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Quants are the new ethical investors

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Non-financial data such as carbon emissions can indicate how a company is performing before it is evident in the financials

Investment strategies based on environmental, social and governance factors are typically assumed to be old-style ethical strategies that prioritise qualitative research and a lot of subjective judgment.

But a new breed of ESG investor looks very different.

"An increasing number of our clients are quants," says Matt Moscardi, senior analyst in the ESG research team at MSCI, the data provider. Quantitative, or rules-based, investment uses a set formula to manage a portfolio, exploiting a perceived inefficiency in the market.

More and more quantitative analysis is supporting the hypothesis that failure to integrate ESG factors into investment decisions is one such inefficiency, and quant managers are looking to take advantage.

Larry Abele, who runs Auriel, an equity long-short hedge fund, has been using ESG factors to improve performance since 2009, and says it is possible to measure the contribution those factors make to performance.

“ESG factors add 10 basis points of return and 13 basis points of risk [to our fund] on an annualised basis,” says Mr Abele, who says he is not in the business to save the world.

“We did not approach the ESG data from any kind of ethical standpoint,” he says. Instead, he believes looking at non-financial data such as carbon emissions, board composition or labour issues in the supply chain can give useful clues as to how a company is performing before it becomes evident in the financials.

Integrating ESG data into a traditional quant strategy is not straightforward, because the data are not straightforward. Not all companies report ESG data, the definitions they use are not consistent, it is updated much less often than most data (once a year is the standard), and the history is very short. This makes it impossible to back test the investment proposition.

Jess Gaspar, head of quantitative research at Commonfund, the $25bn US asset management company, says: “This is similar to the situation with emerging markets data. Significant alpha was available over the past five to 10 years because the data were poor. Someone who carefully scrubbed it and used developed-market models with a few twists was able to generate attractive returns.”

He adds: “In ESG, there is not such an easy place to pull a comparable model from.”

This is a problem for quants, who are used to using historic data to test their theories. “Statistically, you cannot rely on [empirical data] as much as we are used to as quants,” says Mr Abele.

Instead, pioneers have to create models based on theory and intuition, and be prepared to update them as more information comes in.

This is the approach taken by Arabesque Asset Management, a quantitative investment company set up to take advantage of the opportunity of ESG factor investing.

Andreas Feiner, head of values-based research at Arabesque, says: “It is uncontroversial which of the factors are material [likely to have a meaningful impact on a given company or sector]. Then it is about how you make it quantifiable.”

Arabesque has two strategies, one based on a smart-beta concept (using a rebalancing of an index to outperform that index) and the other seeking alpha from its quant strategy. Mr Feiner says the first has outperformed its benchmark by 2.36 percentage points and the latter by 10.70 percentage points. And of that outperformance, almost a third can be directly attributed to the ESG factors within the model.

Although investment return is usually uppermost in portfolio managers' minds, there is another aspect. High returns at the cost of high risks are not always desirable, and risk management is a priority for investors. This is where ESG issues may come into their own.

Mr Gaspar says: "ESG factors typically warn of risks. These may not be realised in a consistent manner. Poor governance or high carbon emissions may not hurt you every day. But they may hurt you a lot infrequently."

Not all quants using ESG factors are doing so because they are convinced it will improve risk-adjusted returns. Mike Hunstad, director of quantitative research at Northern Trust Asset Management, says: "It may well be a positively rewarded factor, but we just do not know yet. Because there is so little data and the definition is not uniform, it is difficult to draw a conclusion."

The lack of good data is the real challenge to quant investing with an ESG theme. "As a quant, I need to be able to measure it. If I don't have the proper ruler, I can't do that," says Mr Hunstad.

Two considerations have the potential to alleviate this frustration. First, the quality, frequency and consistency of data are improving rapidly. Mr Feiner predicts the quality will improve by a factor of 10 in the foreseeable future, while the recent accord on climate change in Paris should help to push companies to report relevant data on a more consistent basis.

Second, and the reason quants are in this area in the first place, is that the very fuzziness of the data is what allows the pioneers to extract alpha. By focusing on data that many investors ignore, it should be possible to find an edge.

As data improves and more investors wake up to its materiality, that edge will disappear, but in the meantime, there is money to be made.

"I would expect an improvement in data to erode returns over time, but not immediately," says Mr Gaspar. "While data gathering and processing is still a heroic process, opportunity should persist."

Let's get ethical: Rush of ESG-themed indices and ETFs

Although quantitative investing is traditionally a niche (and not a cheap) sector within the active management sphere, it could be said that index investing is a form of quant. So it is unsurprising that the rise of environmental, social and governance quant strategies has been accompanied by a rush of ESG-themed indices and exchange traded funds tracking those indices.

The launch of MSCI's low-carbon indices last year brought its suite of ESG indices to more than 130, and led to a flurry of low-carbon ETFs. Assets tracking low-carbon indices (mostly, but not all, from MSCI) came to $460m at the end of July last year.

Elsewhere, there are ETFs tracking indices that are sustainable, socially responsible or dedicated to efficient water resource management or companies with good labour relations.

Although MSCI is keen to appear to be a leader in the field, other index providers are rushing to join in.

Dow Jones has partnered with RobecoSAM, the provider of socially responsible investment data, to create the Dow Jones Sustainability Index family, while S&P has a range of indices weighted for ESG issues.

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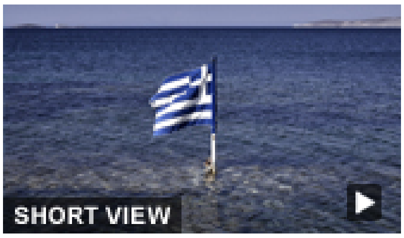

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