Using ESG to Mitigate Risk and Enhance Return

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& CO.

INTRODUCTION

The prominence of Environmental, Social, and Governance (ESG) investing has increased significantly over the past few years. The United Nations Principles for Responsible Investment ("PRI") was formed in 2006 to work towards achieving a sustainable global financial system by encouraging stakeholders to adopt six principles for responsible investment and to collaborate on their implementation; since its formation, the number of PRI signatories has increased from less than 63 to over 3,000 while the assets managed by those signatories has increased from less than $7 trillion to ~$103 trillion as of 31 March 2020. While the popularity of ESG investing has increased, evidence supporting ESG investing's contribution to alpha generation or to enhance risk-adjusted returns as measured by the Sharpe Ratio is inconclusive. Despite the current lack of signal, this paper hypothesizes that one might exist in the future given an appropriate investment orientation combined with consistent internal ESG incorporation by the investment manager. We believe consistent and comparable assessment of ESG factors embedded in a long-term orientated investment process can produce differentiated risk-adjusted returns.

PART 1: IMPACT OF ESG FACTORS ON CORPORATE FINANCIAL PERFORMANCE AND PORTFOLIO RETURNS

To answer the question of whether and how ESG factors enhance or erode returns, we must first clearly delineate what is ESG investing. ESG is often combined, and in our opinion, confused with other forms of responsible investing such as impact investing or ethical investing. While the former can be more broadly described as a method to enhance risk identification and mitigation, the latter methods are exclusionary by their nature. For the purposes of our discussion, we accept the definition espoused by the United Nations Principles of Responsible Investment: "a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership." Defining the term alone is necessary but insufficient to proceed with the analysis because the history of ESG investing and conflation of the terms above throughout that history confounds the analysis.

The birth of ESG investing is thought to have occurred in 1971 with the launch of the Pax World Fund, the first socially responsible mutual fund in the United States. This and subsequent funds used social and financial criteria in the investment decision making process[1]. To achieve the dual mandate of these earlier funds, they employed blunt tools such as exclusionary screens. In doing so, asset allocators approached ESG orientated investments with caution as those products were thought to express a social view at the expense of return. Their suspicion was supported by modern portfolio theory, which discusses the benefits of diversification[2]. Using ESG criteria in portfolio management would apply an additional filter thereby reducing the investable universe and diversification as a result. This hypothesis is more concretely supported in recent works such as *The Price of Sin: The Effects of Social Norms on Markets*[3], where the authors show that "sin stocks have higher expected returns than otherwise comparable stocks." From these works, one is tempted to conclude that adding an ESG constraint to the investment process reduces diversification thereby eroding returns, but that conclusion would be premature; a more careful interpretation of portfolio selection is required. In the referenced research, Markowitz also mentions in the "right kind" of diversification for the "right reason." The relative imprecision of the early tools and differing objectives of early funds leaves open the question of whether assessment of ESG factors can provide the "right kind" of diversification. We believe consistent and comparable assessment of ESG factors embedded in a long-term orientated investment process can produce differentiated risk-adjusted returns.

While the financial impact of ESG inclusion remains an open question, the legality of doing so also has been debated. Subsequently, Title I of the Employee Retirement Income Security Act of 1974 (ERISA) established minimum standards that govern the operation of private-sector employee benefit plans, including fiduciary responsibility rules. This sparked an ongoing debate about whether ESG and other factors are "financial" or "nonpecuniary." For some, ESG factors were not explicitly tied to a quantifiable risk or benefit, which meant that including those factors in the investment analysis was a violation of one's fiduciary duty. Others argued that ESG factors are more tangible because they impact the terminal value of a business. To further the debate about whether the law restricts asset managers from incorporating ESG, the Asset Management Working Group of the United Nations Environment Programme Finance Initiative ("UNEP FI") commissioned a report by Freshfields Bruckhaus Deringer in 2005 ("Freshfields") that provided precise support for incorporation of ESG factors when making investment decisions. Specifically, Freshfields concluded that integrating ESG considerations into investment analysis is "clearly permissible and is arguably required[4]." Freshfields provided important legal clarity and helped catalyze the modern era of ESG investing.

