Are Factors & ESG the New Tea & Biscuits?

Featuring:

Anthony Kruger, Director, EMEA Head of Factor ETFs, iShares

Raina Oberoi, Head of Index Solutions Research, Americas, MSCI

Adam Bass (00:03):

This is MSCI Perspectives, your source for insights, for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass and today is September 2nd, 2021. Today, we explore the rise of investment strategies that combine commonly accepted factors. Those like value in quality with the new kid on the block ESG. We do so by looking at a subsegment of this growing market that would be exchange traded funds or ETFs. Now there are challenges and not every investor is on board with this approach. But, the idea of factors plus ESG, it's gained some traction

Anthony Kruger (00:48):

I was talking with the head of factor investing at BlackRock last week, Andrew Ang, and he coined the term that I love. And that is, factors and sustainability are like tea and biscuits.

Adam Bass (01:03):

That's our first guest.

Anthony Kruger (01:05):

My name is Anthony Kruger. I am Head of Factor ETFs for EMEA at BlackRock. So factors have really been around for a long time. They've been studied in great detail. And if I look back to Graham and Dodd, 1954 classic security analysis, it's kind of like the groundwork for value investing. In that book they actually wrote about quality and ESG measures. Now they didn't rarely use the term ESG or sustainable investing, but they talk about the character of management. They talk about sector and industry trends, which we would classify as environmental concerns. And, they also talk about the social side of things, which in their language was conservatism.

Anthony Kruger (02:02):

They spent most of their time on the quantitative aspects. But that's only because, the underlying ESG data was hard to quantify. We have increasing amounts of ESG data today. We can analyze it and apply it in quantitative techniques. And that's what we've always been doing in factor investing is the quantifying of this data in, into rules-based approaches. If you, let's say, were a value investor, sat 30, 40 years ago, you would probably pore over documents. It would take you a very long time. You would be reading over company's financial statements and balance sheets, income statements, and it would be very time consuming. Now, what we can do with the advancement of data, we can analyze the MSCI world. For instance, there's around 1,600 names in there. We can analyze that within a matter of seconds for value characteristics and put that into a portfolio. And now the exact same thing has happened with ESG metrics. So now we can analyze a portfolio, not only for factor metrics, but ESG metrics as well, and build that into a holistic portfolio.

Raina Oberoi (03:33):

I think with the advancement in the understanding of these concepts, data tools, technology, it is a natural evolution to be able to combine both these components together.

Adam Bass (03:45):

And that's our second guest for today.

Raina Oberoi (03:48):

I'm Raina Oberoi based out of New York. I head the Index Solutions Research team for the Americas. I do want to highlight the importance of this concept. If you think about it in a factor investing and ESG investing are two areas of growing interest in institutional investors. As these two structural trends continue in the future, the list of factors and strategies that investors would like to implement in a more sustainable way will become larger. At the end of the day, simply put, a factor is really a unique investment characteristic of a group of securities that can help explain risk and return of a portfolio. So, you know what we typically call factors in daily jargon are more the traditional style factors like size, value, quality. But, that doesn't preclude us from expanding that thought and incorporating other factors that can help explain risk and return of portfolios.

Adam Bass (04:49):

Other factors like ESG. One issue that comes up here though, is that while the data has increased and improved since Graham and Dodd wrote about what we now call ESG, getting investors to agree on, even a definition, let alone the explanatory power of ESG or sustainable investing... That can be difficult.

Raina Oberoi (05:12):

The way investors usually use these terms, ESG and sustainable investing is used usually interchangeably. That's really because the concept of ESG means different things to different people. Some think about it as a way to reflect their values and beliefs. Others look at it as having a social environmental impact and some look at it in terms of financial metric reality. So as you can tell, it is a very personal way of investing. Taking a step back, the way I think about this area of investing, is the broad umbrella of sustainable investing. And under that umbrella, I consider ESG investing and climate investing as two separate areas of focus. Now, both are growing investment trends, but to achieve the common goal of sustainability.

