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Governance Update Extract

Incorporating ESG investing: a case study

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Incorporating ESG investing – a case study

There has certainly been an upsurge in interest within Albion's client community around ESG (environmental, social and governance) investing, with many firm's seeking to build an alternative set of portfolios to accommodate (perceived or actual) client demand. The issue still creates some concern amongst advisers about how best to raise the issue with clients, for fear of being driven into a 'deep green' corner. The key is to ensure that the conversation is framed suitably and that pre-determined solutions are in place prior to having the conversation. Broadly speaking, we see two main client segments:

1. Those who would like to take some steps in the right direction to try to make a difference, perhaps in the knowledge that they are likely to make some trade-offs, as they do more generally in their broader lives. We often use the analogy of putting recycling in the green bin religiously each week but driving a Range Rover and going on long-haul flights on holiday.
2. Those who want to engage fully and implement their investments truly in line with their deeply held values, perhaps at the expense of the returns they achieve. They also want to be able to measure and see that impact of what they are doing.

We believe that the first approach can be accommodated by building a *'steps-in-the-right-direction systematic ESG portfolio'* but defaulting to non-ESG screened funds until such time as the client can be rolled out of them into new ESG screened alternatives as they become available. The goal is to increasingly overweight better ESG-scoring companies and underweighting lower ESG-scoring companies, whilst maintaining the structural integrity of the portfolio.

The second approach is considerably more challenging as each investor will have ESG concerns weighted towards their own values, finding some trade-offs acceptable and others not. Portfolio construction issues become far more problematic for several reasons:

- Material sector biases arise e.g. in alternative energy
- Smaller company allocations predominate
- Country weights may differ markedly from market cap weights
- Stock concentrations can be high
- Tilts to value are often hard to execute
- Track records tend to be short and funds small

Unless a firm has strong investment management resources, an outsourced DFM approach may make good sense.

In this section, we look at the first approach and specifically how one of Albion's client firms – Ifamax in Bristol – has gone about introducing ESG to all of its clients.

a) Ifamax and Global Systematic Investors (GSI) – a useful case study

In Albion Governance Update 8 we undertook a Q&A with Garrett Quigley of GSI and the GSI Global Value Fund that they had launched. We explored the systematic, risk-factor and sector-rebalancing approach they had adopted. Three years on from that interview we undertake a Q&A with Max Tennant, the founder and CEO of Ifamax and Garrett Quigley of GSI. Max's journey is an interesting one: he fully endorses a risk-factor based, systematic approach to investing for his own clients, but has always felt strongly that, as investors, we are all able to make a difference in the world through sensible ESG investing. Max was frustrated by what he saw as a lack of strong risk-factor based funds with any form of ESG screening and entered a dialogue with GSI, to consider introducing an ESG version of their value fund. It soon became evident to all that placing the ESG screening at the heart of both Max's client proposition and GSI's existing fund structure, was the obvious way forward. Max has become a Director of GSI to help them to roll out the now-named GSI Global Sustainable Value Fund to a wider, systematically focused financial planning audience. The Q&A below covers this story.

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b) Q&A with Max Tennant and Garrett Quigley

Albion Q1. Max, what does sustainability mean to you?

Max: 'It's simply trying to look at our future environment, today. I'm sure we all want a great place for our kids and their children to grow up in; clean air, clean water, pollution free and free to explore our natural world. If I can be a tiny part of the generation that took ownership of our current problems and found ways of fixing them; then that would be something worth working towards.

I could take the view that just waiting for some authority to rule and regulate as if it is someone else's problem to sort. But, as we've seen with pensions, what our Government does is normally far too little, far too late and I see the same thing happening again with issues relating to sustainability.

Just as we should save for later life, individuals must take some personal responsibility for sustainability. I believe in taking care of yourself in terms of exercise, what you eat, what you learn, what you save and how you behave towards others. We should also make more carefully considered choices about what we consume.'

Albion Q2. In your view, how does it impact returns, in the long run?

Max: 'I think that's a broad question that can be divided in two different approaches whether it be 'core' or 'impact'.

An impact approach involves schemes where you want to make substantial change in things such as renewable energy, battery technology, water resources, improving poverty etc. Returns on these investments can vary wildly and usually only form a small part of someone's investment strategy, if anything at all.

