HOW ESG OVERLAYS CAN LEAD TO UNINTENDED MARKET BETS

ESG CONSTRAINTS CAN CREATE UNINTENTIONAL SYSTEMATIC EXPOSURES WITHIN EQUITY PORTFOLIOS. ONCE IDENTIFIED AND MEASURED, THESE EXPOSURES ARE EASILY MANAGED.

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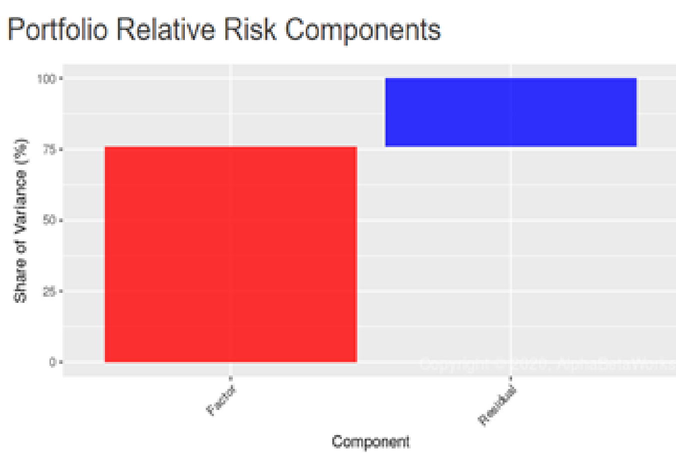
Over the past decade, many insurers have incorporated Environmental, Social, and Governance (ESG) investment strategies into their portfolios, either by creating separate ESG mandates or by incorporating ESG constraints across the entire portfolio.

These developments raise the vital question of how ESG criteria alter the risk profiles and the factor exposures of portfolios.

To help address this question, we used the ABW – Peer Analytics U.S. Equity Statistical Risk Model, which was built for oversight and only uses investable factors. Using the model, we compared an ESG constrained S&P 500 Index portfolio with its unconstrained counterpart.

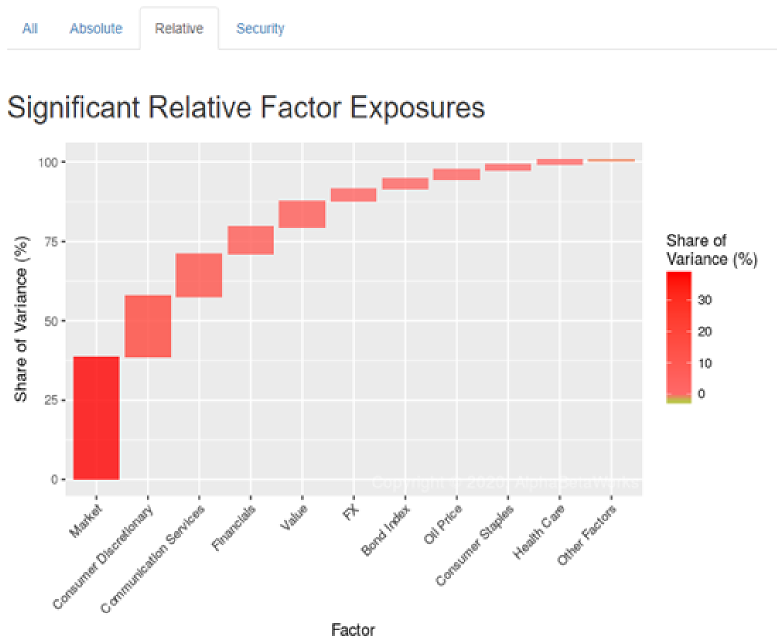
Using FTSE-Russell ESG ratings for S&P 500 Index constituents, we created a sample ESG constrained index fund by excluding companies with ESG ratings below 2.6 from the index benchmark. This constraint excluded 23% of the market capitalization of the index.

In this simple example, ESG constraints changed the risk profile of the portfolio and added 1.7% volatility (tracking error) relative to the unconstrained benchmark.



Source	Volatility (ann. %)	Share of Variance (%)
Factor	1.50	75.95
Residual	0.84	24.05
Total	1.72	100.00

However, 76% of relative risk in this example is due to relative exposures to market factors. These may be offset with inexpensive passive investment vehicles such as index funds, ETFs, futures, and swaps.



In fact, 72% of relative factor risk in our sample portfolio is due to only three factors: Market, Consumer Discretionary, and Communication Services sectors.

We've seen how ESG constraints can significantly alter the risk profile and passive factor exposures of portfolios. One option is to adjust the benchmark – this leaves the unanswered question of whether performance is sacrificed. Instead, insurers who have adopted, or are considering, ESG guidelines would be well-served by multi-factor risk models, built with investable factors. Such models can identify and offset the unintended market bets, thus avoiding style drift and potential underperformance.

We would be more than happy to provide a complimentary review of your portfolio. Please feel free to contact Garth Flint for additional information or any questions.

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