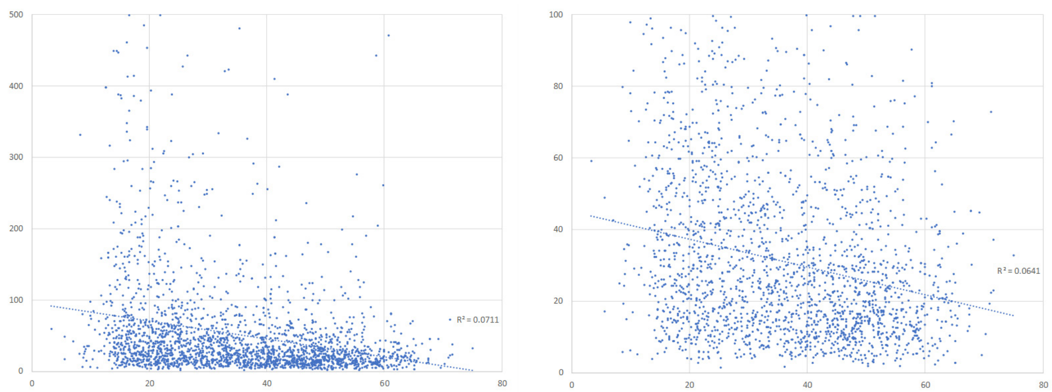
While Freshfields established important legal clarity that facilitated the adoption and incorporation of ESG factors into investment analysis, it was not prescriptive about that adoption or incorporation. As a result, a disparity exists in the way that investment managers have approached ESG analysis and incorporation. Before proceeding with our discussion, we must delineate among the differing approaches to incorporation of ESG factor analysis, which we will refer to throughout this document as ESG incorporation[5]. We have identified three main ways investment managers have incorporated ESG into their investment processes: integration with an internal ESG-dedicated group identifying and analyzing ESG factors ("Internal Dedicated Integration"); integration with industry or company-level research analysts identifying and analyzing ESG factors ("Internal Organic Integration"); and integration with external service providers identifying and analyzing ESG factors ("External Integration"). When combined with the conflicting objectives of earlier funds and the imprecision of the tools used to express their investment views, the disparate ways in which investment managers incorporate ESG factors confound the analysis and conclusion of whether ESG incorporation adds value to investment outcomes. The complexity of the analysis at the portfolio levels requires a multi-step process, which begins at the company level and seeks to answer the question of whether companies with a long-term orientation and robust ESG principles produce more consistent financial results.

A review of the available academic literature on this topic and our own analysis supports an affirmative conclusion: companies with a long-term orientation and robust ESG principles produce more consistent financial results. In their paper *ESG and financial performance: aggregated evidence from more than 2000 empirical studies*[6], the authors reviewed over 2,200 individual studies on the relationship between ESG criteria and corporate financial performance. They conclude: "The results show that the business case for ESG investing is empirically very well founded. Roughly 90% of studies find a nonnegative ESG–CFP relation." They are not alone in this finding. In their paper *The Impact of Corporate Sustainability on Organizational Processes and Performance*[7], the authors find "High Sustainability companies are more likely to have established processes for stakeholder engagement, to be more long-term oriented, and to exhibit higher measurement and disclosure of nonfinancial information. Finally, we provide evidence that High Sustainability companies significantly outperform their counterparts over the long-term, both in terms of stock market as well as accounting performance." Further supporting this hypothesis is the paper *Assessing Risk Through Environmental, Social and Governance Exposure*[8], where the authors found a strong positive relationship between a company's ESG exposures and the statistical risk of its equity. Finally, a report by Bank of America Merrill Lynch found that companies with high ESG rankings have lower future earnings volatility (ESG Matters – US, 23-Sep-2019). While it is tempting to accept the results of the academic community, we undertook our own analysis to confirm these findings.

The analysis we pursued sought to identify whether a relationship exists between a company's financial performance and its ESG disclosure. To accurately determine whether a signal exists and whether that signal had implications by sector or geography, we needed to use a sufficiently large sample set. We used the MSCI AC World Index as a starting sample set as the index is not overly concentrated in one sector or geography and sufficiently large given the informational constraints we faced[9].

For ESG disclosure we chose to use the five-year average of Bloomberg's ESG Disclosure Score. To measure financial variability, we calculated the standard deviation of Adjusted EBITDA over the same five-year period. Our results show a negative correlation of 0.27 and r-squared 0.07 (Exhibit 1). These results suggest that there is some signal between the five-year average ESG Disclosure Score and variability in financial results as measured by the standard deviation of five-year Adjusted EBITDA. Notably, these results are consistent across sectors.