A core approach to sustainable investing, broadly invests in everything (mining, oil, tech, all sectors), but will allocate more capital to companies with a sustainable vision or track record and will under allocate or exclude companies with a poor vision, track record or high controversy. With this 'best in sector' approach, I don't expect to have a poor outcome. If anything, I expect a slightly improved return; we will see. Although it is far too early to say whether this is a factor or not; which is what some are suggesting. A successful investment experience is enough for most of my clients though.'

Albion Q3. How are you implementing it in your firm?

Max: 'In 2005, we offered portfolios with some sort of sustainability overlay and 20% of our clients (and AUM) elected for this. As time passed on, we noticed no discernible difference between those clients that opted for it and those that had opted for a regular portfolio. Quite often we'd get husband and wife going down different routes, so it was always interesting to compare, and trust me, as couples they did – in a fun, competitive sort of way.

In 2015, after reading a few papers on the subject, meeting Abacus Wealth Partners (who have implemented sustainability at their core) and my experience of investing this way, we decided that some form of sustainability would be at the core of our strategy for all new clients, and you'd have to opt out of it if you did not want it. Not a single new client has opted out to date and what's more, we just had our biggest year ever.

Now we are switching all our existing pre 2015 clients across. Again, no objections. In fact, the feedback has been extremely positive, and many referrals have flowed from our work.'

Albion Q4. How have you framed the conversation with clients? What has been their response?

Max: 'Managing the conversation is the key, and clients are looking for leadership and direction on this subject; just as with any other financial matter. I start this topic off by asking "what do you want from society and the world at large?" and the responses can vary wildly, but normally centre on three topics – fears around global warming, pollution and peace.

It is at this point that I point out that I share their values and concerns in these areas; which is why we have built in a sustainability overlay to our strategy. And that sustainability is measured by Environmental, Social and Governance factors. I also clearly explain that this won't fix it (their issue/value) because we can't, but it is a contribution towards it. I will then go on and explain in a little more about what each of them mean at our next meeting.

Unlike other choices that someone will make in their lives relating to environmental issues - food, car, clothes, holiday, filling the recycling bins for tomorrows collection; there is no friction. It is probably the easiest to implement. Following a client meeting, we often get a call from work colleagues to come and meet us. I never found that happen when I discussed the EMH or Fama French!'

Albion Q5. How and why did you get involved with GSI and what is your role?

Max: 'I have had a real passion for sustainable investing for years. It goes all the way back to 1990 when I was a broker rep at Commercial Union.

Nothing, until I met up with the GSI boys, really hit the mark, as I'm also passionate about factor-based investing as well. Sorry, but as good as simple trackers have performed, I do think size, value, profitability and momentum all have an additional role to play, and I wanted to combine these with ESG from top to bottom of a fund.

I joined the GSI team for a few reasons. 1. They needed a broker rep and they didn't have one. 2. They also needed a broker rep who understood the subject of marrying up well understood factors, with sustainability. 3. I really wanted a new challenge that could make a difference.'

Albion Q6: Turning to you Garrett, last time we interviewed you the fund was a systematic factor-tilted fund; why did you decide to turn it into one with a sustainability (ESG) overlay?

Garrett: 'The key reason was that we felt that integrating ESG was a direction that we wanted to take the firm. When Max initially approached us about developing a strategy that combined factor investing with sustainability, we considered starting a separate fund for this. However, we eventually decided that we wanted to commit the firm more fully to this approach and so we converted our existing factor-based fund to one that incorporates ESG information. We think that the shift to incorporating sustainability the investment process is a key development in the industry, and we want to be at the forefront of that change.'

Albion Q7: What have you learnt on that part of the journey?

Garrett: 'We started our journey by reviewing the literature in the area. One key question that investors focus on is whether incorporating sustainability in an investment process impacts expected returns. There are two main strands of thought on this – some argue that excluding so-called "sin" stocks from portfolios could lead to underperformance; others argue that there is solid evidence that companies that adopt sustainable policies in their business derive benefits in terms of better financial performance and higher stock prices.

