Private Bank

Is the Rapid Rise of ESG Investments Sustainable?

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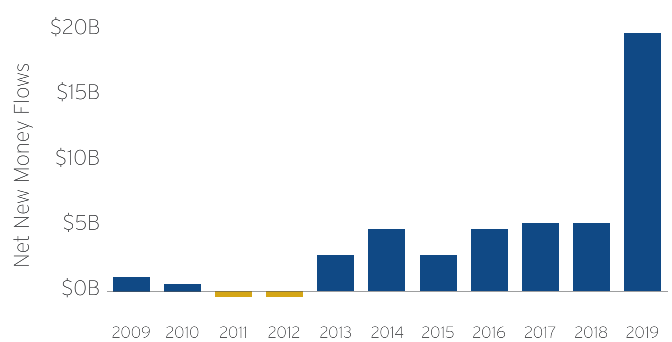
ESG investments have seen record inflows in recent years and we see good reasons why this fundamental shift may continue.

Mutual funds and exchange traded funds (ETFs) that invest based on a combination of environmental, social and governance (ESG) factors saw record inflows of $20.6 billion in 2019, according to Morningstar. That's almost four times the inflows in 2018, itself a record year (**Figure 1**). Record inflows continued in the first quarter of 2020 despite a correction halfway through the quarter. This rapid growth in investor interest has raised questions as to whether this is part of a fundamental long-term shift or an unsustainable fad.

Figure 1: ESG Funds Capture Record Flows in 2019



Source: Morningstar, as of December 31, 2019

In light of the Covid-19 pandemic and its economic impact, we also expect investors to increasingly seek and analyze more ESG-related information in the companies in which they invest, a trend already well underway. In turn, we expect the companies to continue to provide more ESG disclosures.

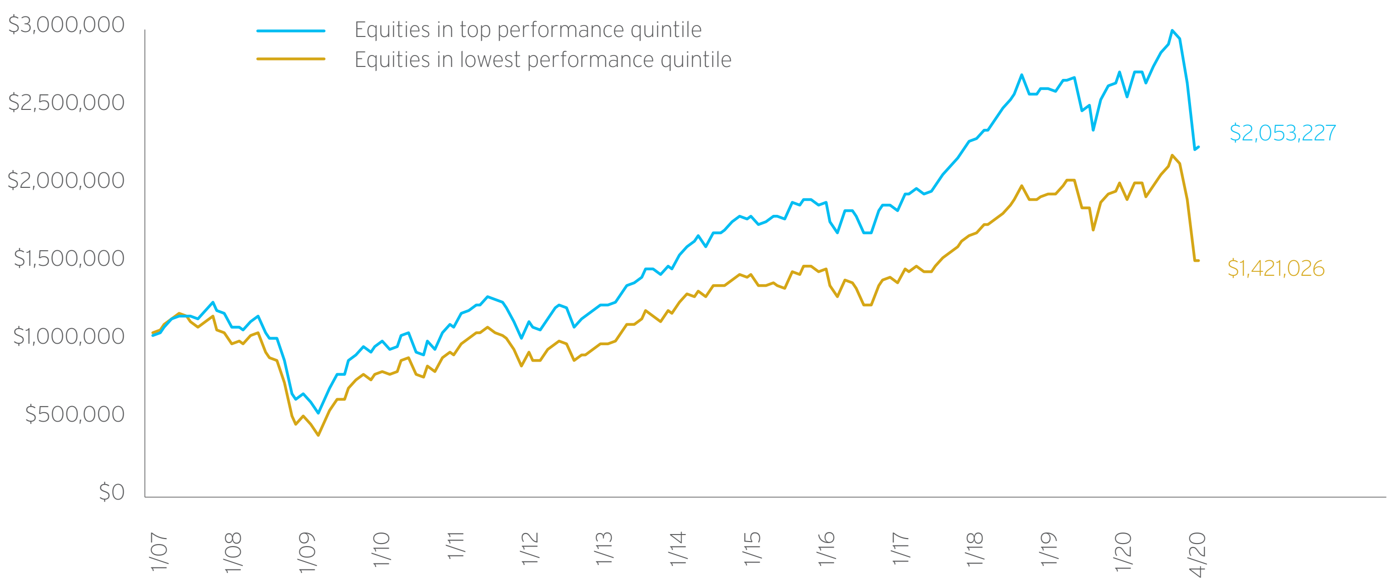
Even as investors and corporations have awakened to ESG's potential on performance and risk mitigation, the ESG investment space is still evolving, and this presents certain challenges. One is that there is not a sole definition of the precise actions that define and prove ESG adoption or that isolate ESG's impact. And there's not a sole metric across all market caps and sectors or a mechanism to measure companies' implementation processes relative to each other. Some of this will change as the investment world moves closer to ESG-focused regulatory standards that incorporate a host of measurements and goals from other initiatives including the Global Reporting Initiative, The UN's Sustainable Development Goals, the Paris Agreement and the Sustainability Accounting Standards Board.