Exhibit 1: Results of Analysis for MSCI ACWI (y-axis = standard deviation of Adjusted EBITDA; x-axis = 5-year average ESG Disclosure Score)



Because a company's level of ESG disclosure correlates to consistency in its financial results, one might conclude that investment managers with an ESG orientation would deliver better risk adjusted returns. However, a review of the available literature and our own work do not support a definitive conclusion. The paper *ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification*[10] found that ESG screening improves risk-adjusted returns in three out of the four universes the authors created. This finding challenges the classical argument supported by modern portfolio theory that screening negatively impacts portfolio returns by reducing diversification. While this conclusion was favorable to the view that ESG incorporation enhances portfolio return, work by Soohun Kim and Aaron Yoon[11] negate this perspective. Their work found, among other conclusions, that funds who have signed the United Nations Principles of Responsible Investment do not exhibit improvements in fund-level ESG scores after signing, while showing a decrease in portfolio return and alpha.

We performed our own analysis to independently verify these results, but our work demonstrates little correlation at the portfolio level between ESG exposure and risk-adjusted return.

Correlation: PRI Status vs. Various Metrics

Metric	Correlation
PRI status + 5yr α	0.082
PRI status + 10yr α	0.069
PRI status + 5yr Sharpe Ratio	0.078
PRI status + 10yr Sharpe Ratio	(0.009)
PRI status + 5yr Gain/Loss Ratio	0.079
PRI status + 10yr Gain/Loss Ratio	0.012
PRI status + 5yr σ	0.014
PRI status + 10yr σ	0.054
PRI status + 5yr Cum. Return	0.085
PRI status + 10yr Cum. Return	0.032
PRI status + 5yr Cum. Excess Return	0.090
PRI status + 10yr Cum. Excess Return	0.101

Our analysis began with a universe of equity investment products that self-identified as U.S. large cap, U.S. all cap, EAFE, or Global. We refined the universe based on the availability of five-year average turnover, five-year Sharpe ratio, and five-year alpha, which further reduced on sample size[12]. We examined the relationship between a firm's PRI signatory status and five-year Sharpe ratio or five-year alpha; we found no correlation. Therefore, we were able to conclude that ESG incorporation as measured by PRI signatory status does not impede achievement of superior risk-adjusted returns or alpha generation but neither does it appear to enhance those objectives. Our review of the available academic literature as well as our own analysis converge to produce an interesting observation: there is a relationship between higher levels of ESG disclosure and more stable corporate financial performance however there is not a relationship between ESG incorporation and portfolio performance. In pondering this absence, one must wonder why that is and whether there is a type of investment approach that would benefit from incorporating ESG risk factors.

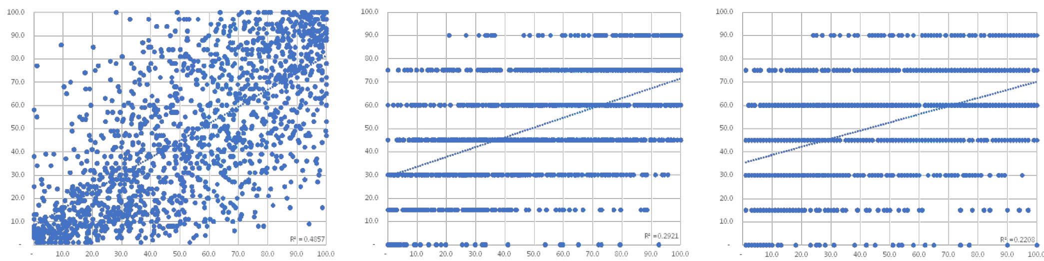
PART 2: IMPACT OF INCORPORATING ESG FACTORS INTO THE INVESTMENT PROCESS

In the preceding section, we sought to understand the nature of the relationship between ESG factors and company-level financial performance and between ESG factors and portfolio returns. The data supported our assertion that companies who more thoroughly disclose their level of ESG incorporation exhibit less variability in their financial performance. However, we could not establish the same link between ESG factors and portfolio returns. There are several reasons why this might be. First, the nature of ESG incorporation may differ among firms. We have previously identified three major ways firms incorporate ESG into their investment processes: Internal Dedicated Integration, Internal Organic Integration, and External Integration. Firms who use External Integration or Internal Dedicated Integration risk creating an informational barrier to effective decision making. Second, there could be varying levels of commitment and thus less robust analytical focus on ESG. As a result, ESG risks might not be fully reflected in the tools used to make investment decisions. These are a few of the reasons why ESG integration and long-term portfolio performance might not generate the results intuition would suggest. Because experience differs from intuition, it is useful to consider the optimal construct under which ESG integration could produce superior investment performance.

