QS Investors

June 2020

Key Considerations in ESG Allocations

The global pandemic has helped convince some ESG skeptics of the value in a secondary data lens, serving as a reminder that ESG issues are potential financial risks that need to be managed appropriately.

Investors have increasingly turned to ESG factors as an alternative data set to more fully understand the sustainability of a company's business model. Understanding nonfinancial considerations can drive short- to long-term risk exposure, resiliency, cost of capital and a company's ability to innovate in order to remain relevant to society. To date, investors have primarily focused on issues such as the impact of climate change, diversity in board composition and respect for human rights within the supply chain.

However, COVID-19 has demonstrated on a global scale the importance of other factors, such as business continuity plans, disaster preparedness and employee treatment through benefits like paid sick leave and health care. The global pandemic has helped convince some ESG skeptics of the value in a secondary data lens, serving as a reminder that ESG issues are potential financial risks that need to be managed appropriately. We have seen a resurgence in the "Social" pillar of ESG with "Health & Safety", "Share Buybacks" and "Redundancies" being the most frequently searched terms in news media pertaining to companies during the pandemic. According to a study published last month by George Serafeim, [1] companies that protected labor forces and supply chains during this year's stock market drawdown saw more net inflows from institutional investors and better returns than their industry peers. [2]

Our research suggests that, over the long-term, high scoring ESG companies have better risk management that translates into lower cost of capital, resulting in higher profitability and higher dividend yields compared to lower-rated peers. Additionally, highly rated ESG companies have exhibited lower idiosyncratic and systemic risk.

While broadening the focus of ESG dimensions is important in developing a full-fledged view of a company, we believe that consideration of the following issues is key when evaluating an ESG allocation.

[1] Alex Cheema - Fox, B. R. (2020). *Corporate Resilience and Response During COVID-19.*

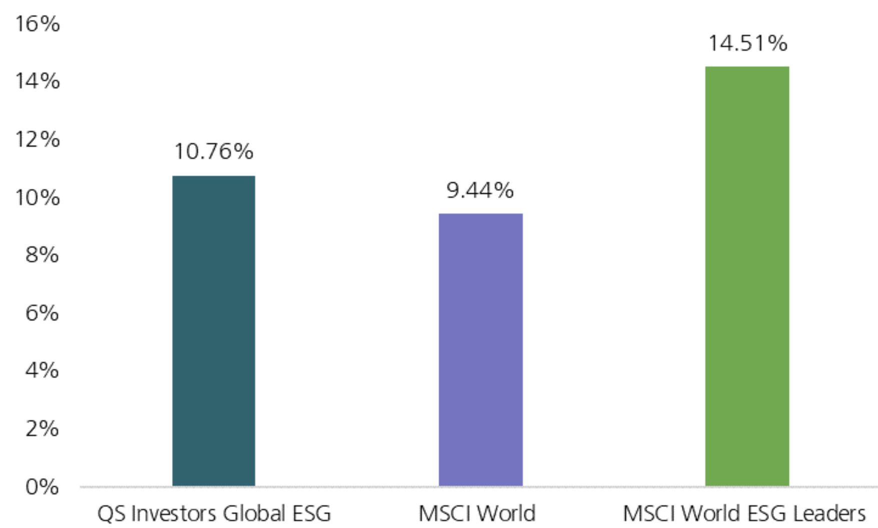
[2] Based on cumulative 20-day lagged active institutional investor money flows relative to total equity assets under management as of February 19, 2020, State Street.

It is important to consider diversification when investing within the ESG space, as concentration within ESG indices has increased significantly over the past few years.

Underlying Security Level Concentration

The concentration embedded within market cap weighted indices has increased significantly over the past few years and has become even more pronounced in ESG indices. For example, Microsoft alone makes up 7% of the MSCI World ESG Leaders Index. The top 5 securities[3] currently make up over 14% of this index, whereas the top 5 securities make up nearly 10% of the MSCI World Index. Diversification should always be a concern for investors. However, as a result of increasing index concentrations, investors should be acutely aware whether their portfolios are adequately diversified, regardless if investing passively or actively.

EXHIBIT 1: WEIGHT OF TOP 5 SECURITIES



Source: Bloomberg, MSCI Indices as of June 5, 2020.