There are now hundreds of studies in this area and the consensus is that the two sides broadly cancel each other out. Whilst there may be some loss from excluding the more profitable "sin" stocks, there are clear benefits from being ahead of the curve in sustainability. Companies that are alert to changes in regulation, industry developments and consumer preferences in sustainability, are generally better businesses. We covered many of the key papers in this area in our white paper on the topic of ESG integration and concluded that overall, there should be no expected performance differential from incorporating sustainability.'

Albion Q8: There are a few different ways you could have done this – why choose the approach you did?

Garrett: 'We had to decide what we wanted our general approach to be when integrating sustainability with our existing process. Since our key objective is to provide diversified exposure to global equities with tilts to size and value-based factors, we did not want the ESG overlay to detract for that objective. Some approaches to ESG are either based on exclusions (e.g. companies exposed to fossil fuels or tobacco etc.) or can be very concentrated in stocks that are focused on, for example, renewable energy or waste management etc. These more focused approached are inconsistent with our aim of providing diversified exposure across markets, sectors and stocks.

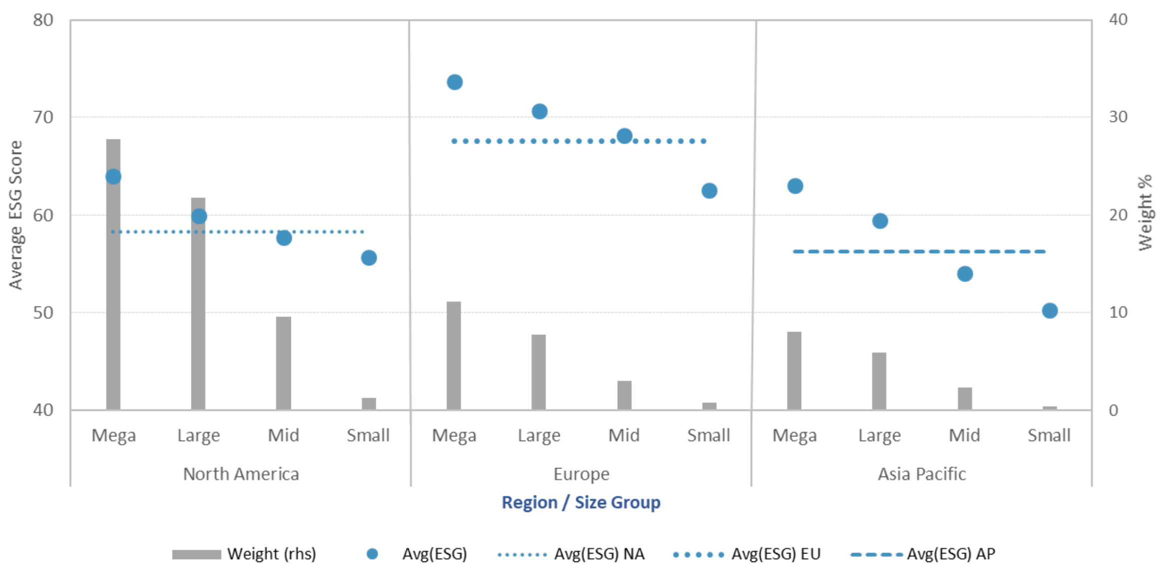
Our approach therefore seeks to integrate sustainability with our pre-existing factor-based strategy in a way that preserves the key characteristics of our approach but tilts toward best-in-class companies across all industries. We believe that our resulting strategy should exhibit a similar return and risk profile to a factor-based investment strategy that does not incorporate sustainability and could provide core exposure to global developed equity markets.'

Albion Q9: How does the ESG overlay work and what are the challenges of implementing it in an integrated manner on a factor-tilted fund?

Garrett: 'The first challenge was to obtain comprehensive data across a very wide universe of stocks. The availability and quality of ESG data has improved significantly over the years and there are now many companies that provide ESG data to investors. However, coverage is still an issue – especially among smaller companies. Since we tilt toward smaller companies, it was important for us to have a data provider that had good coverage in this segment. We chose Sustainalytics, one of the global leaders in this field, to be our provider as they have extensive coverage of ESG data across global smaller companies, as well as large and mid-cap firms.