In Markowitz's timeless work on portfolio selection, he introduces the concept of the "right kind" of diversification for the "right reason," which we believe provides an appropriate framework to think about integration of ESG factors into the investment process. We can use a thought experiment to illustrate this concept. Suppose an investor can choose between two portfolios A or B, each comprised of 40 stocks. Portfolio A has 40 Energy companies, while Portfolio B has 40 companies from various sectors. Recall that the efficient frontier is the set of optimal portfolios that offer the highest expected return for a defined level of risk or the lowest risk for a given level of expected return. Knowing that, your intuition suggests that Portfolio B is more likely to sit on the efficient frontier given the addition of companies from differing sectors increases diversification. In the same way, fundamental evaluation of ESG criteria could enhance diversification through identification of new risks or recognized correlation of existing risks. Regarding new risks, imagine there are two companies with solid long-term growth fundamentals. After reviewing the governance structures for Company A and Company B, the analyst determines that Company B's governance structure poses more significant risk over the long-term. In that case and assuming both securities are priced similarly, adding Company A would further diversify the portfolio's governance risk (the right kind) while not adversely impacting portfolio return (the right reason). This interesting intellectual exercise is supported by research done by Dunn, Fitzgibbons, and Pomorski in *Assessing Risk Through Environmental, Social, and Governance Exposures*[13]. They investigated the relationship between companies' ESG exposures and the statistical risk of their equity, finding a strong positive relationship between the two: specifically, "Stocks with poor ESG exposures tend to have higher total and specific risk and higher betas, both contemporaneously and as far as five years into the future." Thus, for a given level of expected return, a portfolio manager would be improving the diversification benefits of the portfolio by adding a stock with better ESG exposure. This finding supports ESG's long-term diversification benefits (the right kind). While this analysis supports an affirmative answer to the question of whether ESG is the right kind of diversification, it does not address whether assessing ESG criteria is best done via Internal Dedicated Integration, Internal Organic Integration, or External Integration.

In Part 1, we found no relationship between ESG orientation and alpha or superior risk-adjusted investment returns as measured by the Sharpe ratio. As a result of this finding, one cannot definitively conclude that an internal approach is better than an external approach. However, alpha is generated when return potential per unit of risk is recognized before that potential has been imputed into the stock price by the market. Thus, it stands to reason that External Integration is an inferior strategy for ESG incorporation because it uses a third-party provider of ESG-risk assessment whose information is publicly available and thereby likely incorporated into current stock prices. In addition, there is little relationship among the scores of the major third-party providers (Exhibit 2). The disparity among scores could be due to the inconsistency of the reported data or a total lack of data. In addition, the standardized collection and synthesis of that data in a "one size fits all" fashion might be inconsistently or inaccurately applied in the investor's process. Finally, an absolute score lacks context because it does not provide the depth of data required for investment decision making. Absolute scores do not answer the questions of corporate evolution in a category; they do not identify a strength or weakness; and they do not confer whether the company's orientation in an area could be a long-term competitive advantage. Using External Integration as the sole means of assessing ESG factors should not be an alpha generating strategy because it lacks cohesion and context for interpretation. Internal incorporation avoids these issues and should confer an informational advantage to the investor who pursues it.

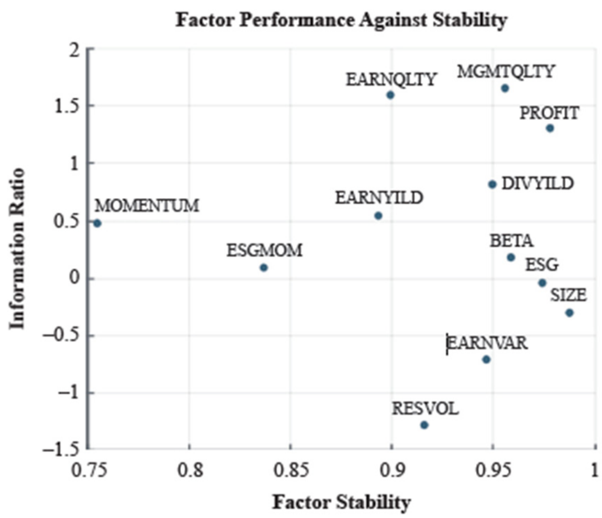
Exhibit 2: R-squared of ESG scores from third-party services providers (Left = Sustainalytics vs. S&P Global, Middle = Sustainalytics vs. MSCI, Right = S&P Global vs. MSCI)



The lack of correlation between ESG orientation and risk-adjusted returns appears to indicate that using ESG criteria does not have a uniformly beneficial impact across implementation methodologies. In the preceding paragraphs, we have discussed how implementation plays a role in that performance disparity, concluding that External Integration does not capture the benefits of ESG. We further discuss how internal ESG incorporation should confer an informational advantage and that Internal Organic Integration avoids contextual issues that plague Internal Dedicated Integration. Because Internal Organic Integration closely connects the research to the investment decision, we hypothesize that it is a superior approach to ESG incorporation. To this point our analysis has not addressed whether a particular investment strategy yields more substantial benefits from ESG incorporation. Understanding whether ESG is more beneficial to a specific strategy is an interesting research question, and the one to which we now turn our attention.