In gauging whether these inflows are a fundamental shift versus a fad, let us begin with the motivations behind these inflows.

Driving the take-up of ESG investments are the growing number of investors who want to see their assets perform competitively, while also having a positive influence upon societal issues such as climate change, gender equality, and workplace safety. As a result, asset managers are creating ever more ways for them to invest, which in turn attracts further inflows. However, we see little evidence of the sort of irrational exuberance and unrealistic expectations that typically accompany a fad or a bubble. Instead, we believe that investors are taking a long-term view of ESG investments. Rather than treating them as speculative holdings – as with internet stocks in the late 1990s – there is a growing recognition of ESG investments' potential to enhance core portfolios. Evidence suggests that high ESG scores may be positively related to equity performance over time. Arabesque,[1] a global asset management firm and ESG ratings provider, equities from the MSCI World Index whose ESG scores were in the highest quintile have produced annualized total returns of 6.8% since 2007, as of April 21, 2020. This compares to 4.5% a year for equities from the lowest quintile of ESG scores (**Figure 2**).

Figure 2: High ESG Score Stocks Have Outperformed Low ESG Stocks

Cumulative Return Plot



Source: FactSet, Arabesque S-Ray,[1] as of April 21, 2020. High ESG scoring equities are defined as those in the top performance quintile; low ESG scoring equities are defined as those in the lowest performance quintile.

[1]Arabesque is a global asset management firm and ESG ratings provider. Their S-Ray tool uses self-learning quant models and big data to assess the performance and sustainability of approximately 7,000 companies. There are numerous ESG data providers that evaluate companies on their ESG performance and provide reports and ratings. Report and ratings methodology, scope and coverage, vary greatly among providers.

Importantly, investors are also paying attention to the risk profile of ESG investments. Again, the evidence here is encouraging. Not only have equities with the highest ESG scores produced stronger returns, but they have also been less volatile than those with the lowest ESG scores. The top quintile of equities ranked by ESG score had an annualized standard deviation of return of 16.7% versus 18.9% for the bottom quintile. High ESG score stocks also suffered smaller maximum drawdowns (-52.3%) in times of market stress than low ESG score stocks (-60.5%). (**Figure 3**)

In our studies of FactSet and Arabesque S-Ray data, the highest ESG score equities' outperformance of the lowest ESG score equities was a result of the former's greater resilience in the stock market's down months. From **Figure 3**, we can see that the highest ESG score equities' down capture is lower than 100 percent, while the lowest ESG score equities' down capture is higher than 100 percent. Since down capture is a measure of the sensitivities of the stocks to the market during the downturn, this observation indicates the resiliency of the highest ESG score equities. As a result, they typically did not need to make up as much lost ground after sell-offs. This pattern held up during 2020's pandemic-induced market pullback. The highest ESG score equities had outperformed their low ESG score counterparts by 4.8% year-to-date through April 21, 2020. In positive months, by contrast, the performance of both groups has been closer.

