

# ESG Scores as a Measure of Quality

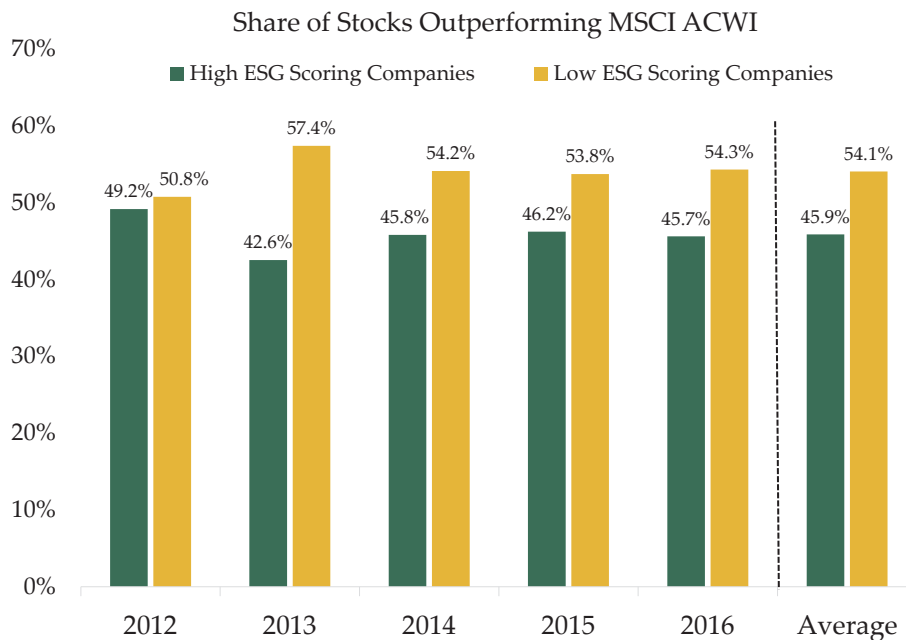
## Key Takeaways:

- Our findings suggest that investors may prefer lower-quality and ESG rated securities early in bull markets and higher quality and ESG rated companies as the bull markets mature.
- We believe interpreting and integrating Environmental, Social and Governance—or ESG—scores differently than others may produce capital markets technologies with actionable portfolio management implications across a variety of investment strategies.
- We believe there is growing opportunity for ESG scores as a non-financial measurement of quality.

One long-running tenet of our investment philosophy holds that long-term success requires interpreting information differently—and more correctly—than the vast majority of investors. We believe ESG scores open a new avenue on this front. ESG scores are calculated from security attributes that widely used financial statements don't easily capture.

There is a vigorous debate occurring in the investing community about whether highly rated ESG firms may provide durable risk reduction or alpha generation opportunities over time—most findings appear somewhat underwhelming or inconclusive (Exhibit 1).