One analytical approach we could use to address this question is to assess the impact of various factors including ESG on portfolio returns. One can then compare the intensity and longevity of each factor on return. In their paper *"How ESG Affects Equity Valuation Risk and Performance[14]"*, the authors undertake exactly this analysis, which allows us to understand why ESG factors would not benefit equally all types of investment approaches. They found that "ESG ratings were lower in intensity than traditional factors such as momentum or low volatility (i.e., the financial impact per unit of time for ESG ratings is relatively low) but typically lasted for several years. Classical factors such as momentum typically have lasted for only few months, making them suitable for factor investing but not necessarily as long-term policy benchmarks." (Exhibit 3).

Exhibit 3 – Intensity and Longevity of Common Factors, ESG Ratings and ESG Momentum



EARNQLTY: earnings quality
MGMTQLTY: management quality
PROFIT: profitability
DIVYILD: dividend yield
EARNYILD: earnings yield
BETA: historical beta
ESG: MSCI ESG score
SIZE: market cap
EARNVAR: earnings variability
RESVOL: residual volatility
MOMENTUM: momentum
ESGMOM: ESG momentum

Notes: Factor stability is computed as the average cross-sectional correlation between factor exposures (or ESG scores and ESG momentum scores) at month end and three months later. For GEMLT factors, factor performance is computed as the annualized information ratio of monthly factor returns; for ESG, it is computed as the annualized Sharpe ratio of the equal-weighted top minus bottom quintile portfolio created from ESG scores.

Because ESG criteria are geared towards identifying long-term opportunities or risks thereby protecting sustainable growth, they are, by their nature, best suited for long-term investing[15]. ESG criteria are not particularly relevant in a short-term oriented portfolio, one that tries to benefit from market momentum and quick trading. On the contrary, they should benefit investors with a multi-year horizon, who look for stocks to perform over a variety of cycles. As the factor analysis above suggests and, in a market prone to having an investment horizon of no longer than a few months, long-term investors are best positioned to benefit from ESG factor assessment. Assessing ESG as an investment factor sheds some light on the type of investment approaches that most benefit from including it: the long-term investment approach. In Part 3, we will show how ESG integration into a long-term investment approach contributed to driven outperformance at Sarofim & Co.

PART 3: IMPACT OF ESG INCORPORATION AT SAROFIM & CO.

Driven by our fiduciary responsibility to investors looking for multi-generational outperformance across market cycles, Sarofim & Co. has applied our Sustainable Growth philosophy to identify companies capable of compounding growth over the long term. Our rigorous and systematic approach aims to identify all drivers of a company's outperformance as well as potential risks. Since our inception in 1958, this approach has driven us to consider factors and inputs that over time would become classified as ESG factors. These factors complement and enhance other inputs such as a company's strategic positioning, financial strength, growth prospects, profit generation, and overall stability. Organically integrating ESG into our research and investment process ensures that we have a complete 360-degree view of our holdings and portfolio, a view that comprehensively assesses opportunities and risks. Opportunities and risks stemming from ESG issues are sufficiently complex and long term by nature. Their consequences have significant ramifications, which manifest over years or even decades. As a result, careful and deep analysis with an orientation towards long-term risk assessment is necessary to assess them. Not every market participant has the skills, capabilities, desire, or time horizon required to appropriately assess ESG issues, which is perhaps why for so long the market has ignored these issues. In doing so, the market may be incorrectly assessing and discounting their consequences, which provides a unique opportunity for active investment managers who possess the skills required to accurately assess ESG risks and invest with conviction behind that view. Comprehensive assessment of all investment opportunities and risks, including ESG, is integral to Sarofim & Co.'s Sustainable Growth strategy, in which we apply an active, fundamental, and bottom-up approach that is present in each step of the investment process.

Sector/industry level

The first step of our fundamental and bottom-up process is to analyse the structural trends that will impact the future profit potential of various industries and sectors. ESG issues have a long-term impact on the sustainability of each industry, even if the complexity and consequences of these issues make it impossible to systematically determine the winning and losing industries.

