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RESEARCH

ESG Investing resilience study.

November 2020

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Editorial.

While ESG investing has existed for years, the market crash triggered by the COVID-19 pandemic came as a key test for a proposition that has gained popularity since the Global Financial Crisis. In the past, some strategies had great returns and inflows, only to almost disappear in the next financial meltdown. Quite logically, asset managers may wonder if ESG frameworks could have affected their funds in any way. How did ESG oriented funds behave, in regards to performance but also inflows, in this extremely volatile period? Did ESG investment funds allow for better resilience when financial markets were experiencing the winter market crash? **In this report, Sia Partners provides insights on how ESG criteria impacted flows and performance of French funds during this critical period (i.e. H1 2020).** This study was conducted by Sia Partners and was supported by Morningstar's data.

The current COVID-19 crisis has strengthened even more of what was already a very strong upwards trend in SRI (Socially Responsible Investing) and more broadly in ESG related investments. Now and more than ever before, investors seek to measure the real impacts of their investments and not only their financial performance. Furthermore, and according to recent research by Morningstar, "interest in sustainable investing has grown tremendously in recent years, and [...] this applies to most investors, regardless of gender or age"[1] .

This paper highlights that in spite of an extreme market volatility period, ESG oriented funds managed by French asset managers kept attracting new money and performed better. More precisely, during the COVID-19 crisis, French funds who had better Morningstar Sustainability Ratings were able to attract new capital in a very adverse environment while poorly ranked funds were met with redemptions. What's more, European Equity Large Cap funds with good ESG ratings had better returns than their lower ranked counterparts. Crucially, while better performance could explain the stronger inflows, the inflow differential between well ranked funds and poorly ranked ones holds regardless of the performance quartile of the fund.

In summary, ESG oriented funds clearly benefitted from a stronger appeal than poorly ESG ranked funds, and during a period of stress, ESG funds seem to do at least as well if not better than the average fund.

[1] Can Interest in ESG Investing Hold Up During a Pandemic? – Morningstar, Aug 26, 2020 https://www.morningstar.com/articles/998953/can-interest-in-esg-investing-hold-up-during-a-pandemic

Methodology.

Conducted by Sia Partners in September 2020, the conclusions in this report are based on information provided by Morningstar which was then analyzed in detail by our Asset Management team. In order to evaluate to what extent a fund had an ESG bias, **Sia Partners used the Morningstar Sustainability Rating[2] as its key indicator.** This rating methodology measures historical ESG risks in a portfolio using the company-level ESG Risk Rating provided from Sustainalytics. The rating is expressed in terms of Globes, from 1 (worst) to 5 (best).

Index funds, monetary funds and funds with less than 10 million of assets under management were removed. The analysis was based on the domicile of each fund and **only the funds based in France were selected** in order to achieve the objective of assessing how the French asset management industry performed during the COVID-19 crisis. Arguably, some funds in France are managed from abroad but it could be said that, putting index funds aside, the bulk of French active funds are managed from France even when the asset manager doesn't have its headquarters in France. By contrast, French asset management funds which are domiciled outside of France, in Luxembourg for example, were deliberately removed for the purpose of this research as there is hardly a reliable criterion that can tell whether the fund is effectively managed from France. What's more, some of these funds have a French share class. It was also decided not to manually select the asset managers in order to avoid any potential biases or subjective judgement.

This report mainly focuses on equity funds as this asset class offered the widest sample. To avoid any strong size or geographical bias, the report used the Morningstar categories to partition the investment universe. They key area of study was **Europe Equity Large Cap (360 funds)**, which had the largest sample. Other samples such as Europe Equity Small & Mid Cap (124 funds), Euroland Equity (38), Global Equity (85), and France equity (52) were also analyzed.

Furthermore, this paper focuses on the COVID-19 crisis period (H1 2020: from 2019-12-31 to 2020-06-30) but also gives additional background data (from 2017-01-01 to 2019-12-31) for illustrative purposes.

In order to evaluate ESG-oriented funds versus others, and to have larger samples, three "sustainability groups" were formed according to their sustainability ratings (globes):

- 'High and Above Average' (H&A), i.e. the category of funds with the best sustainability rating: 4 or 5 globes
- 'Average', i.e. the category of funds with 3 globes
- 'Below Average and Low' (B&L), i.e. the category with 2 or 1 globes

The aim was to compare these groups during the Covid period in order to identify any trends in terms of:

- Estimated Fund-Level Net Flow
- Average absolute returns and average excess returns versus their respective benchmark
- Average volatility
- Average excess returns relative to the volatility of the active returns (information ratio)
- Financial ratios

