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# Are ESG tilts consistent with value creation in Europe?

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## EXECUTIVE SUMMARY

Based on the analysis of Environmental, Social and Governance (ESG) factors in markets and active manager portfolios, we observe that:

1. **Median and average ESG factor scores** for market indices and for manager positions have grown significantly over the last three years.
2. **Active managers in Russell's European universes** exhibit high ESG scores that are consistent with the relatively high scores for the European market, with a small majority displaying positive ESG tilts.
3. **There are regional differences** in ESG scores of markets and active manager portfolios, with Europe being a leader in the incorporation of ESG into the investment process.

The implication from our research is that investors may need to pay more attention to the impact of ESG on their investment returns. Our observations indicate that ESG is a moving target and a portfolio attribute that may be useful to monitor and evaluate.

The good news for investors who are concerned that ESG tilting might be value-eroding is that professional active managers, who are seeking to add value over a benchmark, do not seem to think so (i.e. ESG factors are likely consistent with the intent of adding long-term value through security selection). Moreover, there may be information in ESG scores that might assist active managers in the security selection process – information that they are not yet explicitly considering.

However, the varying importance of ESG factors across markets and manager behaviour means that investors cannot assume a 'one-size-fits-all' model will have a uniform impact globally. They need to understand the importance of each factor in each region to gain a better understanding of how ESG factors will influence their total portfolio.

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## Introduction

With some $13.6 trillion of the invested assets evaluated by the Global Sustainable Investment Alliance (GSIA) now incorporating environmental, social and corporate governance (ESG) analysis,[1] the integration of ESG considerations into active portfolios seems to be gaining steam.

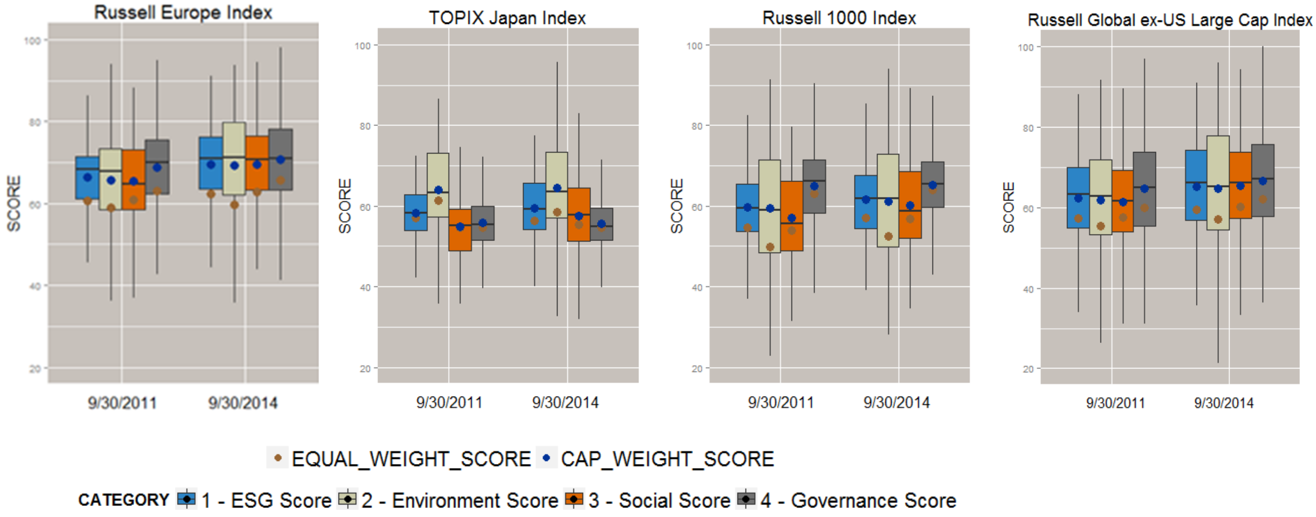
In our July 2014 research paper[2], we revealed the growth and regional variations of ESG scores in different equity markets using three-year data to 30 September 2013. We also discovered that US and global ex-US active managers exhibited ESG tilts and were positively biased toward higher ESG scoring companies. This suggests ESG factors are consistent with value creation, i.e. it is not value eroding.[3]

In this paper we update the market analysis to include data to September 2014 and investigate whether we see similar evidence portfolios of active European equity managers. The results show that ESG scores within equity indices have increased and that active European managers have higher ESG scores than their US or global counterparts. Moreover, we have observed a clear increase in the time and effort dedicated to ESG by European equity managers as a community in recent years and broad support for its importance to investing.