## Exhibit 1: High or Low ESG Scores are Unlikely to Produce Durable Alpha Generation<sup>1</sup>

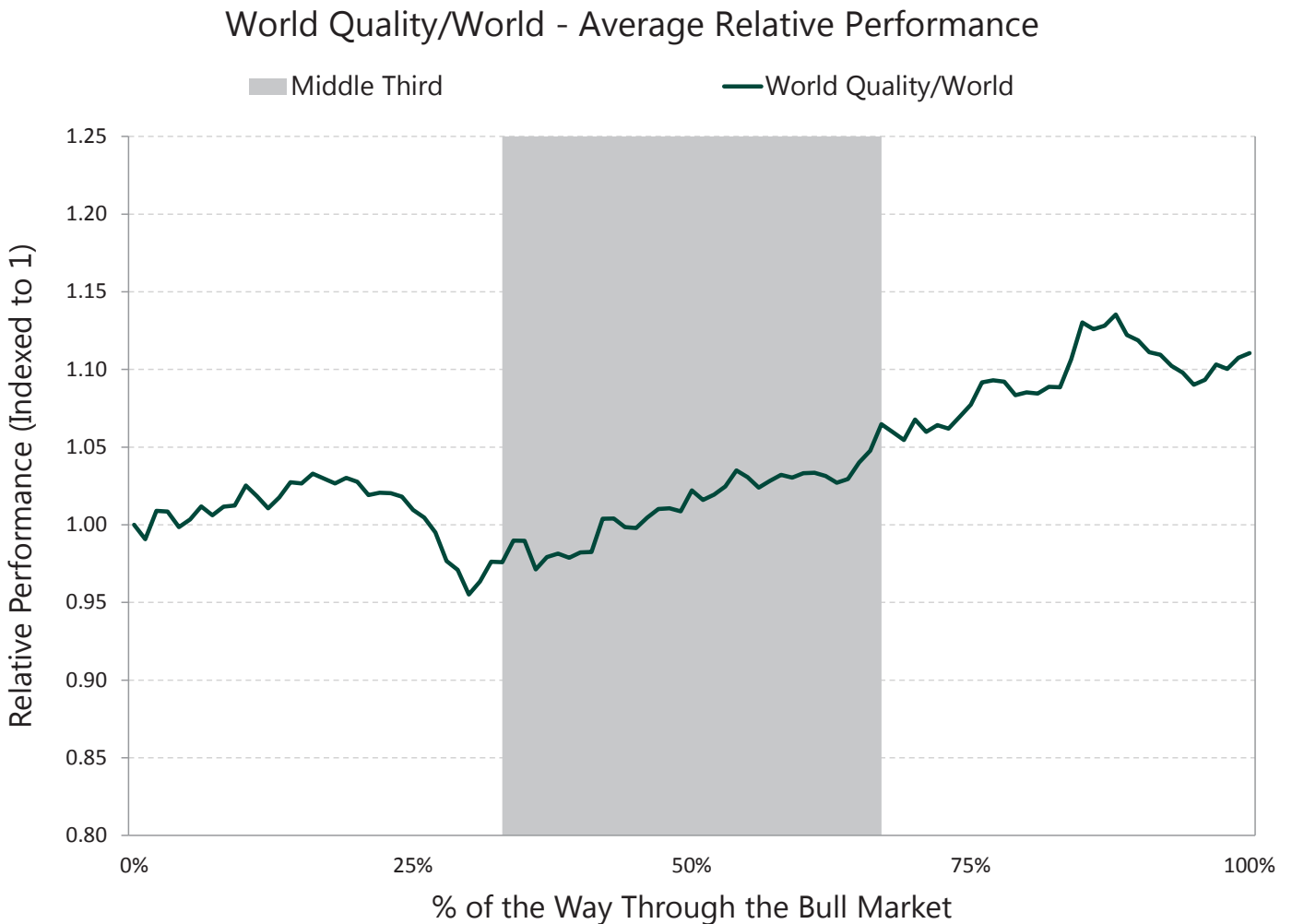


1. Source: FactSet, as of 31/12/2017. MSCI ACWI Index used to define the equity universe. MSCI ESG Manager used for company-level ESG scores. "High" indicates a company with an ESG score exceeding the MSCI ACWI's. "Low" indicates a company's score is below the MSCI ACWI's. Investing in securities involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance is never a guarantee nor reliable indicator of future results. The value of investments and the income from them will fluctuate with world equity markets and international currency exchange rates. Other methods may produce different results, and the results for individual portfolios and for different periods may vary depending on market conditions and the composition of the portfolio.

However, this may be the wrong question to ask, as it presumes there is one superior investment characteristic or style throughout a market cycle. Because markets deal efficiently with widely known information, including leadership trends, it seems unlikely any one category or characteristic of stocks would provide enduring superior risk-adjusted returns for a long, uninterrupted stretch. Such advantages tend to get priced in relatively quickly.

Fisher Investments' research has shown markets favour different characteristics at different points in the market cycle. We think ESG quality should be no different. Our prior studies on quality—which we define using measures of return on equity, earnings variability and debt-to-equity ratios—indicate investors' prefer lower-quality securities early in bull markets and higher quality as bull markets mature. (Exhibit 2)