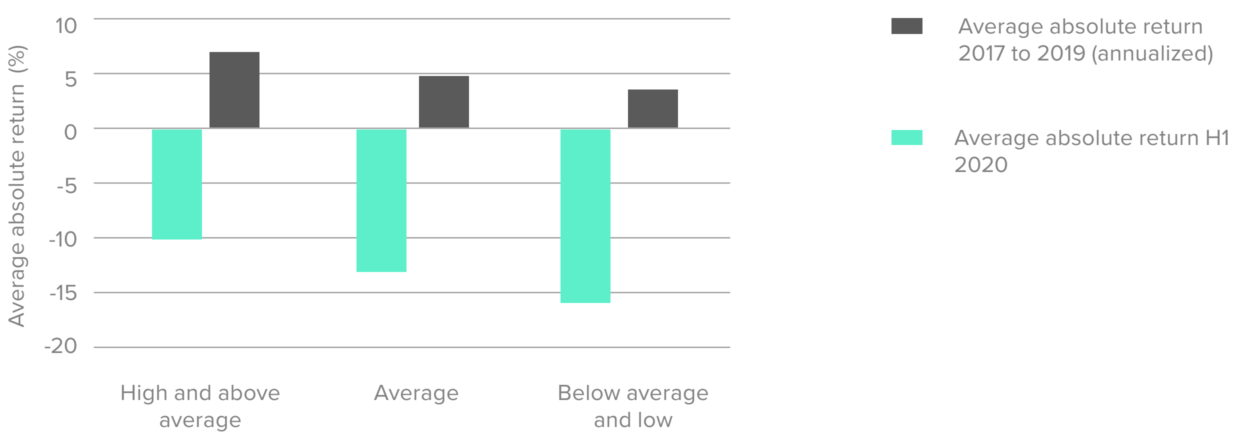
[2]See page 17 for details

European ESG funds performed better in H1 2020.

As previously mentioned, this report focused on the European Equity Large Cap funds domiciled in France and having a Morningstar Sustainability rating (from low to high) at the end of 2019. This represented a sample of 360 funds.

In terms of absolute returns (see below), ESG funds seem to have suffered from the COVID-19 crisis (January to June 2020) with negative returns compared to average positive returns during 2017-2019 period. However, these absolute returns comparison also shows that **funds with good Morningstar Sustainability ratings (high and above average) have been less affected by the COVID-19 crisis (less significant negative returns).** They also had higher positive returns during market upward trend (2017-2019), although it can't be asserted that they had the same sustainability rating during those 3 years.

Average absolute return (Europe Equity Large Cap)



Funds' Morningstar Sustainability Rating on 2019/12/31

Source : Sia Partners - Morningstar

Even if absolute returns give a first overview of ESG funds' resilience during market crisis, the excess returns analysis allows us to draw a more precise assessment: **ESG funds outperformed their relative benchmarks (defined by Morningstar) during the COVID-19 period.** Indeed, the outperformance of funds with high and above average Morningstar Sustainability ratings is clearly above the outperformance of those which have an average rating, and the group with below average and low ratings, which actually underperformed their benchmark during the same period.

Even during market upward trend (2017-2019), it seems that funds with higher Sustainability ratings were outperforming their benchmark more so than funds with average and low Sustainability ratings. Reassuringly, these results are quite consistent with previous papers[3] .

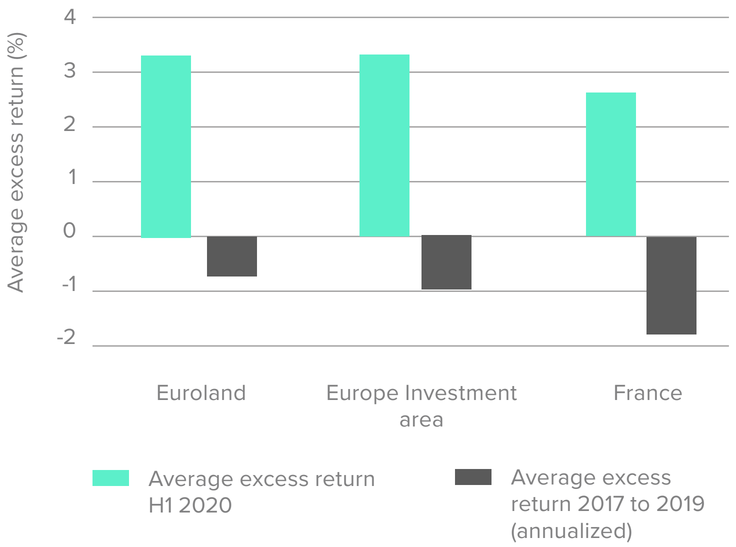
[3]ESG and financial performance: aggregated evidence from more than 2000 empirical studies ; Gunnar Friede, Timo Busch & Alexander Bassen ; Journal of Sustainable Finance & Investment, Volume 5, 2015 - Issue 4

Average excess return (Europe Equity Large Cap)

Funds' Morningstar Sustainability Rating on 2019/12/31
Source : Sia Partners - Morningstar

To go further into the analysis, it's worth highlighting that ESG funds (Morningstar Sustainability rating high and above average) invested in France had lower excess returns during the COVID-19 period than European invested funds.