In order to provide a fair and reasonable quantitative evaluation of a company's ESG factor exposure, we analysed the ESG factor exposures of various stock market indices using ESG scores from an independent third party, Sustainalytics[4]. We provide more details of the data and methodology in the Appendix.

## ESG trends within equity indices

**Exhibit 1: Security-level ESG score distribution across different equity markets**




Source: Russell calculations based on data from Sustainalytics.

[1] This represents roughly 22% of the funds under management in the regions surveyed by the GSIA, as reported in the 2012 Global Sustainable Investment Review (page 35). Note that this is 22% of assets evaluated by GSIA, but not necessarily 22% of Russell universes. Our current understanding is that ESG analysis is rarely an explicit input into portfolio construction for the universes considered in this analysis.

[2] See Ross, Song and Pearce (July 2014) "Are ESG tilts consistent with value creation?", Russell Research

[3] We are not seeking to link directly ESG tilts with excess return in a portfolio. Our thesis is that active managers with neutral or positive benchmark-relative ESG tilts offer an implicit endorsement of the consistency between ESG factors and the process of active value creation. Russell's experience in evaluating security selection among active equity managers is that these tilts are not engineered, but rather are by-products of ESG-agnostic processes; i.e., they are not intentional. Others have indicated that ESG may impact risk management in active portfolios (see UNPRI *Report on Progress 2014* and Churet, Cécile 2014).

[4] www.sustainalytics.com The Sustainalytics data incorporates a number of selected indicators, weighted according to the sector in which they are operating. These include a broad range of core and sector-specific indicators that address sustainability policies, management systems and performance outcomes.

The charts above show the change in results for four equity indices from 30 September 2011 to 30 September 2014. The charts show the capitalisation-weighted 10th percentile (bottom of lower whisker), 25th percentile (bottom edge of box), 50$^{th}$ (horizontal line in the box), 75th percentile and the 90th percentile. We also highlight the equal-weighted average and the capitalisation-weighted average with reddish-brown and dark blue dots, respectively.

## Europe

*Europe as a region is strongly tilted toward high ESG scores relative to US and Global ex US indices*

Of the securities covered, we find that very few have ESG, E, S or G scores below 60 in Europe. Europe's focus on social welfare (often called a cradle-to-grave system), early development of public transportation systems, high population density[5], and centuries-long development of business practices are likely explanations for the high ESG scores among businesses. In more recent years, the regulations in some countries will have contributed to the relatively high Environment scores as well.

We make several observations about ESG scores in Europe:

1. The "typical" range of European ESG scores is approximately 62 to 76—these scores are materially higher than the scores we observed in Ross, Song and Pearce (2014).[6] Therefore, we infer that **Europe as a region is strongly tilted toward high ESG scores relative to US and Global ex US indices.**
2. ESG, E, S and G scores exhibit increasing trends over the sample period as measured by cap-weighted average. Medians also increased during this time period. Therefore, we observe that **all scores have increased over time**.
3. The highest ranging scores in 2011 were Governance. By 2014 Environment, both at the median and at the 75$^{th}$ percentile exceeded Governance. We infer that **the importance of Environment to Europe has risen to parity with governance over the past three years.**
4. The cap-weighted index ESG, E, S, and G scores are uniformly and materially higher than the equal-weighted scores. From this we know that **Europe has a strong capitalisation bias in their ESG ratings.[7]**
5. **ESG scores for developed markets are greater than for emerging markets.** Exhibit 1 illustrates security-level ESG score distribution for securities in the Russell Europe Index, i.e. includes emerging markets. The coverage for the Russell Developed Europe Index was 74% in 2011 Q3 and 92% as of 2014 Q3, i.e. noticeably higher.

## Japan

Japan exhibits two main differences from the rest of the world. First, Japan ESG scores are dominated by Environmental. In a densely populated island nation, such attention to Environmental is not surprising. Second, Japan Governance scores are markedly different from other economies' scores. Japan's long history of cross-ownership among large corporations and the insularity of corporate board memberships have long been noted as very different from other developed economies. The latter is acknowledged by Prime Minister Shinzo Abe through his measures to reform corporate boards in Japan.[8]

## U.S. and Global ex-U.S.

The U.S. and Global ex-U.S. regions exhibit similar trends to Europe, with lower ranges of scores universally.[9] The US is clearly the laggard on Environment at the lower end, but has some very high scoring companies. As well, the US exhibits lower Social scores than other regions. While we don't exhibit here, the US scores are similar to Emerging Markets on the Social scores.

