OUTCOMES

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PGIM QUANTITATIVE SOLUTIONS

ESG AT A CROSSROADS: TIME FOR A NEW RISK DIRECTION

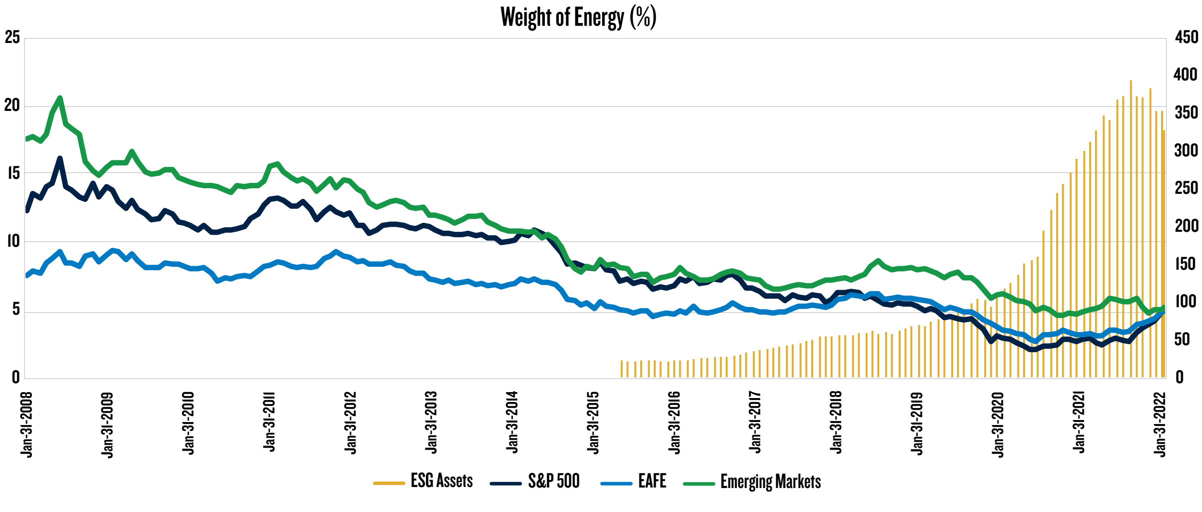
July 2022

Why meaningful ESG investment results require risk management and transparency

ESG investing is at a crossroads as regulators are demanding more transparency just as investors face inflation's rising threat to portfolio performance. One of the key reasons that ESG investing faces such scrutiny from regulators is the historical tendency of some asset managers to repackage existing strategies by adding a sprinkling of "good" companies to create a "new-ish" product that's been labeled ESG-friendly – or worse, some firms don't bother to make any changes at all, call it an ESG strategy anyway, and invite regulatory investigation. I think that, publicly at least, everyone would agree ESG investing should be much more than that. To be effective for ESG-aware clients, ESG investing will need to make a fundamental change to the way portfolios are designed to include comprehensive risk control with targeted ESG directives and complete transparency.

By definition, ESG investing introduces risk into portfolios as it deviates from the original investment mandate, and therefore, from the originally selected benchmark. But risk is not always a bad thing. Let's take a look at the weight of the Energy sector (a "bad" ESG investment by anyone's definition) within three major equity universes going back to 2008, when the weight of the sector spiked. Since that time, energy's representation in each of the indexes has fallen sharply. Coincidently, ESG assets have grown rapidly during this period, rising well over 1000% between 2015 and today. And as assets rose, ESG exposure became virtually "free," as not owning the worst ESG names proved to be a winning result as those constituents fell in index weighting.