Average excess return (Europe Equity Large Cap) by investment area



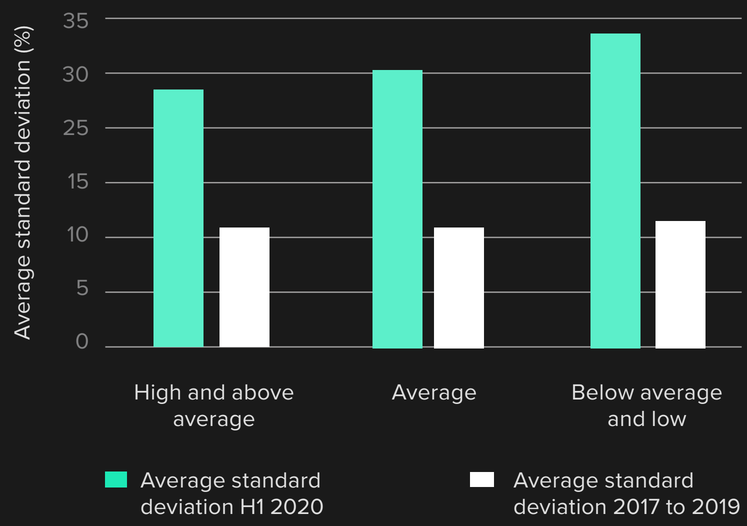
Source : Sia Partners - Morningstar

ESG funds were less volatile.

While ESG funds showed positive excess returns during the COVID-19 crisis it's worth assessing if this was generated with a lower risk profile or not.

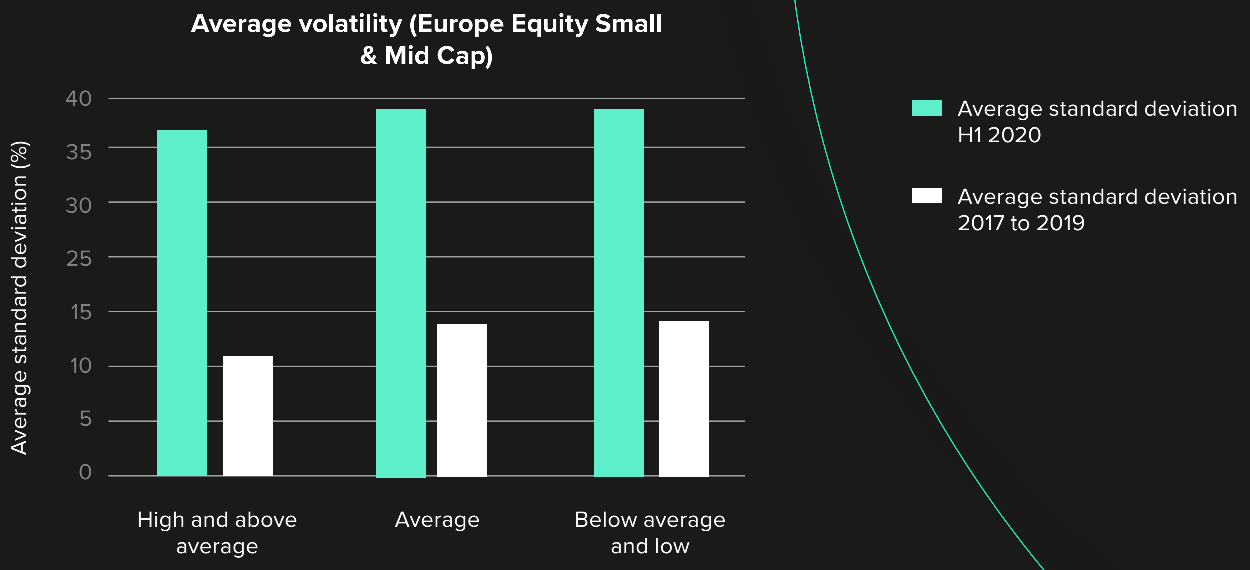
An analysis of the average volatility (defined by the historical standard deviation of returns) between funds with high & above average Morningstar Sustainability ratings and funds with lower ratings show that well rated ESG funds had lower volatilities during the COVID-19 period. Indeed, all the European Equity Large Cap funds studied in here had very similar volatility patterns between January 2017 and December 2019 but funds with higher Morningstar Sustainability ratings were slightly less volatile during the January – June 2020 period as shown in chart 4 below. **Lower ESG rated funds were more impacted by the COVID-19 crisis and suffered from a stronger increase in volatility.**

Average volatility (Europe Equity Large Cap)



Funds' Morningstar Sustainability Rating on 2019/12/31
Source : Sia Partners - Morningstar