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[5] Public transportation and high population density are indicative of a low-carbon culture relative to other regions where personal automobiles and urban sprawl are more dominant.

[6] In Exhibit 2, we observe that this observation may be generalised to most regions outside Europe.

[7] This strong cap weight bias is typical across the globe. Note that Europe certainly has its share of heavy industry and manufacturing. Large capitalisation companies in Europe include pharmaceuticals, mining, metals and energy.

[8] "Shinzo Abe's Bid to Shake Up Corporate Japan," Hiroko Tabuchi. New York Times, June 24, 2014. As part of this initiative, Japan introduced the Japan Stewardship Code in 2014. http://www.fsa.go.jp/en/refer/councils/stewardship/

[9] See Ross, Song and Pearce, 2014, for a full exposition of the U.S. and Global ex-U.S. regions.

Where Europe is similar to the rest of the globe is that most scores are trending upward over time across the globe. Where Europe is dissimilar from the rest of the globe is in the level of ESG scores. Along with Australia, the European region is a global leader for ESG scores.  These scores are bolded in the table below.

**Exhibit 2: Cap weighted ESG scores around the globe as of June 30, 2014**

| REGION | ESG | E | S | G |
|---|---|---|---|---|
| **Pan Europe** | **69.3** | **69.1** | **69.4** | **70.6** |
| **United Kingdom** | **67.6** | **66.1** | **67.4** | **71.2** |
| **Continental Europe** | **71.1** | **72.0** | **70.9** | **71.3** |
| United States | 61.5 | 61.1 | 59.9 | 65.5 |
| Canada | 62.7 | 58.1 | 63.1 | 68.8 |
| **Australia** | **68.8** | **63.4** | **69.3** | **75.0** |
| Japan | 59.8 | 65.3 | 57.7 | 55.7 |
| Emerging Markets | 58.6 | 56.2 | 59.5 | 60.8 |
| Global | 63.2 | 62.6 | 62.4 | 66.0 |

Source: Russell calculations based on data from Sustainalytics.

*We also know from our long history of evaluating active equity portfolios that most of these active products have a negative cap bias.*

## Equity indices – Summary

From our analysis of the Europe index and around the globe, we have three main observations:

- A rising range of scores across the globe
- A consistent cap bias, in that the larger companies exhibit higher ESG scores than smaller companies in the Sustainalytics universes
- A regional bias in Europe toward relatively high ESG scores

These findings are interesting, but largely descriptive. What we still don't know is how the active management community looks when viewed through the ESG lens. What biases are lurking in our active portfolios? In the next section we answer just this question.

# Analysis of European equity active manager behaviour

Our goal was to infer a link between value creation and ESG. We did this by investigating whether managers in the active universes exhibit ESG bias as they seek to add value over benchmarks. If the naysayers are right and ESG is a money-losing strategy, we should find that managers are biased against ESG – particularly in a marketplace where the ESG scores are so high. If the proponents of the value-based investing hypothesis are right, we should find evidence that active managers are positively biased.

Indeed, we do not find a negative bias in Europe and find that active managers have high ESG scores that are consistent with the relatively high ESG scores in the European market. We include details of the analysis in the Appendix.

Russell has observed a clear increase in the time and effort dedicated to ESG by European equity managers as a community in recent years and broad support for its importance to investing. There is also an increase in the number of dedicated ESG specialists who have collaborated with investment teams to make ESG part of the investment process. Russell has not observed a similar trend in all regions and views Europe as a regional leader in the incorporation of ESG into the investment process. For example, Governance and Environment appear to dominate the debate among UK based European equity managers while a more screening approach for 'best of breed' seems to prevail in France. Most typically, we observe that positive ESG criteria are seen as an indicator of higher quality stocks.

We demonstrate our final analysis in Exhibit 3. Here we compare the cap-weighted index scores noted in Exhibit 2 with the median manager scores from our universes. While our analysis (see the Modified Average Tilts in Exhibit A within the Appendix) depicts a neutral stance on ESG among the active managers in the Europe index, we find that recently more than 50% of the manager universe has a score that is higher than the cap-weighted benchmark (noted by the orange, bold numbers).[10]