Figure 1:

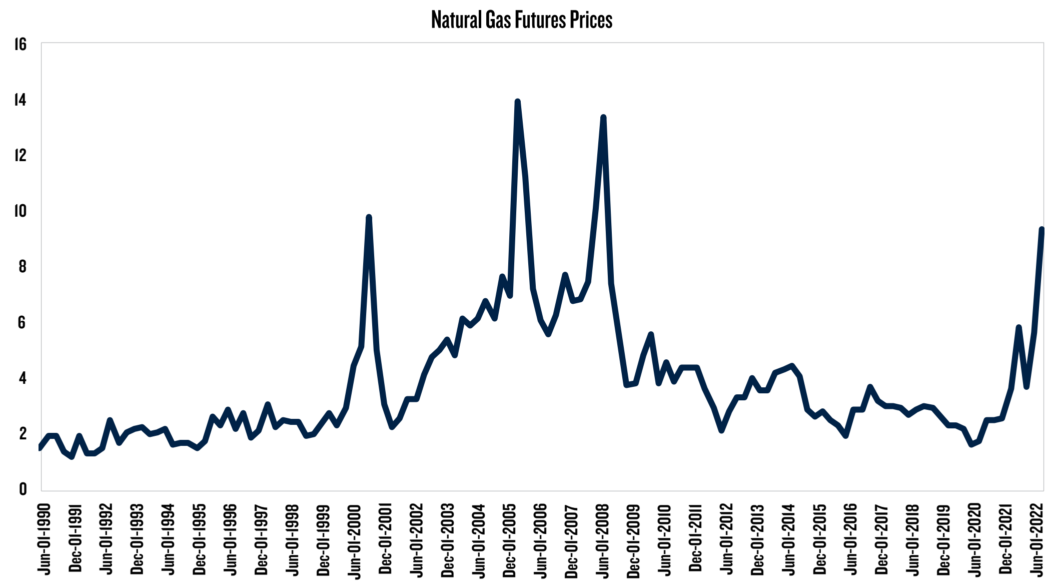


Sources: Bloomberg. Data as of 6/6/2022.

For Professional Investors Only.
All investments involve risk, including the possible loss of capital.

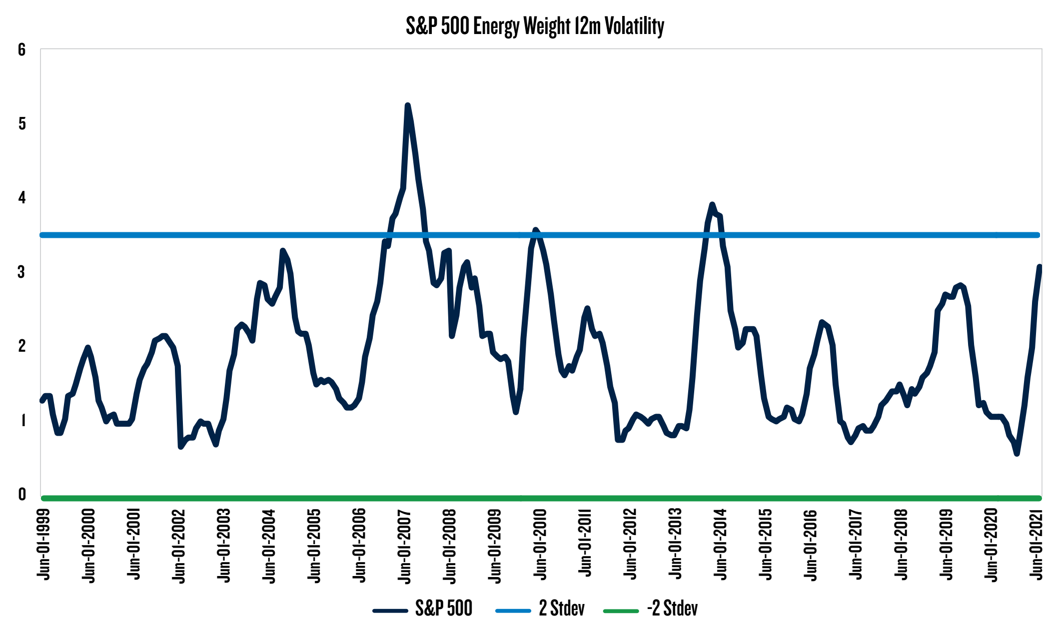
But, as we were taught in Econ 101, there's no such thing as a free lunch. As presented in Figure 2, energy prices have risen sharply over the last two years. The impact on equity markets and indexes has been dramatic, as seen in the 12-month volatility of Energy sector weights, which have also climbed substantially (Figures 3, 4, and 5). Said more plainly, the risk of excluding "bad" ESG energy names has gone up sharply – and will most likely continue to rise as the z-scores of current volatility for the S&P 500, EAFE, and EM indexes are only at 1.34, 1.29, and -0.93 respectively, even with such elevated energy prices[1]. Additionally, as this volatility has increased, ESG assets under management (AUM) have decreased sharply, with year-to-date AUM falling by roughly 20%.

