Capstone Project Public Summary

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Project Title: Testing the Resilience of ESG Focused Investing During Covid-19
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Project Overview and Objective

Over the past decade, there has been a massive restructuring of investor preference towards including more Environmental, Social and Governance (ESG) focused securities into investment portfolios. The thrust towards ESG motivated investing comes from the idea that ESG investing can offer an element of downside risk protection during financial crises due to enhanced scrutiny placed on an entity's business models, governance and risk management frameworks. This leads to more robust strategies motivating higher and more consistent performance in the long run.

The COVID-19 outbreak has triggered large-scale disruptions and pushed global financial markets into freefall as investors forecast dire economic and financial implications against a backdrop characterized by immense uncertainty. However, the current financial downturn presents an opportunity to test the credibility of the hypothesis that ESG focused investing leads to better and more consistent financial performance during a financial crisis.

The objective of the project was to assess the resilience of ESG focused investing since the repercussions of the outbreak began to impact global markets. The main idea was to compare performance and risk indicators of dedicated ESG indices, funds and high rated ESG companies from December 2019 to May 2020 with traditional market benchmarks and draw conclusions as to whether the hypothesis holds merit.

Business Background

The project sponsor is a global investment management firm and one of the largest asset managers in the world with total assets under management (AuM) exceeding USD 7 trillion. Earlier this year, the company CEO announced that the broader investment thesis will be revised to include a greater focus on ESG as part of a larger move to make positive contributions towards global sustainability.

Following this announcement, there is an increased focused on building internal frameworks which can help identify the best opportunities for investment in the ESG space and weave ESG friendly investments into decision making. This project will shed light on whether this is the move in the right direction and serve as a platform for further research as the impacts of the pandemic unfold.

Research Framework and Data Resources

The project was divided into three sections, namely dedicated ESG indices, funds and ESG rated companies. Figure 1 below lays out the framework in detail.

Figure 1.

1 ESG Indices vs Parent Index	2 ESG Funds vs Traditional Funds	3 High vs Low ESG Rated Companies
Identify dedicated ESG indices and parent index within the Fixed Income and Equity asset class	Identify BlackRock ESG funds within the Fixed Income and Equity asset class	Identify 2 large ESG Indices (Global and Emerging Markets (EM))
Select the 4 largest indices based on members/constituents and data availability	Use the Morningstar category from the above to pull all other available funds	Acquire ESG ratings for each Index
Compare performance and risk metrics to draw conclusions	Sift funds based on similar benchmarks used by BlackRock funds	Group members based on ratings into 3 buckets and identify as High, Medium and Low
	Group funds based on Morningstar ESG Yes/No classification	Pick top 10 members in each bucket based on market capitalization
	Compare weighted average performance and risk metrics	Compare weighted average performance and risk metrics

Only publicly available data was used for analysis as per the agreement with the sponsor. Indices were identified based on online research to find large index providers. Eikon Reuters and Bloomberg were then used to sift for the largest indices in each of the Fixed Income and Equity asset class.

Morningstar was used extensively to narrow down funds within each asset class and categorize them as ESG or traditional as it is one of the best platforms for competitor analysis and ESG data.

As a more holistic approach, a global and an emerging markets index was used to compare high ESG rated companies with low ESG rated members. MSCI indices were chosen as MSCI is the largest ESG Ratings providers and has a comprehensive ratings methodology. Index constituents and ratings were acquired directly from the MSCI ESG research helpdesk.

Tickers for all the above were used to create a Bloomberg linked excel file which pulls specified and available performance (e.g. total returns, price performance) and risk indicators (e.g. beta, volatility, sharpe ratio) directly from Bloomberg as per the chosen time horizon.

Summary of Results and Conclusion

Overall, the results indicate that ESG focused investing produces varied performance for different asset classes and regions, and conclusions should be drawn within a specified context to accurately assess the resilience of ESG focused investing during times of financial downturn.

Fixed income ESG indices moved almost in tandem with their parent index/market benchmarks with high correlations. The only variation was seen in a greenbond index which showed slower recovery than its parents index. Equity ESG indices produced the same results except for emerging markets where the ESG index performed better.

For funds, the fixed income global ESG funds outperformed the traditional funds. The opposite was true for emerging markets, where recovery has been slower for ESG funds since March, when the market reached its lowest point. Equity funds outperformed the traditional funds.

Assuming that enhanced focus on ESG leads to more robust risk management frameworks, during a crisis higher rated ESG companies should show better price performance, have the mechanism to lower cost of capital and as a result have higher valuations and more profitability. The highest ESG rated (AAA) companies in the global ESG leaders index showed better price performance and risk indicators than the lowest (BB) ESG rated companies. Interestingly, the lowest (BB) ESG rated constituents of the Emerging Markets ESG Leaders Index showed the best price performance compared to the high (AAA)ESG rated and medium (A) ESG rated buckets. However, this was accompanied by the greatest volatility and high-risk indicators. The Weighted Average Cost of Capital (WACC) of the companies was expected to increase with a decline in price and decrease once the price performance shows recovery. Increase in the WACC for all buckets in both the indices was seen with a 3 month lag – the WACC may decrease over the next 3 months to complement the price increase after March.

Overall, ESG focused investments have performed at least in line with traditional investing strategies in most asset classes and regions. This postulates a 'why not' argument – perhaps ESG may not outperform traditional benchmarks drastically but is an avenue for large investors and investment management companies to support the ESG space and fulfil their responsibility towards the larger global sustainability initiative.

Areas for Further Research

The project framework and results provide a bird's eye view of the resilience of ESG focused investing and whether it is an apt strategy for downside risk protection during times of financial instability. However, the foundations of this project can be used to expand the analysis which includes looking at performance by region, sectors, asset class or a permutation of all over a longer time horizon. Tracking the performance over a longer term will provide greater insights into which factors influence performance and provide a more credible platform to draw concrete conclusions.

Learning Outcomes

The project was quite comprehensive which required the application of many concepts, softwares and data platforms. In addition to gaining a deep understanding of global financial markets, the project provided an opportunity to learn Bloomberg, Morningstar and Eikon Reuters and their inbuilt tools in a detailed manner. It also helped get familiar with other databases such as MSCI ESG Research Database. Professional presentation skills were a key learning, along with understanding how to portray large sets of information which is an important skill needed in the financial world and the chosen industry.