference is in the last line, the ESG score (as calculated by BlackRock), which shows ESG funds to be substantially better on non-financial characteristics.

Perhaps index performance and real-world fund performance are different; have actual ESG portfolios shown the same parity with traditional funds? To examine this question, Morgan Stanley studied over 10,000 mutual funds and ETFs from 2004 to mid-2020, a span that includes periods of both "value" and "growth" dominance. The year-by-year performance comparison is shown in Chart 2:

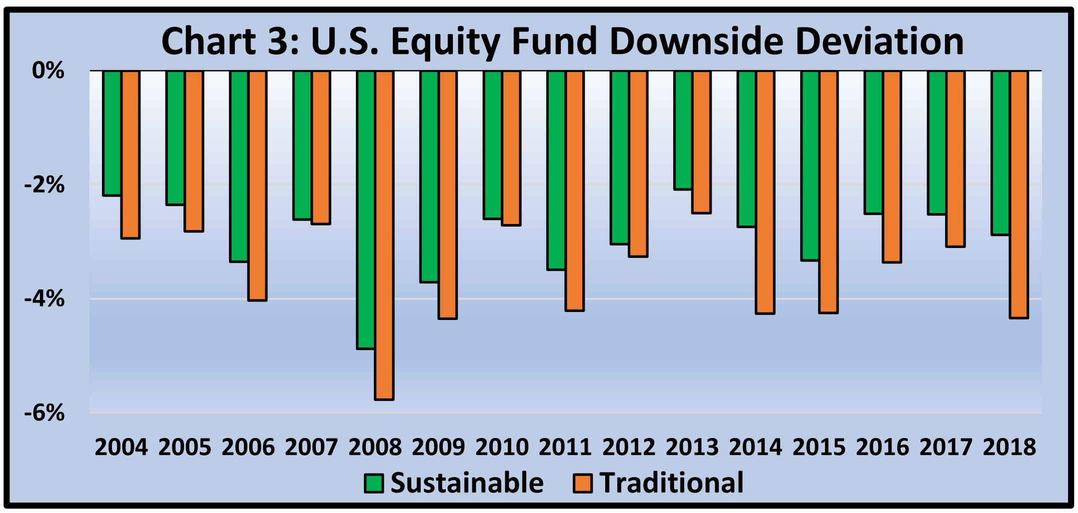


Source: Morgan Stanley

[5] BlackRock Investment Institute, "Sustainable Investing: A 'Why Not' Moment," published May 2018.

The firm's authors concluded that "The returns of sustainable [i.e., ESG] funds were in line with comparable traditional funds. There was no consistent and statistically significant difference in total returns."[6] An update published late last year concluded that ESG funds generally surpassed traditional funds during the Covid-19 pandemic.[7] Cumulatively through June 2020, the ESG funds produced about 7.2% *better* returns than traditional funds – not a statistically significant margin over nearly two decades, but still enough to meet the DoL's Final Rule requirement that ESG funds don't detract from returns.

The case for ESG investing gets better when we look at *risk* as well as *return.* The BlackRock study in Chart 1 shows that standard deviation and Sharpe ratio, both of which measure volatility (the standard measure of risk for investors), are nearly identical for ESG and traditional indices. The Morgan Stanley study goes further, calculating the downside deviation[8] of the mutual funds and ETFs in its study. As shown in Chart 3, ESG funds exhibited less downside volatility – less risk of losing money – in every single year from 2004 through 2018. This is quite remarkable: Investors not only don't take more risk to own ESG funds, they actually take *less* risk to get the same (or slightly better) returns.



Source: Morgan Stanley

At this point, it's reasonable to ask *why* ESG funds seem like the proverbial free lunch. If I construct a portfolio that is optimized for financial returns, wouldn't any alteration almost automatically detract from returns? How is it possible that altering that portfolio to reflect ESG themes actually improves risk-adjusted returns?