Anthony Kruger (06:03):

I think about it as about giving investors choice. I categorize it into two areas. There is avoiding companies involved in controversial business activities, or that do not align with an investors values. And then there's advancing ESG integration or advancing some sort of goal that an investor might have say for instance with climates. Now avoiding strategies, as I've mentioned, you normally eliminate certain companies or sectors that are associated with an increased ESG risk. And you can think about that as just screening out in a pretty simple way. Advancing strategies, they focus on increasing exposure to positive ESG characteristics and they align capital with certain behaviors or target specific positive social or environmental outcomes.

Adam Bass (07:11):

Beyond that lack of an agreed upon definition is the pesky issue of data. Without it, how can you possibly look at ESG as a factor?

Raina Oberoi (07:22):

In general? I would say it's changed quite a bit, but investors do view ESG as a consideration in their portfolio management process and not necessarily as a traditional systematic risk factor. At the technical level, sometimes we get asked that, okay, well, how do you combine it? If ESG is such a subjective thing is such a personal thing, how can you quantify it to be a factor? I think it's pretty clear if you compare ESG to factors that there is naturally lesser history on the ESG side. But, we still do have like 10 to 15 years of rich history to analyze ESG strategies.

Raina Oberoi (08:02):

Yet, I do think advanced technology, including artificial intelligence and alternative data extraction techniques can help minimize the reliance on voluntary company disclosures. We also use machine learning and natural language processing that has actually helped us increase the timeliness, the precision of our data analysis. So, you know, ESG data has definitely become a lot more robust and there is a lot of research that goes into figuring out different sources and to make the data even more robust as we go forward. So as ESG gets integrated into more and more portfolios, I think it's efficacy as a distinct factor will also come to light.

Adam Bass (08:46):

What about the argument that, what looks like explanatory power for ESG is really just about exposure to the quality factor?

Raina Oberoi (08:55):

You know, we've heard this before that ESG is just another way of saying quality. We have seen in our research that there is a positive correlation between quality style factors and ESG scores and that highly rated ESG companies do tend to also be high quality companies. I think we've also found that ESG scores could have been improved for a quality oriented strategy without any meaningful reduction in the exposure to the quality factor. But, that does not mean they're the same thing. In our research, we've looked at highly oriented ESG managers and try to explain the risk and return using a risk model that actually includes ESG as a standalone factor alongside other traditional factors. And what we saw is that ESG does show a [inaudible 00:09:48] of explanatory power, which does not get explained by a factor like quality. In fact, in this was the very reason we launched this model with ESG as a factor to bring that transparency to such nuances and really help investors evaluate what was driving their risk and return.

Adam Bass (10:09):

And other times that we've had you on this program, it was very early on in the COVID crisis during lockdown. And you spoke about how the crisis had basically proven the strength of ESG as a factor based on how it performed during the crisis period. Now that we are more than a year away from that, do you have any further insight into that question of how ESG performed during the early days of the pandemic?

Raina Oberoi (10:45):

Yeah, Adam, I think there is something that we spoke about at that point. ESG was showing its resilience and MSCI has obviously done a lot of research in this area. But there's other industry organizations that have also, looked into ESG. Typically it's been a potential way to mitigate systematic and idiosyncratic risk. But, it's really the crisis, as I had mentioned, in the earlier episode, that really gave us the opportunity to test the ESG factor and the hypothesis; that, does it really work?

Raina Oberoi (11:21):

What the crisis did make the investors realize even, a year and a half out, is that ESG does stand the test of time. We saw that portfolios that had high ESG exposure, and good ESG characteristics, actually suffered smaller drawdowns compared to others. But I think that was only part of the story. The other part of the story, which I think is quite important, is that when you go beneath the surface, and you do the attribution analysis. Which we didn't have at that point, to see what was the reason for the out performance of good ESG portfolios? A large part of the out performance did come from the ESG factor and was just not a proxy for other defensive factors like quality or low volatility.