Figure 3:- High ESG Score Stocks Have Outperformed Low ESG Stocks with Less Risk

	High ESG Scoring Equities	Low ESG Scoring Equities
Mean Annualized Return (Gross of fees) %	6.8	4.5
Number of Months	160	160
Standard Deviation %	16.7	18.9
Minimum (Monthly) %	-21.0	-24.8
Maximum (Monthly) %	15.1	19.5
Median (Monthly) %	12.4	12.1
Percent of Positive Return Months %	61.3	61.9
Percent of Negative Return Months %	38.8	38.1
Percent of Zero Return Months %	0.0	0.0
Mean Return/Standard Deviation	0.41	0.24
Maximum Drawdown %	-52.3	-60.5
Start Drawdown Date	10/31/2007	05/31/2007
End Drawdown Date	02/27/2009	02/27/2009
Up Capture %	104.3	106.3
Down Capture %	97.8	110.8

Source: FactSet and Arabesque S-Ray.[1] Jan 31, 2007 to April 21, 2020. High ESG scoring equities are defined as those in the top performance quintile; low ESG scoring equities are defined as those in the lowest performance quintile.

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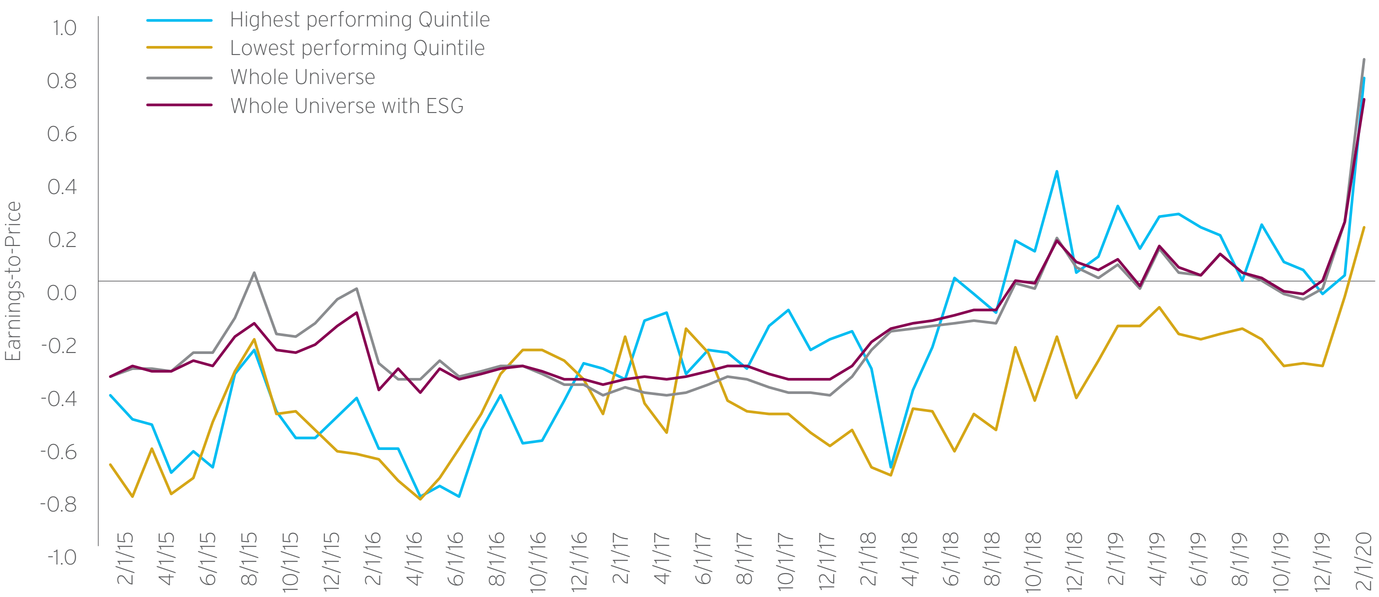
Finally, we see no signs of irrational exuberance in ESG investments' valuations overall. True, the highest score ESG equities examined have become more expensive relative to their lowest scoring counterparts in the last couple of years. This is true whether we look at earnings (**Figure 4**) or book value based multiples (**Figure 5**). However, the difference is not extreme either in relative or absolute terms. As of the end of the first quarter, high ESG score equities looked attractive compared to their valuations of the last ten years. Put simply, record inflows into ESG equities have not driven their valuations to unsustainable levels.