A second set of challenges comes when we integrate the ESG scores with our size and value-based factor tilts. There is a clear relationship between ESG scores and company size in all regions in that they tend to be higher for large cap companies and lower for smaller companies – see Figure 1. Since we don't want our pursuit of higher ESG exposure to significantly reduce our tilt to small cap, we had to control for this. If we did not, then integrating the ESG scores would certainly cause the portfolio to be more exposed to larger companies.'

Figure 1: Average ESG score by Region and Size Group



Source: GSI, Sustainalytics.

'There are also significant differences in ESG scores across regions (North America, Europe, Asia Pacific) and sectors. So again, we need to control for that otherwise the regional and sector composition of the portfolio would change too much.

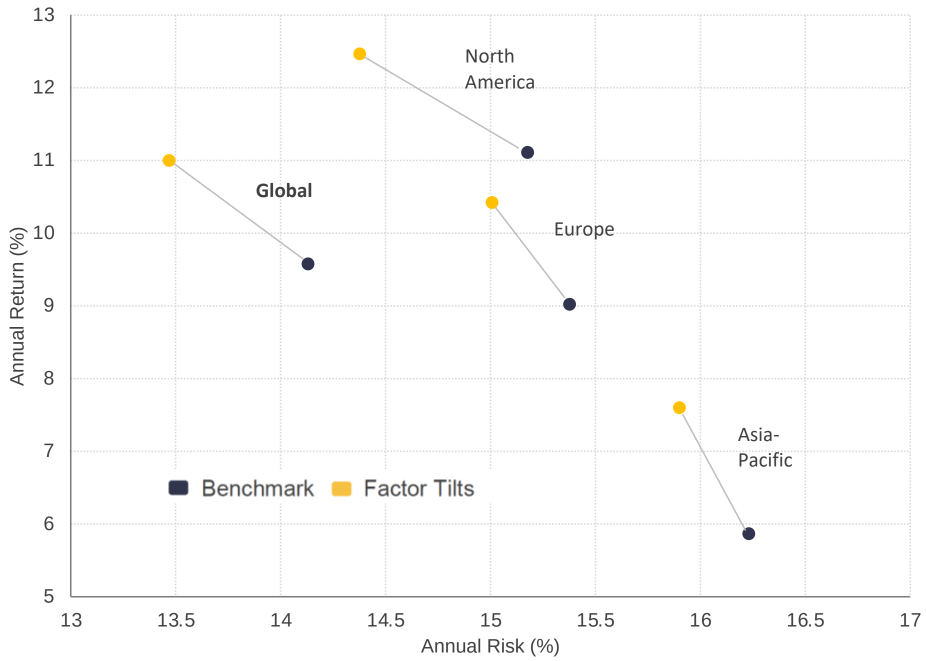
Once we have adjusted company-level ESG scores to control for regional, sector and size differences, we then combine the ESG scores with our Value-based scores. The latter are based on typical value and profitability metrics that are widely documented in the academic literature *as being associated with higher expected returns. The combined Alpha-ESG score is then used to reweight each stock - if the score is less than 1, we underweight a stock vs. our neutral weight in proportion to the score; if it is higher than 1, then we overweight.'*

Albion Q10: What levels of return and risk – relative to a broad market global index – are your targeting?

Garrett: 'We target an excess return – relative to a market weighted benchmark – of 1.5% p.a. before fees and expenses (but after estimated transaction costs). Our risk target is the same as the market or slightly lower.

Our long-run simulations show excess returns of around 1.5% p.a. at the global level. More details on this are available in our white paper mentioned previously. The chart in Figure 2 below shows the risk (on the X-axis) and the return in sterling (on the Y-axis) of a market-weighted Benchmark and a Factor Tilts portfolio which is tilted toward smaller stocks as well as to our composite Value score. In all regions, as well as at the global level, the Factor Tilts portfolio shows higher returns as well as somewhat lower risk.'