Adam Bass (12:08):

Regardless of any lingering resistance, you can't argue with numbers. And the numbers suggest that the idea of ETFs that combined factors in ESG... That's resonated with investors.

Anthony Kruger (12:21):

Yeah, Well, it's been a record year so far. So globally ETFs have gathered three quarters of a trillion dollars. So $750 billion dollars. And the industry is on track for a record year. Now, what is leading that? That is equities and that is making up again, three quarters of the new assets. And as markets have reached record highs, and investors have been looking towards the global economic reopening. They really have used ETFs to express their views.

Anthony Kruger (13:02):

Looking on a regional level, US growth continues to be strong, and that's been led by the market cap type of ETFs, sectors, and thematic exposures. Europe is catching up and in Europe, it's a bit of a different picture. It's again, sectors, but factors are also having a record year. But rarely the stand up is sustainable ETFs. And that's really leading the European trend and there's been over $40 billion in sustainable ETFs this year alone. Now what that suggests to me that flows, they tend to be more strategic in nature. Indicating that now sustainable ETFs are making their way into model portfolios, their making their way into long-term allocations from asset managers and wealth managers.

Raina Oberoi (14:04):

We've seen a lot of growth, a lot of assets tracking ESG strategies across the board. And I think it's a global phenomenon. You know, if you think about in the Americas, if you're still on the topic of, you know, factor plus ESG. Factor investing and ESG investing still remain distinct areas of investing. But as ESG integration increases and investors understand the nuances in greater detail, and as regulation increases around the integration of ESG, we will see a growing interest in combining these strategies. We've already seen a lot of interest around this concept in the Americas, across a wide array of clients.

Raina Oberoi (14:45):

Now in EMEA, they are clearly ahead of the game. There's been a lot more adoption of ESG across portfolios. That's also reflected an increased interest in product creation in factors plus ESG. I think, for clients, the big big ask is, "give me more transparency." Clients are naturally pushing for transparency. They want to be able to evaluate and explain these strategies better. The better they can do that, the better investment decisions they can make.

Adam Bass (15:19):

What it seems to come down to for those who call themselves factor investors is, sure, if adding ESG provides that clarity and that transparency, then bring it on. In fact, I may actually want to actively account for ESG or climate risks in my portfolio. But, I don't want to sacrifice the fact that my portfolio, it's built on the investment idea of maximizing my exposure to value, or momentum, or, some other factor.

Raina Oberoi (15:50):

So I think the framework that we used to combine ESG and factors, we saw that was the easy way of constructing indexes. Combining these two, without any major impact on historical performance or trade-off in factor characteristics. We've also tried to expand that approach to include climate based outcomes in alignment with The Paris Agreement. That obviously includes the risks and opportunities associated with transition to a low carbon economy, the physical risks associated with Climate Change, and net zero corporate targets.

Raina Oberoi (16:26):

We've tested this approach on our standard factor indexes as well as multi-factor indexes. What we noticed is that some factors like value were more impacted as you start integrating climate and give up some target factor exposure. And, other factors like low volatility, one truly impacted in terms of target exposure, once you start integrating climate.

Raina Oberoi (16:48):

In general, what we saw across the board was that we were actually able to combine climate based outcomes to factor strategies and retain significant factor exposure to the targeted factor. That would be really the goal. It would not really serve anyone's purpose if you try to integrate climate and then lose a significant amount of factor exposure and not be able to target what we really want the outcome to be.

Adam Bass (17:13):

This research is important for asset managers and other institutional investors that Raina and team are working with because they're getting pushed from both ends in terms of regulation especially in the EMEA region. But also, from retail investors. It's an issue that can't be ignored and is simply not going away. I asked Anthony about this squeeze.

Adam Bass (17:37):

I would like to keep us moving on these drivers of ESG. Specifically as you combine factors in ESG, one of the big, big ones being regulation, of course. SFDR in Europe is the big one. A Lot of press around the reporting requirements. But, there's also the idea of classifying different types of investments purported to be ESG. I'm thinking, I think it's Article 8, Article 10, is it? Why don't you tell me? What are the classifications? What do they mean?