Figure 2:



Source: Bloomberg. Data as of 6/6/2022.

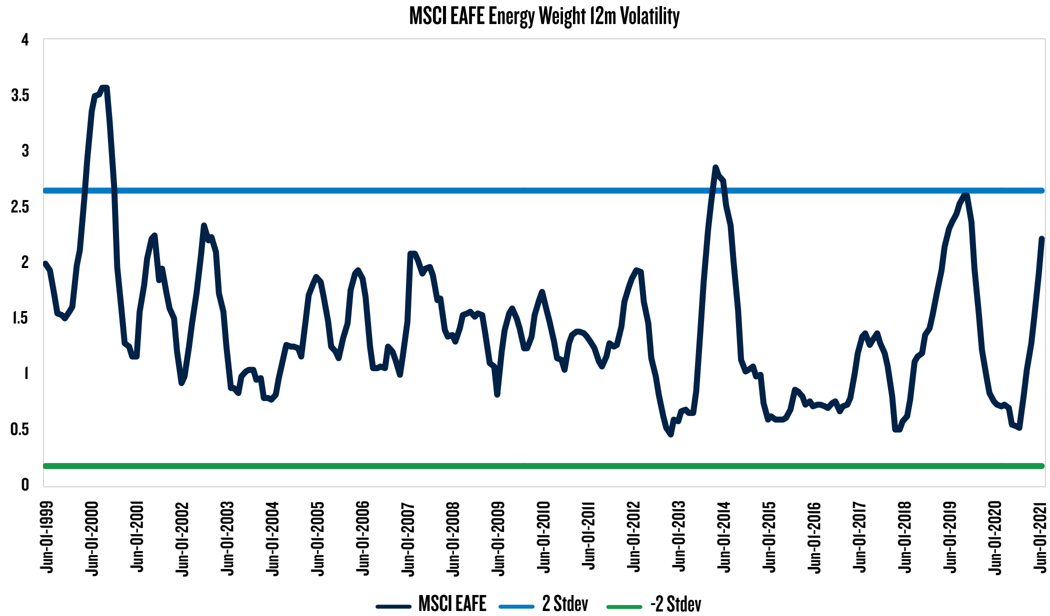
Figure 3:



Source: Bloomberg. Data as of 6/6/2022.