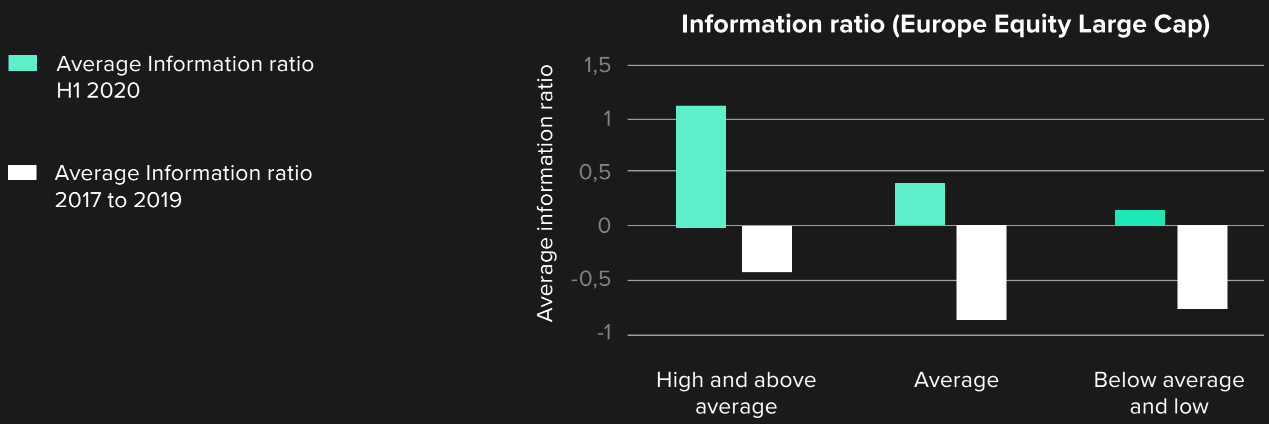
Conclusions should be drawn carefully as this assessment for European Equity Large Cap funds is less significant for other categories like the European Equity Small & Mid Capitalization (see chart 5). Here, even if funds with a H&A average Morningstar Sustainability rating display less volatility during both COVID-19 and 2017-2019 periods, the differential with funds that have a lower ESG rating is less tangible.



Funds' Morningstar Sustainability Rating on 2019/12/31
Source : Sia Partners - Morningstar

Were ESG funds able to outperform their relative benchmark without taking excessive risks?
To be able to conclude on how the outperformance of ESG funds was obtained in H1 2020, a closer look at the information ratio was given. This metric highlights the excess returns fundholders get for an additional unit of tracking error. It is thus a good indicator of how the funds are managed in terms of risk and whether additional risks are worthwhile.

The study of the information ratio between funds with higher Morningstar Sustainability ratings and funds with lower ratings illustrates that ESG funds had an excellent information ratio during the COVID-19 crisis (above 1) demonstrating a positive excess return without excessive risk.



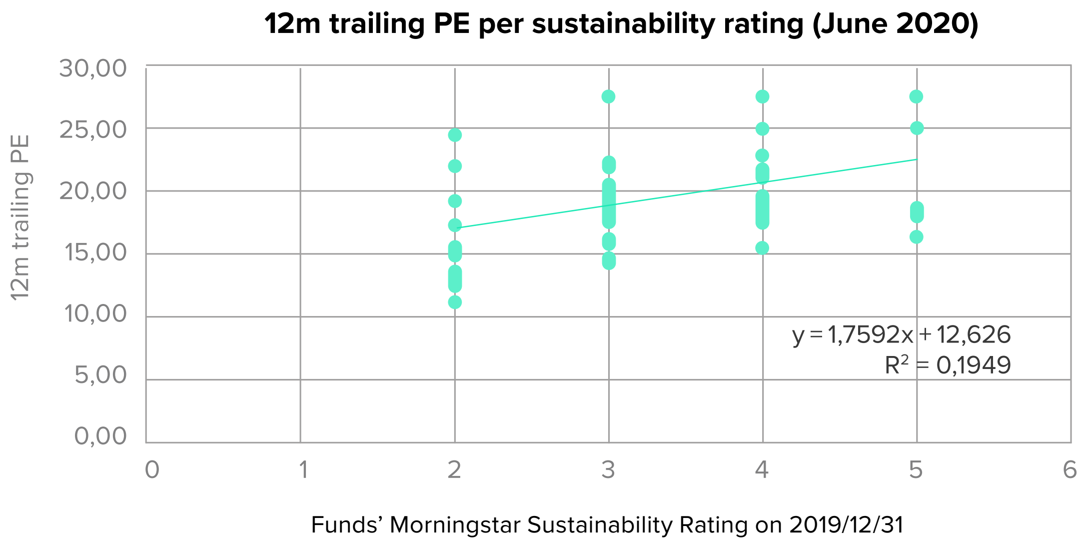
Funds' Morningstar Sustainability Rating on 2019/12/31
Source : Sia Partners - Morningstar

Funds with a good Morningstar Sustainability rating (high and above average) were consequently able to outperform their relative benchmark during the COVID-19 crisis with limited risk taking by the asset managers. **ESG funds then appear to be an interesting alternative during stress periods for investors that are seeking more resilient investments.**

ESG funds have higher valuation ratios.

Another aspect of ESG funds that deserves scrutiny is whether higher rated funds have any fundamental features that may help evaluate the kind of investments, and potential risks, that fundholders are exposed to.