Figure 2: Back-Test Portfolio Risk and Return (in GBP) - Factor Tilts vs. Benchmark (Period: Jan 1992 – Sep 2018)

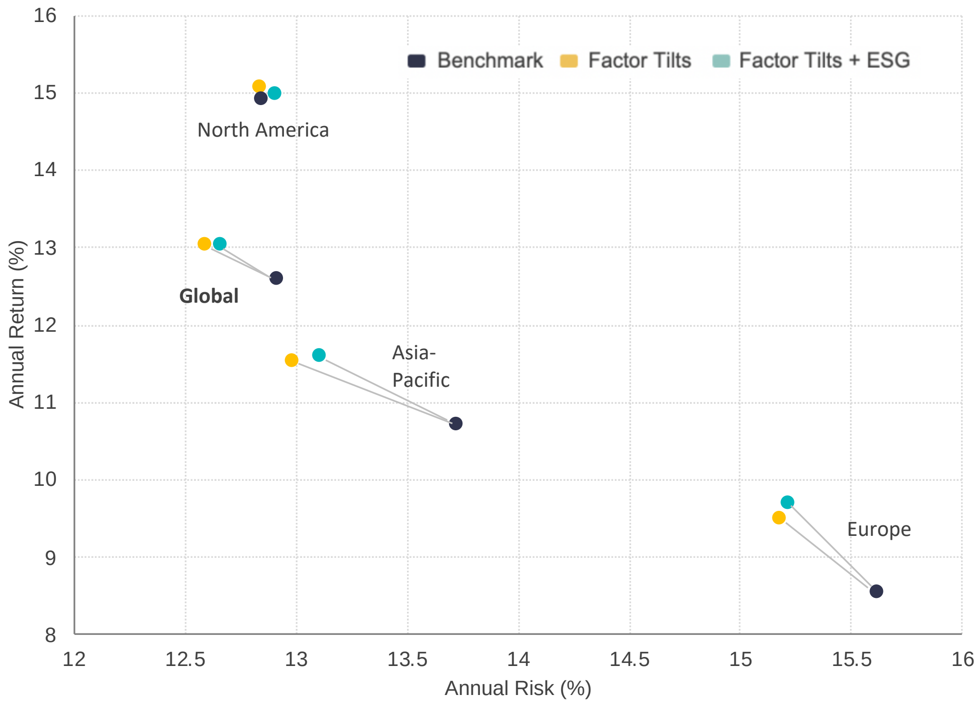


Source: GSI, Sustainalytics, FactSet, S&P. Based on S&P Global Developed Markets Large/Mid Cap Index constituents 1992-2018; Market and fundamental data provided by FactSet. ESG data provided by Sustainalytics. Returns are in GBP before taxes, management fees and administrative expenses, and are after estimated transaction costs. These results refer to simulated past performance and past performance is not a reliable indicator of future performance.

'However, if we want to show the effect of ESG integration on our investment process, we can only go back 10 years since ESG scores across the broad market have only been available for that shorter period. The chart below shows the effect of including ESG scores with our factor tilts and we therefore add a portfolio to the chart which we call Factor Tilts + ESG, which integrates ESG scores with our Factor Tilt portfolio. During this 10-year period, value stocks as measured by the MSCI Developed Markets Value Index underperformed the corresponding broad market index by around 1% a year so the value effect was in fact negative over this

period. Notably, both the Factor Tilts and the Factor Tilts + ESG portfolio have almost the same realised return and very similar risk. There is therefore no meaningful impact on returns or risk after we have integrated the ESG scores in the strategy. The main reason for this is because we carefully manage the key dimensions of risk and return in the Factor Tilts + ESG portfolio insofar as we do not alter regional allocation, we maintain sector diversification, and we maintain the same exposure to size and our composite Value score as we would in a strategy that does not include ESG information. We would expect that the key drivers of risk and return are associated with these dimensions, which are well established in the academic and practitioner literature.'