Figure 4: Earnings-to-Price Z-Score

Average Z-score[1]: Higher earnings-to-price is cheaper



Source: FactSet and Arabesque S-Ray.[1] Jan 31, 2007 to April 21, 2020. Highest ESG scoring equities are defined as those in the top performance quintile; lowest ESG scoring equities are defined as those in the lowest performance quintile. A Z-score measures an observation's standardized departure from the mean (average). A score between -1 and 1 occurs about 68% of the time and a score be-tween -2 and 2 occurs about 95% percent of the time.

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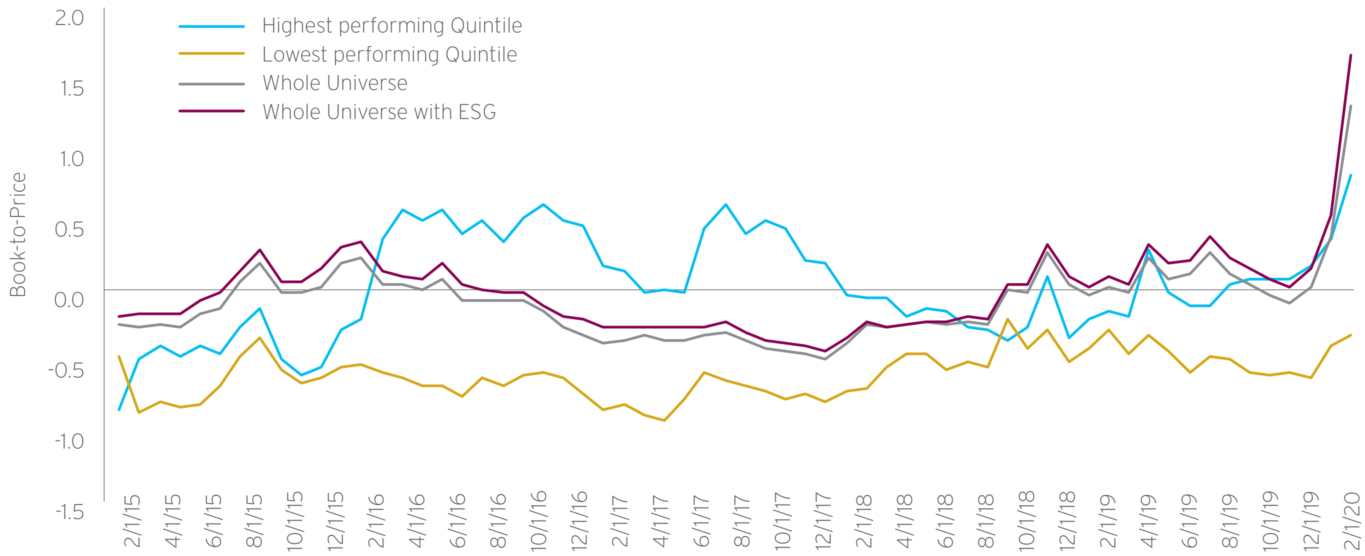
Figure 5: Book-to-Price Z-Score

Average Z-score: Higher book-to-price is cheaper



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So, what next? After another standout year for ESG fund inflows, total ESG mutual fund and ETF assets stood at $137.3 billion at the end of 2019. However, this amount represents less than 1% of the $20.7 trillion held in US mutual funds and ETFs, according to Morningstar. As investors continue to prioritize the greater good alongside their long-term investment returns over the coming years, we expect the shift into ESG investments to continue.

At Citi Private Bank, we are committed to meeting the growing needs of our clients who seek to invest in an environmentally responsible, socially sensitive, and profitable way.

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