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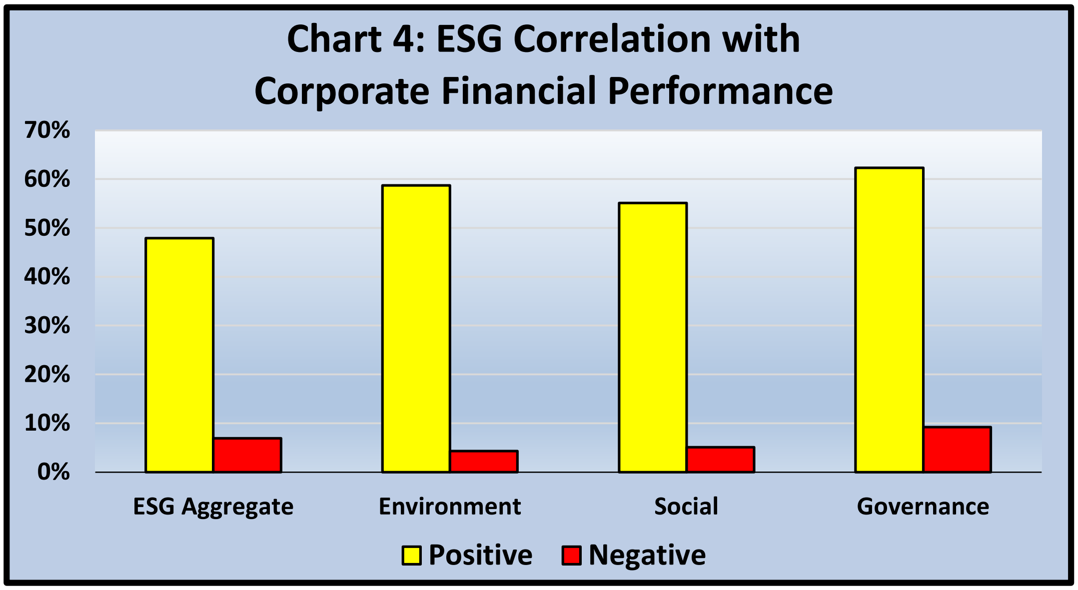
[6] Morgan Stanley Institute for Sustainable Investing, "Sustainable Reality: Analyzing Risk and Returns of Sustainable Funds," published August 6, 2019.

[7] Morgan Stanley Institute for Sustainable Investing, "Sustainable Funds Outperform Peers During Coronavirus," published September 17, 2020.

[8] The definition of "risk" for investors is volatility, as measured by standard deviation; this looks at both positive and negative variation around a mean return. By contrast, downside deviation is calculated using only negative variation from the mean return. Most people think of "risk" only as the possibility of losing money, after all.

The answer to this conundrum lies in an intuitive but non-obvious logic: What's true for indices and for mutual funds is also true for individual companies. It turns out that companies' financial performance is closely correlated with their ESG practices: Doing good leads to doing well.

A 2015 Deutsche Bank / University of Hamburg study[9] reviewed over 2,000 empirical studies of corporate performance in relation to various ESG factors. This meta-analysis looked at whether each of these empirical studies showed positive, neutral, or negative correlation of ESG factors with corporate financial performance (measured by return on equity, profit margins, balance sheet strength, and other metrics). Without inferring causation, the correlations are stunning, as shown in Chart 4:



Source: Friede et al., Journal of Sustainable Finance & Investment

Some studies showed negative or neutral relationships between ESG factors and corporate financial performance, but the large majority showed a positive relationship: Scoring well on ESG is associated with better financial outcomes for individual companies.

How can this be? A corporate CEO presumably is seeking to maximize profits without respect to non-financial factors; how can introduction of non-financial ESG factors do anything but detract from profitability? As with mutual funds, we can hypothesize that incorporating ESG factors into corporate decision-making acts to *derisk* corporate performance: A demographically diverse board of directors and management team is more likely to consider a wider array of possible options for any situation, thereby reducing the risk of missing the optimal choice; a careful evaluation of carbon impact may help companies avert the threat of stranded assets that may lead to writedowns and losses; perhaps awareness of social issues may help a management team avoid a major political gaffe that could lead consumers to boycott the company's products.

[9] Gunnar Friede, Timo Busch & Alexander Bassen, "ESG and Financial Performance: Aggregated Evidence from More Than 2000 Empirical Studies," Journal of Sustainable Finance & Investment, May 2015, pp. 210-233.

So to put this in the language of the Department of Labor's Final Rule about ESG investing: The most powerful reason to incorporate ESG factors into investment portfolios is that these factors are indeed pecuniary! Whether looking at an individual company or a mutual fund, consideration of ESG factors isn't just a way to align an investor's personal values or organizational mission with the assets in a portfolio; it's also a way to reduce risk without adversely affecting financial returns.

Our ESG Sustainability models explicitly use ESG factors to assess all stocks and bonds being considered for purchase. We also apply ESG standards in choosing how to vote shareholder proxies, and we seek out investments that actively promote positive impact – all without adversely affecting risk or return.

Even our traditional models implicitly incorporate an ESG sensibility; we just don't call it that by name. As Tim Curry so memorably sang in *The Rocky Horror Picture Show,*

> *Don't get strung out by the way it looks*
> *Don't judge a book by its cover*
> *It's not ESG by the official name*
> *But in truth it's there to discover*
> *It's just a sweet investment.*

We aim to maximize risk-adjusted returns in every client portfolio we manage; the use of ESG factors is more explicit and prominent in our ESG Sustainability portfolios, but it's part of the DNA of everything we do. Just don't tell our friends at the Department of Labor!