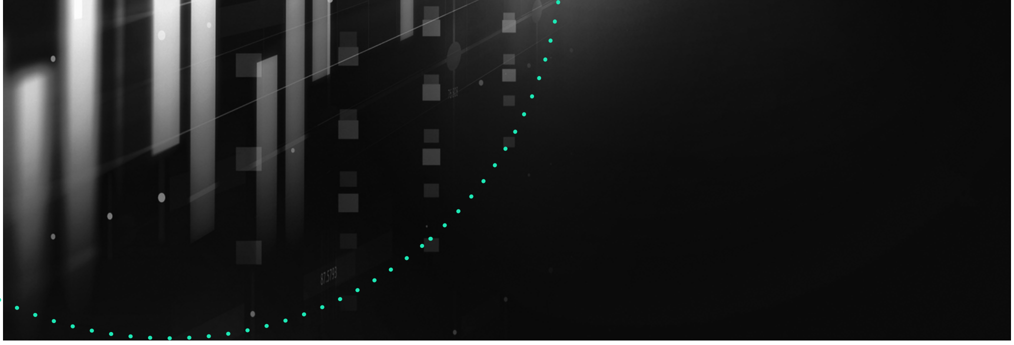
Sticking to European Large Caps (again, to remove any biases) and taking only funds for which there is both sustainability and fundamental data determined at the end of June 2020 (57 funds), one can notice that, generally speaking, better rated funds tend to have higher trailing PEs. More precisely, **each additional sustainability rating seems to add about 1,8pts of trailing PE.**



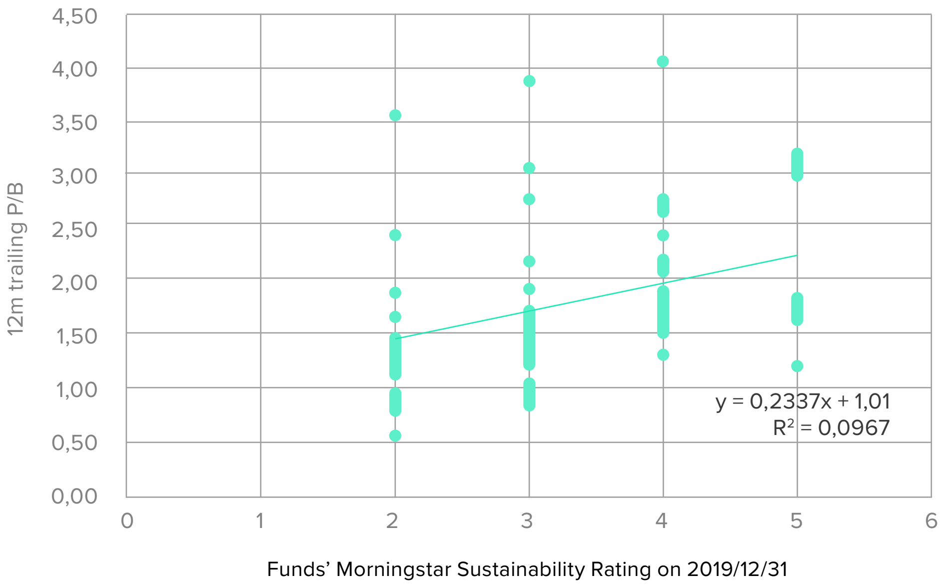
Source : Sia Partners - Morningstar

The same chart but with 12m trailing P/B ratios was also generated (see below). Then again, **higher rated funds seem to have higher trailing P/B ratios.** Each additional Sustainability rating seems to add about 0,23pts of P/B although the relationship is softer than for PEs (R^2 of 0,1 vs 0,19 for PEs).

It would be pretty straightforward to conclude that better rated funds are essentially Growth funds. However, when the same relationship using the Long-Term Earnings Growth Expected as the explanatory variable is computed, there doesn't seem to any particular link between sustainability ratings and the expected growth in profits. Put otherwise, better rated ESG funds simply seem to invest in more expensive companies. **One conclusion from the section about performance and volatility could be that, in fact, they invest in higher quality companies (lower volatility, lower cost of capital).**

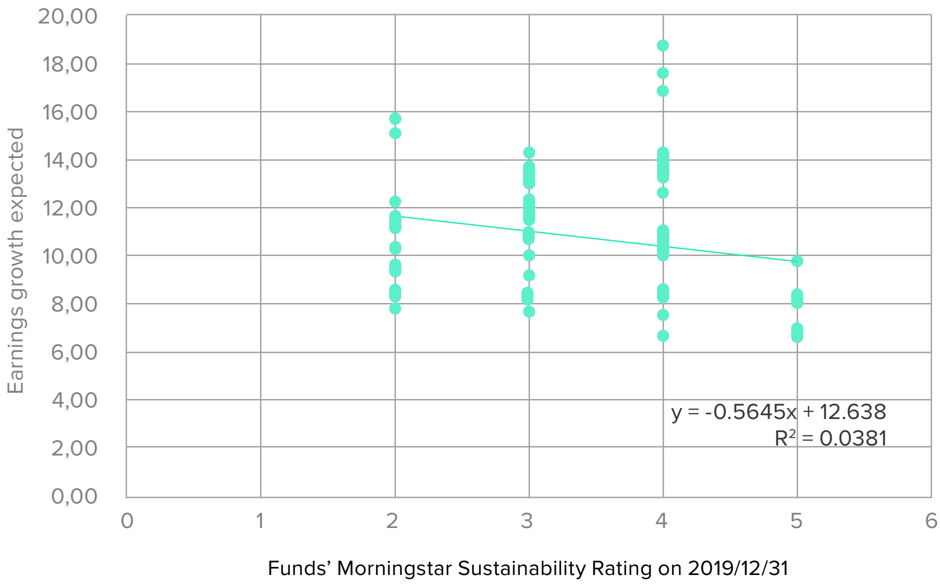


12m trailing P/B per sustainability rating (June 2020)

