# ESG and Risk Management Integration

**Hitendra Varsani**: Welcome, everyone, from our global home offices. MSCI Research is committed to bringing you our latest insights into key themes driving markets. My name is Hitendra Varsani. I'm part of MSCI's Core Research team based in London. And I'm joined with my colleague, Guido Giese, a thought leader in ESG research.

The recent crisis has brought risk management to the forefront of clients' minds, recognizing the fact that risk, return, and long-term sustainability are interlinked, and gaining transparency on key exposures is critical. At MSCI, we are leaders in factors in ESG, and we've been conducting deep research on the impact of environmental, social, and government issues in portfolios and indexes, as ESG has become a key consideration throughout the investment process.

Now let's turn to Guido, one of our experts in ESG research. Guido, could you walk us through some of your key findings in ESG during the COVID-19 crisis and how that reflects on the long-term characteristics that you've identified in your work?

**Guido Giese**: Yeah. Now, at MSCI, we've done quite a bit of research on the financial relevance of MSCI ESG Ratings. So we looked at the difference between high ESG-rated companies versus low-rated companies for a life track record of our ratings, which is now 13 years, since 2007. And what we found over this long period of time is that high ESG-rated companies were clearly less exposed to systematic risk, meaning in market downturns, they showed more stable earnings but also more stable stock prices. And we've seen the same in MSCI ESG Indexes that are based on MSCI ESG Ratings. They've also shown clearly less exposure to systematic risk. So in market downturns, they were typically doing better than the benchmark. And over long periods of time, we've seen that our ESG Indexes at a global level have outperformed the MSCI ACWI, so the benchmark.

Now, the latest coronavirus crisis was, of course, the first real world stress test for our ESG Indexes since the financial crisis. And although it's a short period of time, we were very interested to see the performance of our different ESG Index families compared to the benchmark. And we found that during the crisis, so the first quarter of 2020, the ESG Indexes have outperformed their benchmark even more than what we've seen in the long term, which means it confirms our understanding that ESG clearly added resilience to your portfolio.

**Hitendra Varsani**: It's good to see the consistency in the outperformance of ESG Indexes across various markets and reflecting the long term research that we conducted. Now let's address a couple of misconceptions, as well as questions that we receive in the field. And the first is, is the recent ESG outperformance simply due to the oil price collapse? Is it due to the underperformance of the energy sector? And the second question that we often get asked is, is ESG simply masking a large cap quality factor? Could you share your thoughts?

**Guido Giese**: Yes, these are the questions we really get very often. Many investors say, oh, we like the performance of your ESG Indexes. But is it really the ESG effect? Isn't it just an [inaudible] in oil or an [inaudible] in quality stocks? So to address this question, what we've done, we integrated our ESG Rating into our MSCI Barra Factor model, which allows us to do a Performance Factor Attribution to all the different factors, plus ESG. And we did such a Factor Attribution for all our MSCI ESG Indexes over long periods of time and the coronavirus crisis. And the results that we got was actually a very consistent picture. And I would like to show you one slide showing the active performance of our ESG Indexes during the first quarter of this year, so the crisis situation. So what you see in the following slide is the active performance, so the outperformance compared to benchmark, of the different ESG Indexes. On the left hand side, you see our ESG Universal, which has a slight tilt towards high-rated companies, compared to benchmark. Then you see the ESG Leaders, the ESG Focus, that has a stronger ESG tilt. And finally, on the right hand side, the SRI Index, which has the strongest ESG tilt.

Now, the different colors indicate the performance contributions that we see in our factor model. And what you see very clearly, the outperformance has not been created by industry position. So there's no large oil factor back in there, which is by intention, because our ESG Index has actually tracked the sector allocation of the benchmark fairly closely. And you can see there isn't a big performance contribution from factors. The outperformance came from two sources. The first source is what you can see here, is from equity style factors. This is in fact a tilt towards quality stocks. So quality has, in fact, helped performance. But even after controlling for the contribution from quality, we see there the clearly positive contribution from the ESG Rating. And what is quite amazing, when you move from left to right on the slide, you're moving to higher ESG scores. You're also moving to higher contributions from ESG. So the performance effect that was triggered by the ESG Rating has been kind of monetonically increasing in the ESG Score of the index. So in a nutshell, after controlling for all the other factors, there has been a clear, positive contribution from the ESG Rating. And I mean, I think this is important because this is also how investors nowadays would like to use ESG. They would like to use ESG alongside other traditional factors they've been using for many years. And this is actually a question that I'm very interested in, Hitendra. You've been working with factors for many, many years. How do traditional factor investors integrate ESG?

**Hitendra Varsani**: So over the last few years, MSCI has published extensive research on the integration of ESG and active funds and indexes, as well as Factor Indexes. And over time, we've seen a growing demand to put this theory into practice. Now, in fact, the recent crisis has demonstrated through live stress tests the complementary characteristics of overlaying ESG on defensive factors, such as minimum volatility or quality. And this brings us to our latest innovation, building on MSCI's strength in Minimum Volatility Indexes. We've recently launched Min Vol Plus ESG to meet client demand. We expect this trend to continue across the full range of Factor Indexes, as well as Multi-Factor Indexes. Our clients are also keen for MSCI to extend ESG in factor investing and offerings in the fixed income market. And that's a journey that we have started.

I'd like to thank Guido for your insights. And thank you all for listening. Stay safe.

## About MSCI

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