Figure 3: Back-Test Portfolio Risk and Return: *Factor Tilts, Factor Tilts + ESG* vs. *Benchmark* (Period: Oct 2008 – Sep 2018)

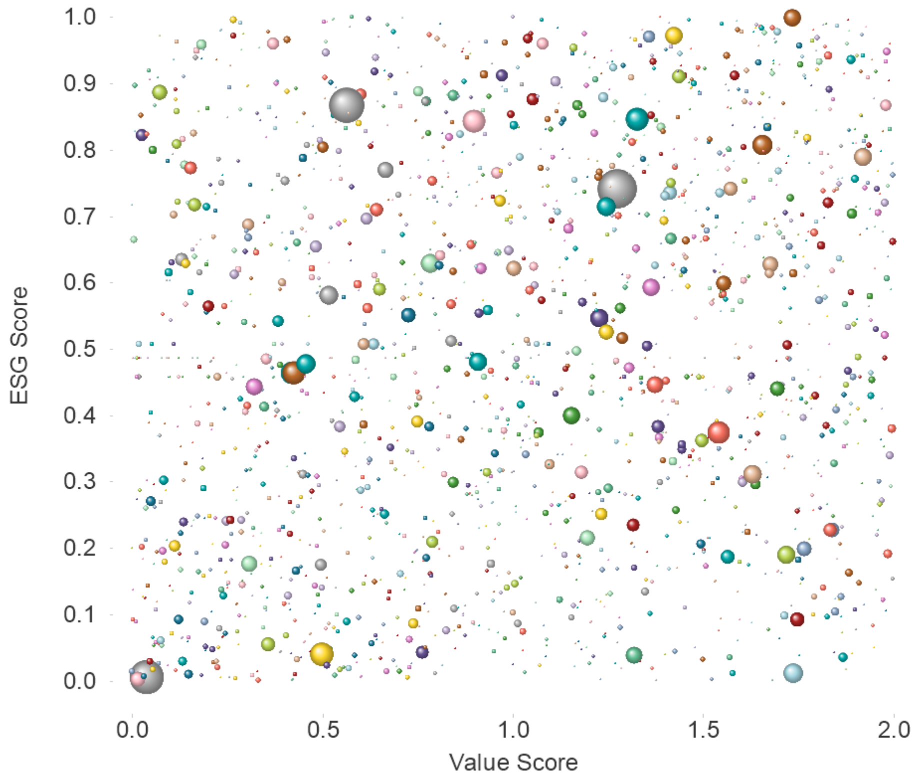


Source: GSI (as above)

Albion Q11: Do you have any visual insights into how the process works in practice?

Garrett: 'We can illustrate the impact on our portfolio of integrating ESG scores from a stock level perspective. In the following charts we show scatterplots of portfolio positions for the Benchmark and Factor Tilts + ESG portfolios above. In Figure 4, we show our Benchmark portfolio positions. The X-axis here is our composite Value score which ranges from 0 to 2. The Y-axis is our adjusted ESG score which is ranked from 0 to 1. Each dot in the chart represents a position in a stock and the size of each dot is proportional to the benchmark weight of each company. For example, the large grey dot in the bottom left corner represents the position in Amazon. Amazon has a low Value score (it trades at a high price relative to its fundamentals) and a low ESG score. Hence its position is close to the bottom-left corner. Another large US stock is Apple which is represented by the large grey dot in the upper-right area of the chart. Apple has a higher Value score and a better ESG score than Amazon.'