Rather than use ESG risk as a screening tool to omit sectors from our universe, we believe that factoring ESG opportunities and risks along with secular economic, demographic, and regulatory trends is key to assessing the long-term profit generating potential of a sector and the identification of structurally attractive industries.

Appropriately pricing decarbonisation

Over the past 10 years, Sarofim & Co. has reduced our weighting of the energy sector from ~20% 10 years ago to ~1% today. The consistent reduction in weighting was based on an active decision that derived from our assessment of the terminal value for these companies. Originally, we identified the industry as an attractive sector as we believed that industrialization of emerging markets coupled with increased consumption in developed market would drive hydrocarbon demand in excess of GDP growth. With demand set to exceed supply, we believed price would move higher, and chose to invest in companies with operations in low cost basins and ones that could satisfy downstream demand for derivatives. We routinely evaluate the attractiveness of a sector. In doing so for the Energy sector, we realized that our thesis for growth was evolving in an unexpected way. Climate change was pressuring demand for traditional hydrocarbons resulting in a shifting mix towards renewable energy. Based on our analysis, we believed the market was incorrectly assessing the longevity of demand for the companies we owned. Given the shifting mix, energy was becoming an increasingly unattractive industry and our companies' competitive position within that industry was increasingly compromised. As a result, we actively reduced our exposure to the sector.

As we defined in Part 1, ESG factors are those anticipated to have a material long-term impact on a company. The materiality of an issue can be nuanced, and these nuances affect one's assessment of the impact an issue may have on the growth of an industry or company. The nuances of materiality suggest that ESG is best analysed by experienced sector teams who can seamlessly incorporate that analysis into their financial projections. Incorporating the nuances of materiality is more challenging if the ESG analysis is done separately; therefore, we do not believe that ESG factoring and scoring can be developed outside of the existing sector team and simply inserted into the process. These individual assessments lack context, which is a major reason why we do not have a separate ESG team. At Sarofim & Co., each sector team is responsible for identification and assessment of all the relevant factors that enhance or erode a company's growth. Consequently, we have internally developed ESG tools to support their analysis.

Company level

After we have identified the structural attractiveness of an industry, we apply our Dominant Company Analysis to identify businesses positioned to win share within that industry. Through this analysis, we aim to discover whether a business truly is a dominant company positioned to capture and grow its share of an industry's profit pool. We do this by analysing its global prominence, industry leadership, management expertise, competitive positioning, financial strength, and by projecting its future growth and returns. Our analysts enhance each of these analyses by embedding our ESG framework. Like the way in which our analysts produce earnings estimates for their companies, we believe that part of the ESG profile of a company can be quantitatively expressed through metrics and scoring. As fundamental opportunity and risk assessment has always been part of our research and investment process, we have found proprietary metrics to be a superior approach.

For managers who wish to integrate ESG into an existing process, external ratings can provide useful input. For managers where ESG has long been an integral of the investment process, their own analysis is of more value and external ratings may be redundant.

As external providers developed ESG rankings over the past few years, we have analysed whether relying on these rather than on our own analysis would enhance our process. We had no doubt about the high quality and analytical efficacy of the external approach; however, we found that there were hurdles incorporating them into our bottom-up fundamental approach. Firstly, putting aside questions about the quality of external providers' ratings, there was an element of redundancy, as external ratings are based upon criteria that Sarofim & Co. already covers. Secondly, a key element to active management is the ability to assess the impact upon profitability. External databases do not address this impact.result, we actively reduced our exposure to the sector.We believe that ESG opportunities and risk are inextricably linked to our long-term orientated bottom-up fundamental analysis, which provide important context for implementation. As a result, we concluded that our investment approach must rely on proprietary research the outputs of which must be reflected in both our financial analysis and in a comparable and consistent metric that can be used by our investment committee to understand these risks. To accomplish this objective, we formalised Sarofim & Co.'s internal ESG factor scoring methodology. This facilitates investment decision making by clearly enumerating a company's level of exposure and degree of management.

We use scoring as a tool that provides a useful framework; however, the complexity of ESG issues and their ramifications mean that this tool alone is not enough to cover exhaustively the risks and opportunities stemming from the ESG behaviour of a company. Consequently, our analyses must include a holistic assessment of material risk factors in addition to Sarofim & Co.'s internal ESG factor score. To perform that assessment, our analysts' research includes an examination of corporate governance issues such as management compensation and board composition. They also evaluate any environmental or social issues likely to have an impact on a company's future earnings power. To the extent that those ESG factors have a material impact upon a company's ability to sustainably grow earnings, those factors would be explicitly included in our fundamental analysis via adjustments to the analyst's financial projections.