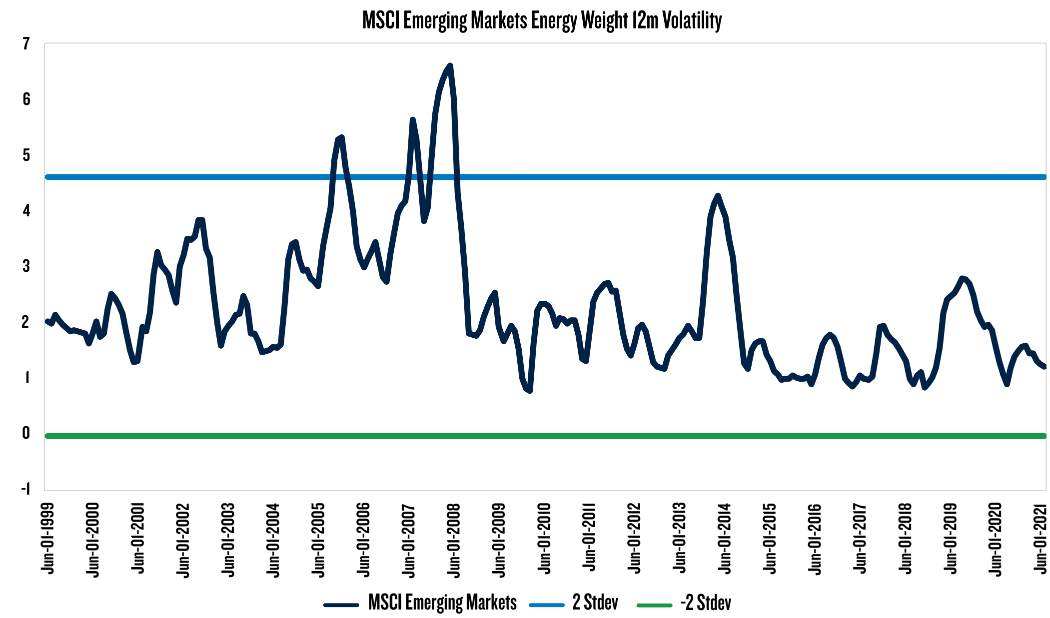
[1] A z-score measures how far away from the mean an observation is, which indicates how extreme the current value is relative to history. In this case, the S&P 500 at 1.34 means the current volatility is elevated from the average of the last 32 years, but by only 1.34 standard deviations. An outlier usually starts at 2 standard deviations.

Figure 4:



Source: Bloomberg. Data as of 6/6/2022.

Figure 5:



Source: Bloomberg. Data as of 6/6/2022.

So, what does this mean? Simply put, an effective ESG strategy is not easy to implement. To traverse the complicated ESG landscape, investors should seek managers that align ESG investing with a sophisticated and complete view of risk management. As noted in our recent paper on the benefits of constructing ESG-aware passive solutions, comprehensive ESG portfolio construction requires a robust ESG model, focus on risk awareness, and the ability to outperform in proportion to the targeted risk. After all, when picking like-for-like ESG companies, why not choose the best investment at the same time? The resultant portfolio should then provide a meaningful ESG profile that matches the client's desired risk and return profile – but not just when ESG is in favor. Rather, the ESG exposure should be additive[2] so as not to detract from the fiduciary goals.

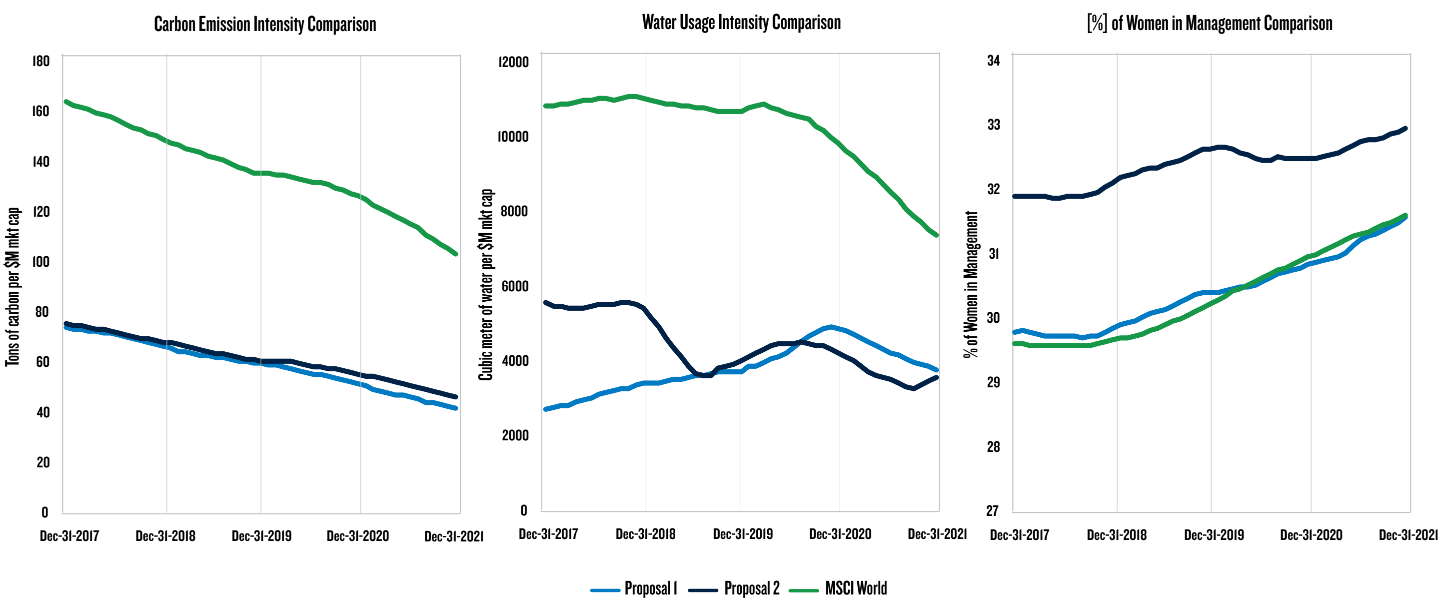
[2] https://www.pgimquantitativesolutions.com/article/esg-indexing-exclusions