Figure 4: Scatterplot of Company Weights by Value and ESG score – *Benchmark*



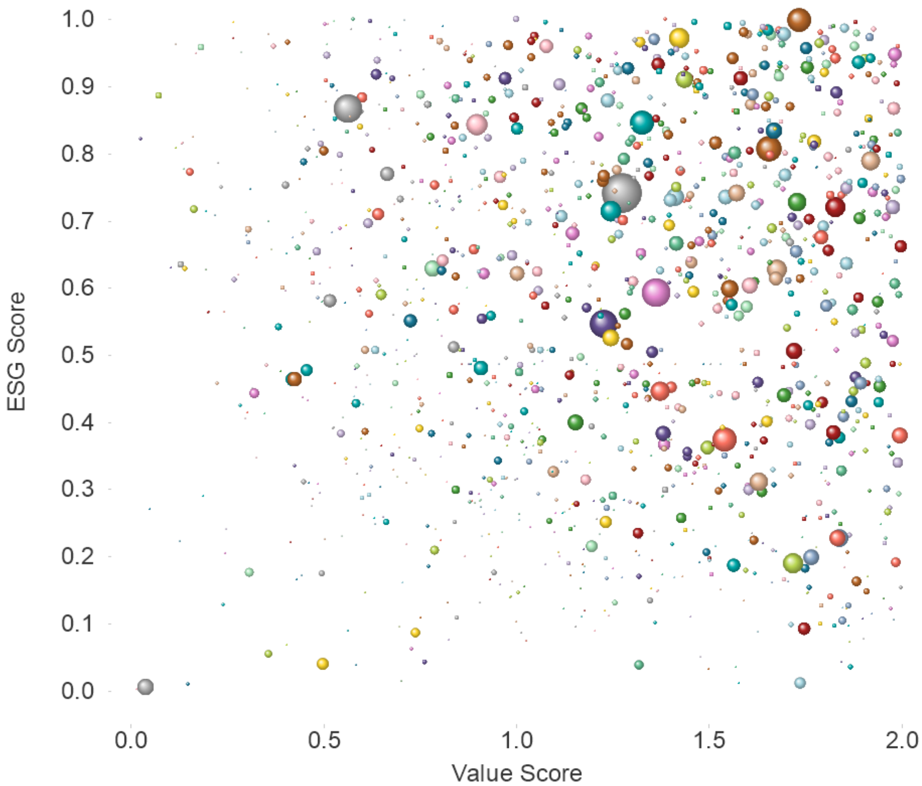
Source: GSI, Sustainalytics, FactSet.

'To illustrate the effect of our factor tilts and ESG integration on the portfolio, we show the positions of the Factor Tilts & ESG portfolio in Figure 5 using the same layout. A key pattern that is evident in the chart is that the positions on the right of the figure, representing the companies with higher Value scores, now have higher portfolio weights - the size of the dots increases. Similarly, companies with lower Value scores (such as Amazon) now have lower weights. While Amazon's weight decreases, it does not go to zero since we don't want to eliminate our exposure to such a large stock in a core global equity strategy. However, some of the smaller stocks with very low Value scores will be eliminated from the portfolio since we are more comfortable excluding them entirely.

This portfolio also tilts more towards smaller cap stocks and away from very large stocks. This partly explains why Apple's weight does not increase in this portfolio. Another reason for this is that, just as we restrict under-weighting mega-cap stocks such as Amazon, we also restrict over-weighting mega-cap stocks such as Apple.

The effect of integrating ESG scores in our Factor Tilts + ESG portfolio is also apparent in Figure 5. From the pattern of weights in the chart it is evident that we also introduce a tilt towards higher ESG scoring companies and away from lower ESG scoring companies. As with Value tilting, we limit the degree of over- or under-weighting for mega-cap companies and therefore some companies with low ESG scores will still have positions in the portfolio to limit excessive under-weighting in them. As with our Value tilting approach, however, some of the smaller *stocks with very low ESG scores will be eliminated from the portfolio since we are more comfortable excluding them.'*

Figure 5 Scatterplot of Company Weights by Value and ESG score – *Factor Tilts & ESG*



Source: GSI, Sustainalytics, FactSet.

Albion Q12: The founders have their own capital in the fund and the fund is growing, which is a good start; what is the plan for raising further assets?

Garrett: 'Now that we have Max on the team, we can more proactively approach advisers who are already comfortable with an evidence-based investment approach and who are also interested in providing a sustainable investing option to their clients.

Our first target is to get to £100 AUM by the end of 2019. The first adviser implementing this strategy (Ifamax) will take assets to £40m plus another £5m net new AUM during the year. In addition to this there is an estimated £63m in the pipeline, which we expect to implement over the next 6 months. We also have an enquiry with a TAMP that would like to start out at £60m with a further £200m over a couple of years.'

Albion Q13: What implications does greater asset size have for the structure of the fund e.g. moving into small cap stocks?

'Currently our eligible universe covers approximately the top 85% by aggregate market cap in each developed market. We now have over 1,100 positions in the fund out of potentially 1,400 potentially eligible positions. We believe that this already represents a very effective implementation of the strategy in the large/mid cap universe.

Once the fund AUM reaches £100M, we will consider extending the universe to include smaller cap stocks. Initially we expect to include the next 5% of each market so that our range would cover the top 90% of the total market universe. When the fund is over £250M, we will consider extending the eligible range to the top 95% of each market. We may subsequently extend our eligible range beyond 95% in certain markets, depending on the quality and availability of ESG information.'