Supply Chain Complexity

Ferrero Rocher accounts for ~30% of all global hazelnut demand, which is an important input in Nutella. In 2018, Ferrero Rocher committed only to use certified sustainable cocoa, hazelnuts and cane sugar. However, a piece of investigative journalism uncovered that some of their hazelnuts were sourced from Turkey where hazelnuts were reportedly picked by migrant and child labour who worked in inhumane conditions.

This example illustrates the complexity of ensuring a company's supply chain uses sustainable sourcing practices. We have a duty as investors to push companies to focus on this and punish such exploitation. Beyond this moral obligation, there is an important financial implication. If companies use unsustainable sourcing, they are trading the benefit of a lower price today against the risk of higher price tomorrow. When incorrectly assessed by investors, that trade-off flatters near-term margins and overstates the company's terminal value. Our approach would reflect this risk in the Social sub-score of our ESG factor score, thereby alerting the investment committee to the potential issue. Additionally, our financial projections and return targets would consider the negative impact re-orientating their supply chain would have on future margins thereby directly assessing the materiality of the issue.

https://www.ft.com/content/ea6e02d6-32e1-11ea-a329-0bcf87a328f2

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Portfolio management and portfolio construction

In order to best translate the risks inherent in our investable universe into investable insights, we have developed another proprietary tool: the Sustainable Growth Zone. To determine whether a company is in the Sustainable Growth Zone, we first look at our internally projected three-year compounded annual growth rate of a company's earnings per share. Because the companies in our investable universe operate in different industries there are inherent difference in our level of confidence across that universe in a company's ability to attain our three-year earnings growth projections. These differences in our level of confidence require adjustments, which we refer to as Confidence Ratings. We determine Confidence Ratings for each company by considering factors that could disrupt long-term growth such as reputational issues, the behaviour and compensation of company boards, treatment of the wider community, impact on the natural world, and working conditions for employees. After determining our earnings growth projections and our Confidence Rating, we plot these metrics against one another. Companies with both a relatively high projected three-year compound annual earnings growth rate and a high confidence rating fall into our Sustainable Growth Zone.

How Incorporating ESG Solidifies a Company's Presence in the Sustainable Growth Zone

Perhaps the best example to illustrate the Sustainable Growth Zone in action is our initial and continued purchases of Microsoft (MSFT). We initiated a position in MSFT shortly after expiration of the consent decree[16]. At that time, MSFT maintained a dominant position in software through the Windows operating system and its Office productivity suite. MSFT was also an emerging player in cloud, an area in which its skills and capabilities provided a unique opportunity to succeed. We believed that winning share in cloud would require the ability to handle data at scale, a strong balance sheet, and a position of trust with customers who would be entrusting the most sensitive part of their business to their cloud provider. MSFT was one a few players who had the breadth of skill required to succeed. Despite its dominant position in software and emerging position in cloud, MSFT's historical earnings were depressed due to heavy investments in search and mobile that did not produce the earnings contribution expected by the company at the time of the investments. In addition, many investors feared the ethics of the historical culture which valued knowing over learning, which was perhaps the genesis of its poor and late investments in mobile and search. In addition, emerging data privacy issues were a concern. Our analysis at the time of purchase showed a robust three-year growth trend based on its existing position in software, emerging position in cloud, and abating of historical investments in unproductive areas. In addition, we saw an important evolution in the corporate culture where MSFT increasingly recognized and rewarded the strength of its talented employees and a culture that was beginning to value learning over knowing. Finally, we saw that MSFT was working to preserve their customer's ability to control their data, which was differentiated from peers. Somewhat offsetting the strength of our earnings projections was our confidence in MSFT's ability to win in cloud; we believed in their capabilities, but it appeared Google was better positioned given its historical superiority in handling data at scale. However, our confidence was enough for the combination of earnings growth and the Confidence Rating to fall into the Sustainable Growth Zone; so, we initiated a position. Over the coming years, MSFT has executed on the opportunity in cloud, fostered an environment of learning over knowing, and protected data privacy, the latter of which was a key point of competitive differentiation. With each emerging data point, our confidence has increased as has the company's position in our Sustainable Growth Zone. Alongside those increases in conviction, we have also increased our position in MSFT.

