The Benefits of Socially Responsible Investing: An Active Manager’s Perspective
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Abstract

Our research looked at the relationship between ESG (environmental, social and governance) ratings of a company and its stock returns, volatility and risk-adjusted return in the post 2008 financial crisis era. We found an ex-post association between ESG ratings and stock returns, where higher return companies in aggregate had better ESG ratings. But the predictive power of ESG ratings on stock performance was most powerful on risk. There was a strong negative correlation between ESG ratings and stock volatility, and this relationship was stronger when market volatility was higher. This implied that asset managers could get diversification benefits by choosing better ESG stocks (through a reduction of the average stock specific risk) and this benefit strengthened when markets were more volatile. The correlation between ESG rating and risk-adjusted return turned significantly positive in the recent years and this positive correlation strengthened further by excluding the lowest ESG stocks. We explored the negative relationship between ESG and volatility in greater depth, given the well documented low volatility anomaly (outperformance of low volatility stocks). Chi-square frequency tests showed that high ESG stocks tended to be in the low volatility group, and low ESG stocks tended to be in the high volatility group, in a statistically significant way in almost all time periods. Both (high) ESG and (low) volatility positively impact stock returns, but the ESG effect was independent of the low volatility effect, and ESG was a positive contributor in its own right.

Given the controversy surrounding the effect of ESG based investment restrictions, we tested the effect of restricting the investible universe by deleting the lower tail of ESG companies on portfolio performance. We created portfolios from the complete and the restricted universe through random selection, and found that restricting the investible universe through deletion of the worst ESG stocks imposed no cost, and actually tended to improve the probability distribution of returns with a higher average and maximum portfolio return. We got similar results using risk-adjusted returns too. Asset managers can therefore actively utilize the association between corporate ESG ratings and stock return, volatility and risk-adjusted return, to enhance their stock-picking and portfolio construction ability.

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