**Exhibit 2: Quality Outperforms as Bull Markets Mature<sup>2</sup>**



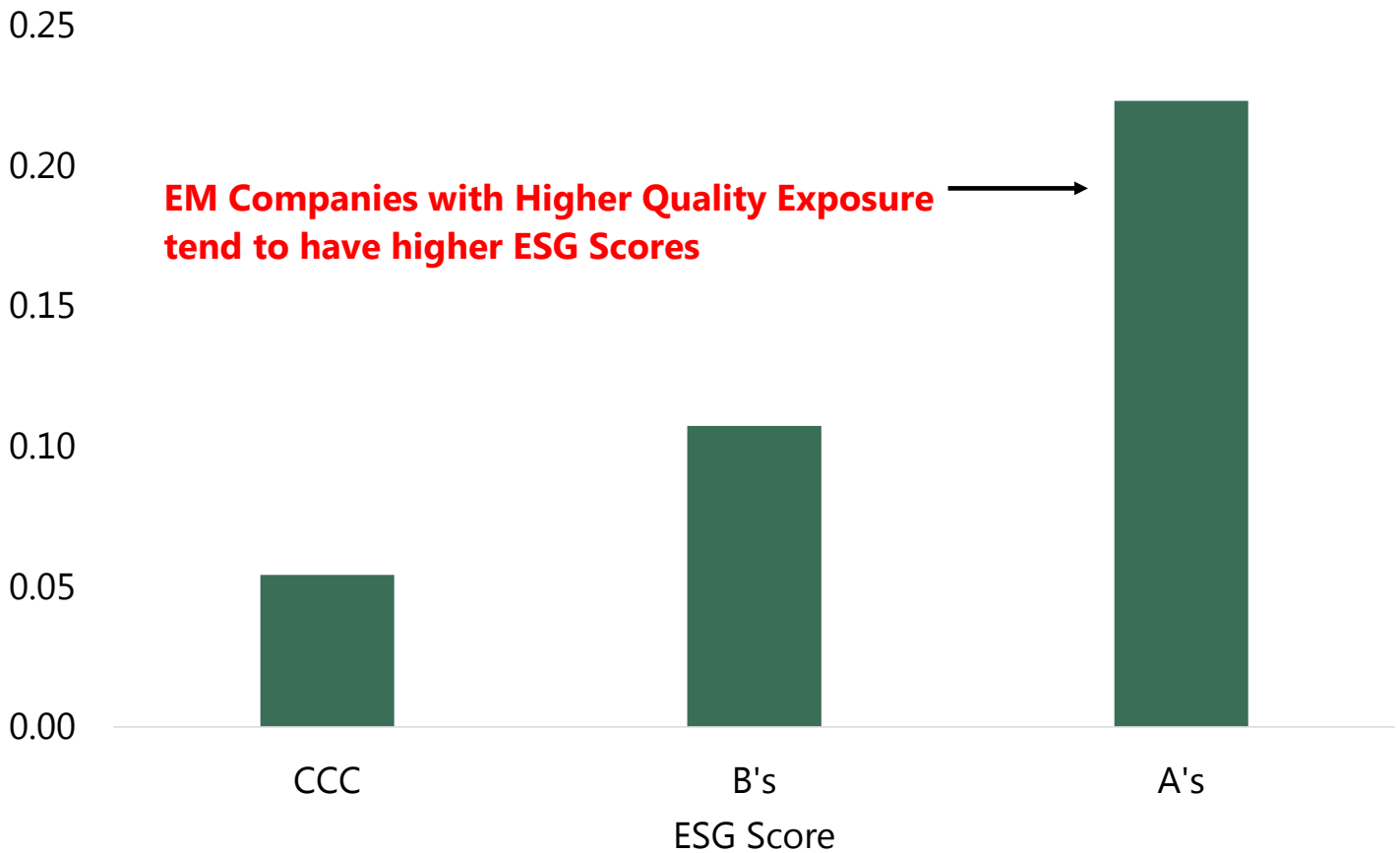
2. Source: FactSet, as of 31/12/2017. MSCI World Index Monthly data through bear ending 30/09/1974; daily after. FactSet MSCI World Quality vs MSCI World (last 4 bull market cycles: 20/11/1980-12/08/1982, 02/08/1987-26/10/1987, 04/01/1990-28/08/1990, 27/03/2000-09/10/2002) Investing in securities involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance is never a guarantee nor reliable indicator of future results. The value of investments and the income from them will fluctuate with world equity markets and international currency exchange rates. Other methods may produce different results, and the results for individual portfolios and for different periods may vary depending on market conditions and the composition of the portfolio.

Further, we noticed our proprietary measurement of quality correlated particularly well with MSCI ESG scores in Emerging Markets. EM companies with

higher quality exposures—via Return on Equity, Earnings Variability and Debt to Equity—tend to have higher ESG Scores (Exhibit 3).