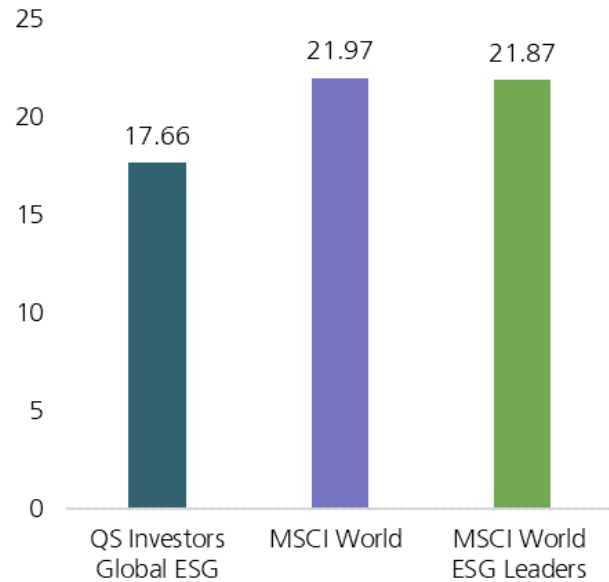
Inclusion of Fundamental Factors

Fundamental factors are an important complement to non-financial ESG factors allowing investors to find the highest scoring ESG companies while also considering valuation, cash flow and a future catalyst for growth. Valuation has become an increasingly significant consideration in the space as ESG gathers momentum.

[3] Top 5 securities in the MSCI World ESG Leaders Index include Microsoft, Alphabet, Johnson & Johnson, Visa, Procter & Gamble. Top 5 securities in the MSCI World Index include Apple, Microsoft, Amazon, Facebook and Alphabet.

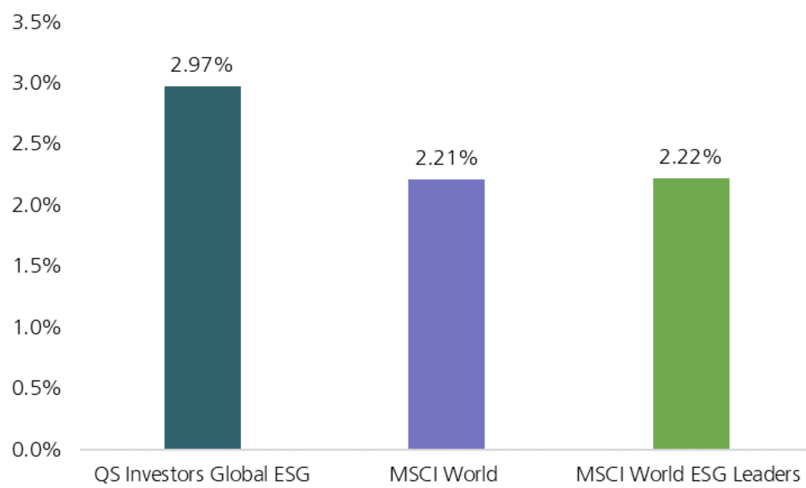
Valuation has become an increasingly significant consideration in the space as ESG gathers momentum. Also, of tremendous importance is the need for ESG ratings and factors to change in order to stay relevant in a rapidly evolving world.

EXHIBIT 2: TRAILING P/E RATIO



Source: Bloomberg, MSCI Indices as of June 5, 2020.

EXHIBIT 3: TRAILING 12-MONTH DIVIDEND YIELD

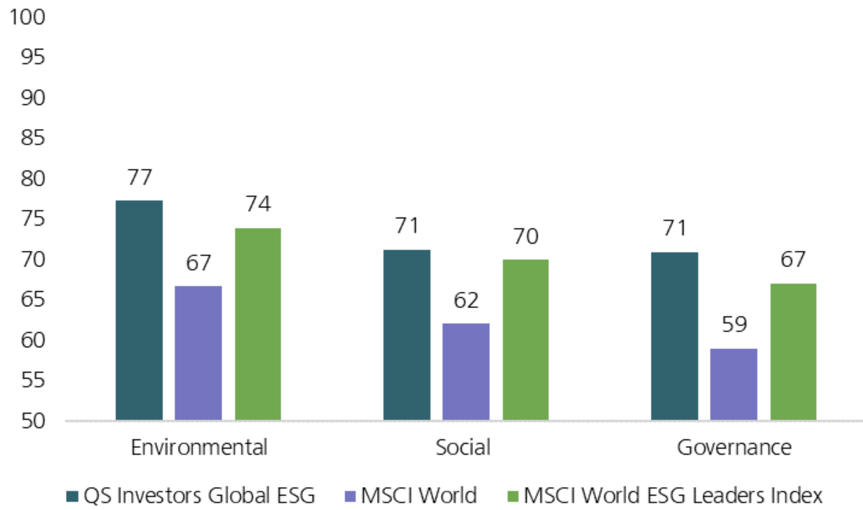


Source: Bloomberg, MSCI Indices as of June 5, 2020.

Dynamism of ESG Rating Factors

ESG ratings and factors need to be dynamic. Markets continue to evolve, therefore, it is vital that ESG measurements capture these changes and innovations. This includes integrating data sources that go beyond a company's self-disclosure.

EXHIBIT 4: 1-YEAR PERCENTILE RANKS



Source: Bloomberg, MSCI Indices. Based on 1-Year Sustainalytics Percentile Ranks. For the top 1% the percentile is 99th; for the bottom 1% the percentile is 1st. Percentiles measure environmental, social and governance preparedness and disclosure in addition to controversies. As of June 5, 2020.

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