Albion Q14: Will the fund's coverage be extended to emerging markets at any point?

Garrett: 'We do not plan to include emerging markets in the GSI Global Sustainable Value Fund which focuses on developed markets. In due course we would like to develop a separate fund that implements the same strategy in emerging markets. Many investors prefer to keep their allocation to emerging markets separate from their allocation to developed markets or may have different allocations between developed and emerging markets. Therefore, we think it is better to have separate funds for developed and emerging markets. We think that this would be a very effective strategy in emerging markets and there is now good ESG coverage across emerging markets.'

Albion Q15: How do you manage and implement a complex strategy efficiently and effectively with a small team?

Garrett: 'Our investment approach is systematic, and process driven, so the portfolio construction is rules-based and is programmed in our software based on a very explicit methodology. While the overall strategy is complex, each stage is relatively straightforward, and we can always map our positions directly to those factors that are relevant at each stage of the process.

We have a well-rounded team with experience in research, portfolio construction and implementation including trading and administration. Therefore, we are able to effectively manage all aspects of the investment process. We also outsource some components of the process to third parties which allows us to leverage their technology and skill set. For example, we have engaged an ETF implementation firm in the US to execute our global trading using their sophisticated trading infrastructure. We also use an existing UCITS umbrella provided be Gemini Investment Funds PLC (Gemini). Gemini is responsible for operational aspects of the UCITS fund, such as the fund administration, fund accounting, transfer agency, risk management, etc. Gemini has appointed the Royal Bank of Canada to provide many of these services (custody, administration, fund accounting, etc.).

In due course and as the firm grows, we will add staff to provide support in key areas.'

Albion Q16: Any other thoughts that you might like to share with us?

Garrett: 'The adoption of sustainability makes it a really exciting time for us as a firm, for our clients, and for the industry as a whole. We are delighted to be playing a part in this broader movement to a more sustainable approach to investing.'

Albion: Thanks Max and Garrett and good luck!

c) GSI due diligence and GSI white paper

We have been requested by a few firms to provide some due diligence on the fund, which we have undertaken. We have provided both the pros and cons of the fund and asked a number of supplemental, detailed questions around their approach. As ever, we cannot make any recommendation around any specific products, but we trust that the due diligence report will provide a starting point for you as part of your own due diligence as the FCA regulated entity providing recommendations to clients.

If you would like a copy of the Due Diligence document, please contact us directly requesting a copy, which we will load to your Basecamp account.

If you would like a copy of GSI's white paper, please contact Max at Max.Tennant@gsillp.com

About Albion Strategic Consulting

Albion was founded in 2001 and initially focused on working with private banks and family offices in the US. In 2006, it began consulting to leading financial planning companies in the UK, many of which have grown into robust, successful and respected firms with strong regional brands. In that same year, *Smarter Investing* was published and is now in its third edition. Our systematic approach to investing was tested in the Credit Crisis of 2008-9 and survived with honours. Our approach has also been shown to be robust in the more positive markets since. Theory, evidence, logic and patience are the key ingredients to investing success.

In essence:

- We are passionate about good investing, because it makes a real difference to peoples' lives;
- Our business is built on intellectual rigour, independent insight and challenge, and hands-on, practical support to our clients;
- We work – on an ongoing basis – with over 60 leading, award-winning financial planning firms around the UK, (and in Norway and Hong Kong) who are responsible for over £10 billion of client assets in aggregate
- We build bespoke centralised investment propositions for our client firms, provide ongoing governance oversight and deliver a rolling programme of client communication and education. We call this our smartersuccess™ service;
- We believe that our smartersuccess™ service creates a level of quiet – but not complacent – confidence in our client firms, who fully understand and believe in the investment advice that they deliver to their clients. We hope that our ongoing support – both in terms of ongoing governance and client communication – allows them the time and freedom to focus on their clients' wider needs;
- As a team, we work hard and try to go *'the extra mile'*. We genuinely enjoy working with the clients that we have. We fully understand the obligations on our shoulders to do a good job, as the decisions our clients make have very real impacts on the lives of their clients and their families.

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