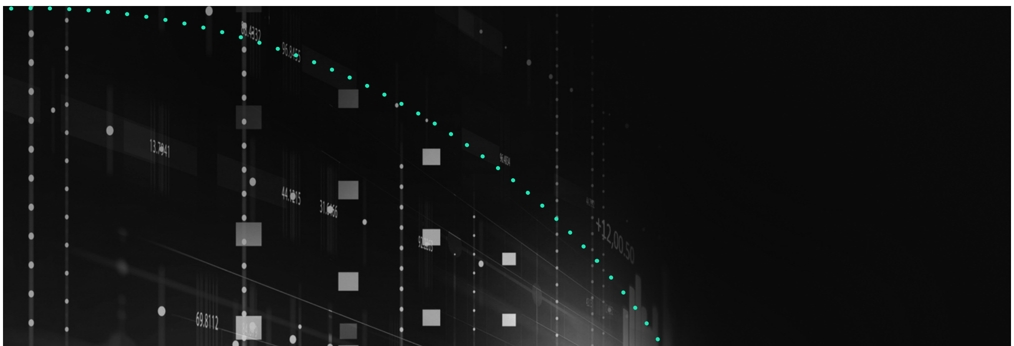


Source : Sia Partners - Morningstar

LT earn growth per sustainability rating (June 2020)



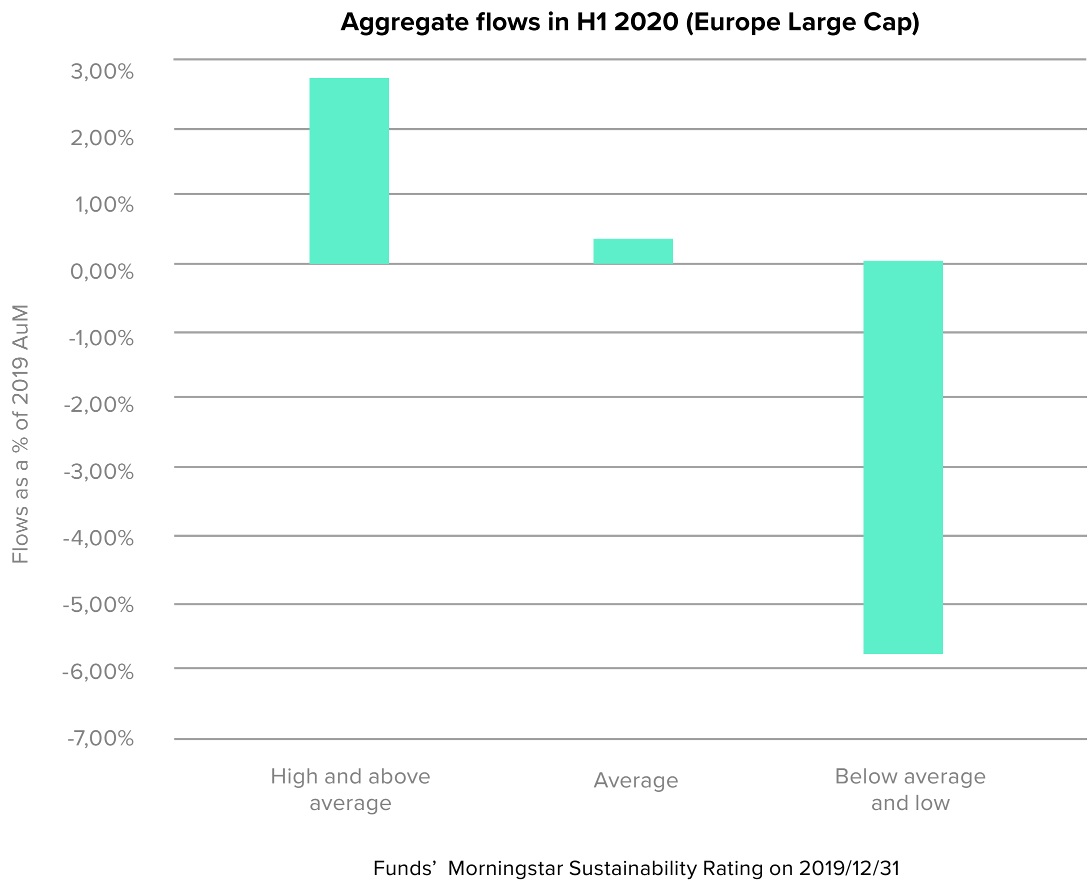
Source : Sia Partners - Morningstar



Sustainability led to more inflows in H1 2020.