**Exhibit 3: ESG Scores and FI Quality Scores Highly Correlated<sup>3</sup>**

**EM ESG Scores Correlate with Quality**



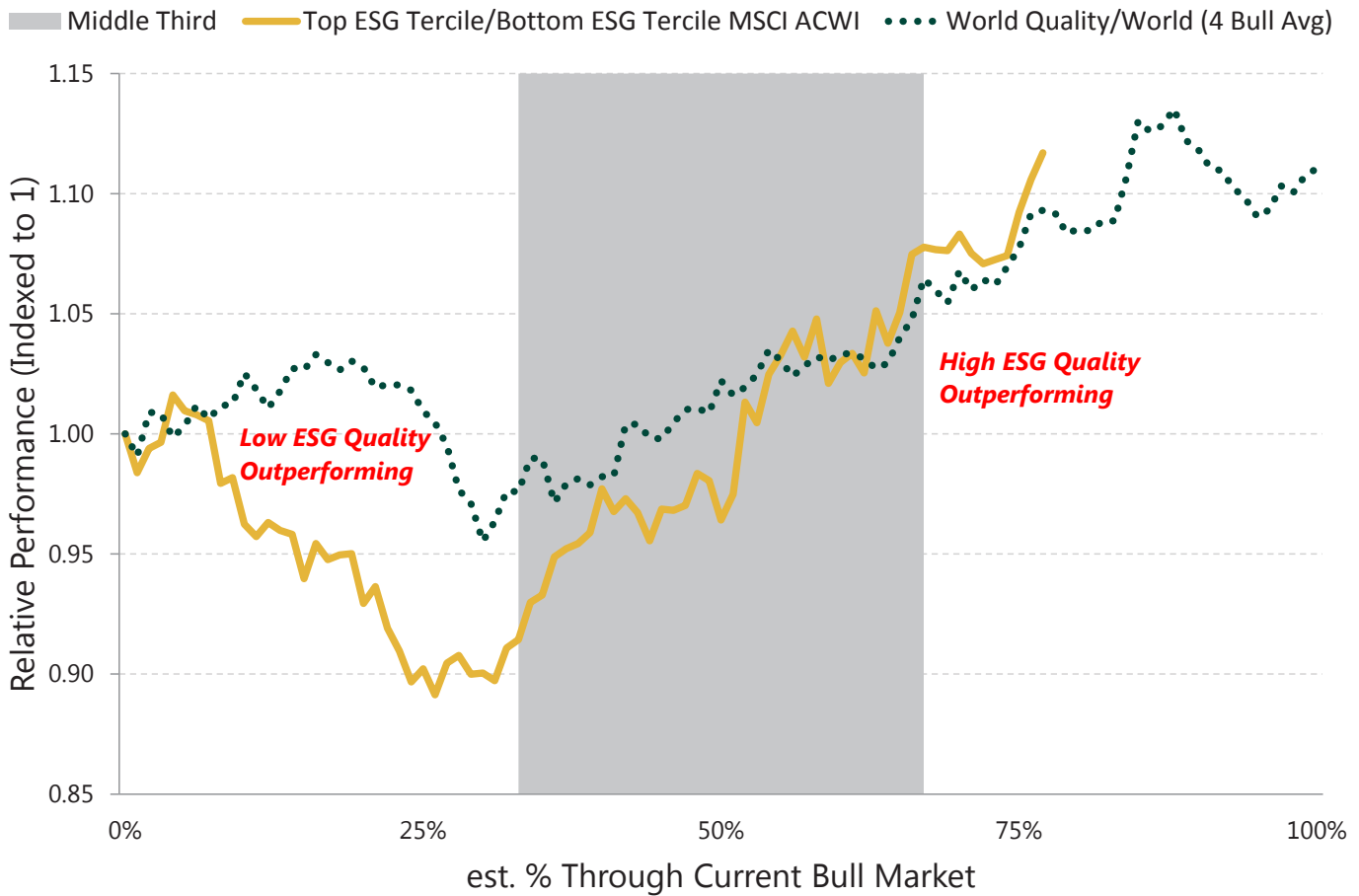
3. Source: All data based on MSCI EM index as of 30/09/2018. Excludes companies without ESG scores (6.2% of companies within the index). Y axis: Quality exposure measured based on Fisher Investments calculation of an in-house quality Z score by utilizing 3 financial ratios: Return on Equity, Earnings Variability and Debt to Equity. X axis: ESG Scores based on MSCI ESG Research. A's include AAA, AA, and A rated companies. B's include BBB, BB, and B rated companies. Investing in securities involves the risk of loss and there is no guarantee that all or any capital invested will be repaid. Past performance is never a guarantee nor reliable indicator of future results. The value of investments and the income from them will fluctuate with world equity markets and international currency exchange rates. Other methods may produce different results, and the results for individual portfolios and for different periods may vary depending on market conditions and the composition of the portfolio.

We saw this as a unique opportunity to merge these two concepts in an effort to use ESG scores as a non-financial measurement of quality. We analyzed the relative returns of MSCI ACWI constituent stocks by ESG score in this bull market, as ACWI constituents are normally distributed across ESG scores. An ESG quality index comparing the relative returns of the best third (high quality) of ESG scores against the bottom third (low quality) showed promising results: Low quality outperformed early on, while high quality outperformed thereafter—just as we would expect.

The results invite further analysis of ESG data as an alpha-generation source. Unfortunately, ESG scoring data is limited to this current bull market, so it is difficult to know whether these quality trends produced similar results in prior cycles. But at the bare minimum, we think these results are an encouraging start to the incorporation of non-financial quality measures in security selection for alpha-generation purposes.

**Exhibit 4: ESG Quality Performance through the Current Bull Market<sup>4</sup>**

High Quality ESG Underperformed Early and Outperforming Late Cycle



4. Source: ClariFI and MSCI ESG Research; ESG scores are MSCI's industry-adjusted ESG scores; 16/07/2018 marks the end of the middle third; returns are cumulative from 09/03/2009 to 18/10/2018; FactSet MSCI World Quality vs MSCI World (last 4 bull market cycles: 20/11/1980-12/08/1982, 02/08/1987-26/10/1987, 04/10/1990-28/09/1990, 27/03/2000-09/10/2002)

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