In addition to complex and robust portfolio management, effectual ESG must be customized to the client's needs – and transparently so. Why? Because simply labeling an investment "ESG" no longer has any true meaning. ESG can mean many things to many people, so leveraging a large data set means finetuning the client's portfolio to ensure true compliance with their goals. The asset manager's response to those goals must be targeted and specific. For example, a client mandate may specify excluding all defense companies to avoid weapons. However, recent events have caused some investors to finetune this exclusion by only avoiding controversial weapons, like land mines. What about excluding something as seemingly simple as tobacco? Avoiding manufacturers is easy, but is it permissible to invest in retail stores that sell tobacco products? Perhaps, rather than a blanket ban, a client would prefer to set a revenue target threshold. These examples demonstrate how it's possible to provide deep, meaningful, and therefore goal-oriented exposure that matches a client's real ESG objectives, rather than managing to a generic ESG score.

The traditional method of arbitrarily classifying a company as either "good" or "bad" based on a simplistic ESG score is outdated. As investor expectations have evolved, we believe it's imperative to broaden the options by focusing on a company's impact – its direct influence on select, tangible issues. In doing so, we can unwind the activities of a company across targeted norms and exclude from our investment universe those firms that fail to meet standards in compliance with a client's beliefs. The recent press on Tesla and ESG could be a meaningful case in point: for environmental reasons, the company will have a strong ESG score, but for investors who desire to focus on the "S" by considering such things as management's treatment of labor, perhaps the company should be avoided.[3]

We can present countless examples of client preferences, but we all know that the proof is in the pudding, and this means transparent reporting. The examples below depict three metrics that we provided in a customized proposal for an MSCI World mandate. The charts in Figure 6 show simply and directly the level of meaningful ESG exposure we are able to provide across the client's key metrics and at their target risk level.

Figure 6: ESG Exposure



Source: PGIM Quantitative Solutions, MSCI, Refinitiv, FactSet. Data as of 4/30/2022.

Instead of simply showing a top-level ESG score, we provided a level of detail to give that client unique ESG insights into their existing and proposed Global Core ESG allocations at the carbon emission and water usage intensity levels and at the percentage of women in management level. Of course, just charting a top-level ESG score could be enough, but the data, focus, and transparency illustrate the true level of ESG exposure.

Looking at the risks associated with ESG – both good and bad – along with the need for transparency, gives investors true exposure to the ESG metrics that matter to them. This is only possible with a robust, systematic, data-driven approach to investing. It requires a true partnership with a manager that takes a nuanced approach to ESG investing and can evolve with both market cycles and ever-changing ESG data.

[3] https://www.nytimes.com/2022/05/18/business/tesla-esg-index-musk.html

Notes to Disclosure

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FOR MORE INFORMATION

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