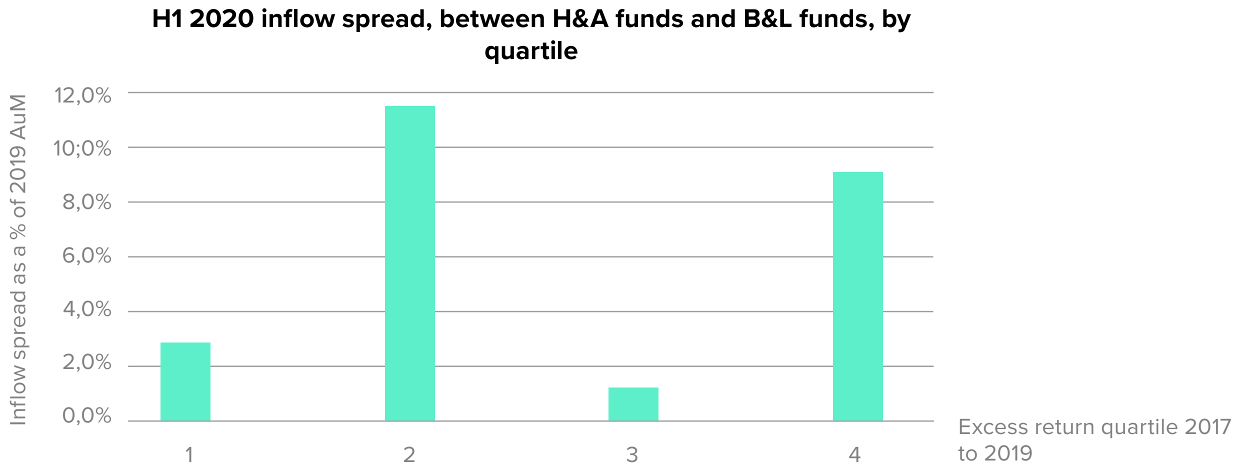
While fund performance is key for the long-term success (or failure) of any asset manager, an appealing and fit-for-purpose family of funds is also paramount if it wants to have strong and steady inflows. Have good sustainability ratings helped in this regard during the COVID-related markets crash in H1?

One way to answer this question is to calculate the difference in inflows (as a percentage of the end of 2019 AuMs) between the funds rated H&A and B&L by Morningstar Sustainability Ratings at the end of 2019. Starting with the European Large Cap category, the results are clear: from an aggregate inflow perspective, **H&A funds had inflows equivalent to 2.5% of their AuM while B&L funds had outflows equal to -5.8% of their 2019 AuM.**