The Results

This paper has sought to show that ESG can enhance returns for long-term investors by identifying opportunities or risks in advance of those factors being imputed into stock prices. We have shown that a relationship exists between a company's long-term orientation and the stability of its financial results. Further, we have shown that no strong relationship exists between ESG portfolios and superior portfolio performance, but that ESG, which is by nature long-term, could enhance risk-adjusted return when properly integrated into a long-term orientated bottom-up fundamental investment process. The conviction of our belief is strengthened by our own experience. The use of ESG as an opportunity identification and risk mitigation tool at Sarofim & Co. is a natural element of an investment process that has produced strong results over our long history. Our holistic assessment of a company's ability to maintain and grow earnings along with our confidence in the company's ability to sustain that earnings stream are key inputs into our investment process. When combined with our finding that companies with a long-term orientation have more stable financial results, one should not be surprised to learn that our Worldwide Growth Fund has outperformed its index over the past 10 years. There are six major fundamental-based style factors to which we can attribute performance: profitability, dividend yield, earnings yield, leverage, growth, and value. Our focus on long-term opportunities and risks is best measured by the profitability style factor, which has been the most influential contributor to our relative outperformance accounting for ~25% of the positive performance difference. This is by far the largest factor contributing to our outperformance over that period[17]. Therefore, our incorporation of ESG at every level of our process in a manner that is broad, consistent, and comparable and geared to augment the analysis of a company's long-term earnings potential has enhanced the long-term intrinsic value of our investments in the aggregate.

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DISCLAIMERS

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[1] source: Fulton, Mark, Kahn, Bruce M., and Sharples, Camilla. "Sustainable Investing. Establishing Long-Term Value and Performance." Deutsche Bank Group, June 2012, pp. 20.

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[3] Hong, Harrison, Kacperczyk, Marcin. "The price of sin: The effects of social norms on markets." Journal of Financial Economics, vol. 93, issue 1, July 2009, pp. 15-36

[4] Freshfields Bruckhaus Deringer. "A legal framework for the integration of environmental, social and governance issues into institutional investment." October 2005. pp. 13.

[5] We define ESG incorporation as the process a firm uses to identify and measure a company and portfolio's exposure to environmental, social, and governance factors

[6] Friede, Gunnar, Busch, Timo, Bassen, Alexander. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment, vol. 5, no. 4, 15-Dec-2015, pp. 210-233

[7] Eccles, Robert, Ioannou, Ioannis, Serafeim, George. "The Impact of Corporate Sustainability on Organizational Processes and Performance." http://ssrn.com/abstract=1964011. PDF download.

[8] Dunn, Jeff, Fitzgibbons, Shaun, Pomorski, Lukasz. "Assessing Risk Through Environment, Social, and Governance Exposures." 24-Feb-2017, https://www.aqr.com/Insights/Research/Journal-Article/Assessing-Risk-through-Environmental-Social-and-Governance-Exposures. PDF download.

[9] At the time of our analysis, there were 2,984 companies in the MSCI AC World Index, but because the scores we needed were not available for the entire universe and removing the outlier observations, our sample was reduced to 2,373.

[10] Verheyden, Tim, Eccles, Robert G., Feiner, Andreas, "ESG for All? The Impact of ESG Screening on Return, Risk, and Diversification." Journal of Applied Corporate Finance, vol. 28, no. 2, Spring 2016, pp. 47-55

[11] Kim, Soohun, Yoon, Aaron S., "Analyzing Active Managers' Commitment to ESG: Evidence from United Nations Principles for Responsible Investment." https://ssrn.com/abstract=3555984

[12] Our initial screen included 5,421 equity investment products which was refined to 2,649 based on availability of data

[13] Dunn, Jeff, Fitzgibbons, Shaun, Pomorski, Lukasz. "Assessing Risk Through Environment, Social, and Governance Exposures." 24-Feb-2017, https://www.aqr.com/Insights/Research/Journal-Article/Assessing-Risk-through-Environmental-Social-and-Governance-Exposures. PDF download.

[14] Giese, Guido, Lee, Linda-Eling, Melas, Dimitris, Nagy, Zoltán, Nishikawa, Laura. "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance." The Journal of Portfolio Management, volume 45, number 5, July 2019.

[15] We define long-term investing as investment process that targets an average holding period of greater than or equal to three years.

[16] Lawsuits brought against Microsoft by the U.S. Department of Justice, 18 states, and the District of Columbia in two separate actions were resolved through a Consent Decree that took effect in 2001 and a Final Judgment entered in 2002. The consent decree expired 12-May-2011.

[17] Ten-year performance attribution of BNYM Worldwide Growth Fund Inc. vs. MSCI World as of 30-Oct-2020. Accessed through Axioma World-Wide Equity Factor Risk Model.