Anthony Kruger (18:17):

Sure, no problem, Adam. It is quite confusing and, you know, anything that comes out from regulators, you know, needs some interpretation. So what you have is essentially three classifications at the moment.

Anthony Kruger (18:34):

One comes under what we call Article 6, and that is basically any investment products at the moment that doesn't have any sustainable aims or features in it. So you can think about it as a standard normal products.

Anthony Kruger (18:51):

Then you have Article 8, and these are products that promote ESG characteristics. So they have some sort of ESG characteristics involved in the selection of securities. And then finally you have Article 9, and that I'd kind of classify a more on the lines of impact investing. So products that have sustainable investments as their objective. It's a huge deal in Europe at the moment. And we're seeing it really drive a lot of change and a lot of product innovation.

Adam Bass (19:41):

So that's from the regulation side. What about from the other side? From retail investors which especially from ETFs, is an important factor. If you'll pardon the use of that word. What changes are you seeing from retail investors in terms of this awareness and about meeting sustainability goals? Or, even having sustainability goals, when it comes to investing?

Anthony Kruger (20:07):

Investors are taking more responsibility for what they are invested in. This is possible with the transparency that ETFs bring and the amount of information that is out there at your fingertips. So, for instance, iShares have been publishing or disclosing the sustainability characteristics and publishing all of the holdings for our ETFs online for over two years. So you can know as an investor, exactly what is in your fund. That is really about transparency and wanting to know more about what you're invested in. And I think that's really, what's what we've been seeing. I mean, one cannot even turn on the news nowadays, or even look outside your window, depending on where you live in the world and ignore Climate Change. As we've seen effects playing out right now in the world. We've seen soaring temperatures in Canada with some, I think temperatures hitting around 50 degrees in some small mountainous villages and towns. There's historic intensity of wildfires in America and Europe happening right now as we speak.

Anthony Kruger (21:38):

So I think as the retail investor, as you consume this, and you see the transparency in starting to come through in the markets, in the investing market. You can start making decisions about where your investments, your retirement investments, your savings are going.

Anthony Kruger (22:05):

I was listening to another podcast the other day and it interviewed someone who swam in the Olympics. And had been following the Olympics broadly and is super in awe of these athletes and what they've achieved. I think the one example that it was Adam Peaty from the British swimming team gave. Is when you look at a problem and say something really big, like climate change, it seems so large that many of us, you know, how do we tackle that? What can we do on a day to day basis to kind of help, or do, or change something?

Anthony Kruger (22:52):

It just seems too, too big a problem. And there are those of us who have dedicated our lives to say, public policy and really changing the way, say governments invest in and have policies out there. But for you or me, Adam, like I'm not involved in the policy world. But, what I can do is, I can influence those around me. I can have a conversation with my colleagues at work. I can have a conversation with my family and my friends about climate, about equality, about any area that's important to you. You could bring that back and understand. Do you know where you are invested? What is your pension fund invested in? Ask the question and start making those small little changes that can really make a big change in the end.

Raina Oberoi (23:55):

I would say something that is very unique for the retail side of things is this mass personalization and mass customization on the ESG side. I think ESG anyway, as I had discussed is such a personal way of investing when it comes to the retail audience. Customization and personalization is really key to be able to incorporate an individual's view of ESG. The whole direct indexing concept that you can create these personalized strategies via indexes has seen tremendous growth for this exact reason because one size does not fit all. That's a very unique element of ESG investing, especially on the retail side. So that's an area of growing importance for us as well as we look to provide these personal and custom solutions for our wealth baselines.

Adam Bass (24:50):

That's all for this week. Our thanks to Anthony, and Raina, and to all of you for listening. Next up on Perspectives, we begin our journey on the road to COP26. That's the UN Climate Conference in Glasgow this November. Until then, I'm your host Adam Bass and, this is MSCI Perspectives. Stay safe everyone.

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