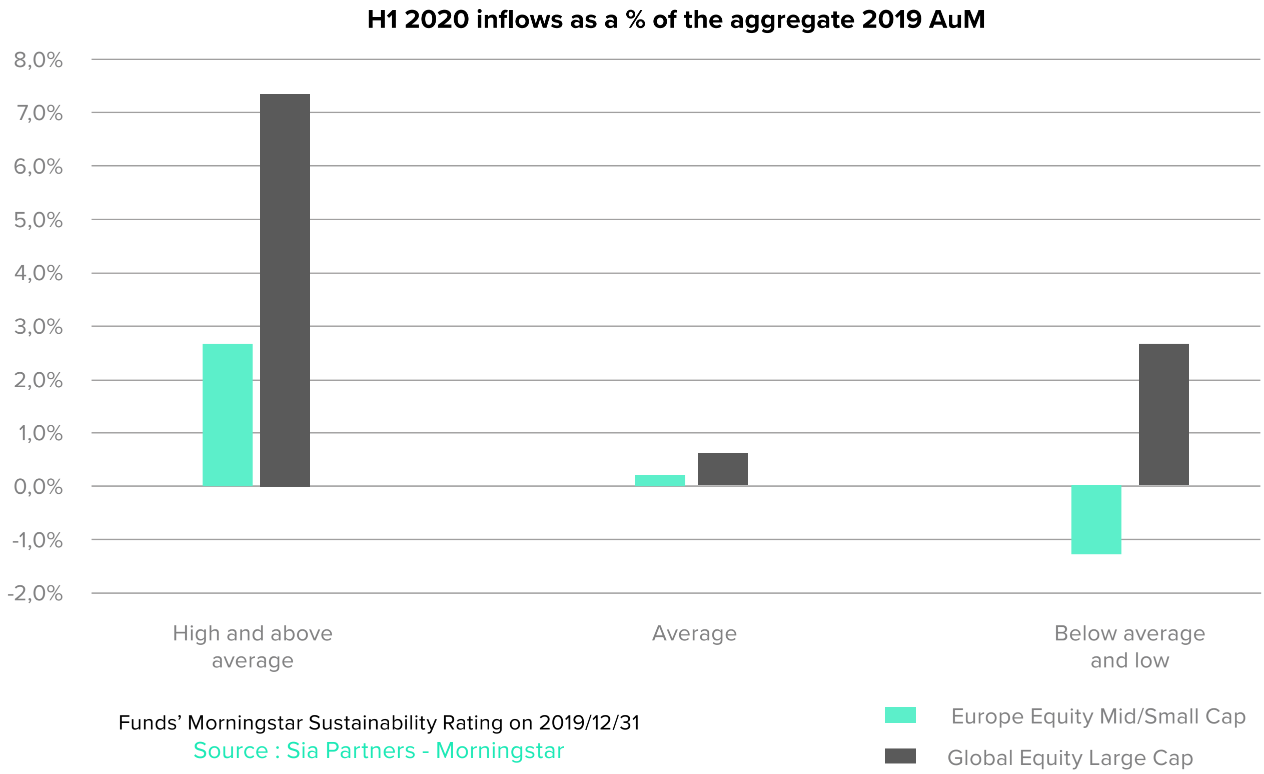
Source : Sia Partners - Morningstar

Is this due to past performance and what about other geographies?
Intuitively, if H&A funds performed better in the past, one would expect them to have stronger inflows. However, the **flow difference seems to persist even after taking into account stronger or softer performances.**
To demonstrate this, the Europe Large Cap group was divided into 2017-2019 Excess Returns quartiles (85 or 86 funds), the idea being that if Sustainability helps, it should also help in funds that performed poorly. As there is less funds in each cluster, the flow difference in each quartile is harder to accurately measure; however, the chart below shows, in each one of the 4 quartiles, H&A funds had stronger flows than B&L funds (in aggregate terms).



Source : Sia Partners - Morningstar

Similarly, the relationship seems to hold in other fund segments. Indeed, in both the European Small & Mid Cap and Global Equity Large Cap spaces (of funds domiciled in France), a flow premium to H&A funds is noticeable. The number of total funds is relatively limited (124 and 85 respectively), hence it is harder to interpret the data, but H&A funds clearly dominate the rest.



Source : Sia Partners - Morningstar

In a nutshell, French funds who had better Morningstar Sustainability Ratings were able attract more inflows that their less well ranked peers, irrespective of their market segment.

Conclusion.

French funds that had better Morningstar Sustainability Ratings, were able to attract more inflows, especially during the COVID-19 crisis, whatever the area of investment (France, Europe, Global). During H1 2020, from an aggregate inflow perspective for European Large Cap Equity category, H&A funds had inflows equivalent to 2.5% of their AuM while B&L funds had outflows equal to -5.8% of their 2019 AuM. Furthermore, while the relationship between ESG criteria and performance is less obvious, at best, they help outperform the benchmark and at worst, they do not have any impact on it. **In regards to the Europe Equity Large Cap cluster, funds with a good Morningstar Sustainability Rating outperformed their relative benchmark during the pandemic, with limited incremental risk taking by the asset managers.** Likewise, those funds had a better average Information ratio (1,08) than the B&L fund category (0,13).

As for Fixed Income, and in a nutshell, a similar but less in-depth analysis seems to show that the positive inflow trend for H&A funds is also true for this asset class.

As Sustainable investment clearly appears to be more resilient when markets become highly volatile, **Sia Partners considers a solid ESG suite as an opportunity,** if not a mandatory proposition, **for asset managers to stay competitive.** To do so, it will be key to have a good understanding of the fund's ESG content and better investment monitoring of those funds managed according ESG criteria. The acquisition of an SRI label and detailed communication on specific ESG investments, for instance, could greatly increase the funds' inflows.

How can Sia Partners help?

Sia Partners has a strong track record of management and strategy consultancy services dedicated to the financial industry. Thanks to its expertise in every aspect of the asset management value chain, Sia Partners will be able to assist you navigating through the many challenges awaiting an investment management firm. Whether you have already launched an ESG funds suite or not, Sia Partners' teams will be glad to meet you and help you either build it from scratch, or improve key aspects of your ESG platform (labels, data providers, regulatory reporting, Target Operating Model design, to name a few). Please, reach out so we can discuss these future-shaping trends.

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Morningstar rating methodology[4].

The Morningstar Sustainability Rating is a measure of the financially material environmental, social, and governance, or ESG, risks in a portfolio relative to a portfolio's peer group. The rating is an historical holdings-based calculation using the company-level ESG Risk Rating from Sustainalytics, a leading provider of ESG research now part of Morningstar group. It is calculated for managed products and indexes globally using Morningstar's portfolio holdings database.

The Morningstar Sustainability Rating is the result of a three-step process. First, the Morningstar Portfolio Sustainability Score is calculated for every portfolio reported within the trailing 12 months. Second, these scores are used to calculate a portfolio's Morningstar Historical Portfolio Sustainability Score. Third, a Morningstar Sustainability Rating is assigned for a portfolio based on its Morningstar Historical Portfolio Sustainability Score relative to its Morningstar Global Category.

Additionally, ratings buffers are applied to increase the rating's stability, and ratings adjustments are made for portfolios with extreme Morningstar Historical Portfolio Sustainability Scores.

[4] Source : Morningstar – more details available on Morningstar website

- Abou Dabi
- Amsterdam
- Baltimore
- Brussels
- Casablanca
- Charlotte
- Chicago
- Denver
- Doha
- Dubai
- Dublin
- Edinburgh
- Frankfurt
- Greater Bay Area
- Hamburg
- Hong Kong
- Houston
- London
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Sia Partners is a next generation management consulting firm and pioneer of Consulting 4.0. We offer a unique blend of AI and design capabilities, augmenting traditional consulting to deliver superior value to our clients. Counting 1,800 consultants in 18 countries, we expect to achieve USD 300 million in turnover for the current fiscal year. With a global footprint and expertise in more than 30 sectors and services, we optimize client projects worldwide. Through our Consulting for Good approach, we strive for next-level impact by developing innovative CSR solutions for our clients, making sustainability a lever for profitable transformation.

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