**Exhibit 3: Median manager ESG scores compared with cap-weighted average ESG scores around the globe as of June 30, 2014[11]**

| REGION | ESG | E | S | G | ESG | E | S | G |
|---|---|---|---|---|---|---|---|---|
| | Manager median Score | | | | Cap-Weighted Index Score | | | |
| **Pan Europe** | **69.4** | 69.3 | **69.0** | 70.5 | 69.3 | 69.1 | 69.4 | 70.6 |
| **United Kingdom** | 65.5 | 64.3 | 64.3 | 69.2 | 67.6 | 66.1 | 67.4 | 71.2 |
| **Continental Europe** | 69.4 | 69.6 | 69.0 | 70.5 | 71.1 | 72.0 | 70.9 | 71.3 |
| United States | **61.7** | **61.6** | **60.0** | 65.3 | 61.5 | 61.1 | 59.9 | 65.5 |
| Canada | 62.1 | 57.5 | 62.3 | 68.2 | 62.7 | 58.1 | 63.1 | 68.8 |
| Australia | 68.2 | 62.6 | 68.8 | 74.6 | 68.8 | 63.4 | 69.3 | 75.0 |
| Japan | **59.9** | 65.3 | **57.8** | **55.9** | 59.8 | 65.3 | 57.7 | 55.7 |
| Emerging Markets | 58.0 | 55.2 | 59.0 | 60.3 | 58.6 | 56.2 | 59.5 | 60.8 |
| Global | 63.1 | **62.7** | 62.1 | 65.4 | 63.2 | 62.6 | 62.4 | 66.0 |

Source: Russell calculations based on data from Sustainalytics.

### European equity active managers – Summary

From evaluating the distribution of active manager ESG exposures, we find that these portfolios are consistent with the relatively high ESG scores in the Europe region and are not negatively biased to ESG. As well, a material portion of the universe, most recently a slight majority, may be positively tilted toward ESG.

While we have not directly demonstrated that ESG is value-adding in active portfolios, using such information in active portfolios may be consistent with prudent active security selection. Our strongest assertion is that Russell's focus on value-based analysis of ESG factors in portfolios is validated by this work.

## Summary

### Observations

This research represents Russell's (and possibly the investment industry's) first attempt to describe market indices and active manager universes in terms of ESG scores. Based on our analysis, we make several noteworthy observations:

1. **Median and average ESG factor scores** for market indices and for manager positions have grown significantly over the last three years.
    - E, S, G and ESG scores are typically higher for cap-weighted indices than for equal weight indices suggesting large cap dominance.
2. **Active managers in Russell's European universes** exhibit high ESG scores that are consistent with the relatively high scores for the market. This behaviour is consistent with that of US equity and global ex-US equity managers.
    - Recently, a small majority of European active managers display positive ESG tilts.
3. **There are regional differences** in ESG scores of markets and active manager portfolios, with Europe being a leader in the incorporation of ESG into the investment process.
    - The typical European ESG scores are between 62 and 76, while scores in other regions are typically lower.

[10] The same is true for ESG, E and S in the United States, ESG, S and G in Japan and E for Global indices.

[11] For this analysis we use the Russell Developed Europe Index for determining the capitalisation weighted index scores for Pan Europe.

## Implications for investors

The implication for investors is that they will need to pay more attention to the impact of ESG on their investment returns. Our observations indicate that ESG is a moving target and something that may be useful to monitor and evaluate.

The good news for investors who are concerned that ESG tilting might be value-eroding is that professional active managers, who are seeking to add value over a benchmark, do not seem to think so (i.e. ESG factors are likely consistent with the intent of adding long-term value through security selection). Moreover, there may be information in ESG scores that might assist active managers in the security selection process – information that they are not yet explicitly considering.

However, the varying importance of ESG factors across markets and manager behaviour means that investors cannot assume a 'one-size-fits-all' model will have a uniform impact globally. ESG scores differ by region and may be tied to differences in corporate culture and history. Investors need to understand the importance of each factor in each region to gain a better understanding of how ESG factors will influence their total portfolio.

That said, the influence of European investment practices may grow in impact as many investment firms are either Europe-based or have teams in Europe.

As an investment community, let's explore the data, learn more, and develop preferences and expectations as regards ESG tilts. They are pervasive and significant, and we should know more about them.

## RELATED READING


Pearce, Will, and Mike Clark (January 2011). "Integrating Environments, Social and Governance (ESG) issues: Russell's manager research and sustainable financial value," Russell Research.

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"RI Europe 2013: the investor-corporate ESG summit," Responsible-investor.com.

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Churet, Cécile, (November 13, 2014) "Mind the gap between RI aspirations and current practices: Part two of an in-depth look into the results of the PRI Reporting & Assessment Framework," http://www.responsible-investor.com/home/article/cc_2/

Financial Services Agency (September 2014) http://www.fsa.go.jp/en/refer/councils/stewardship/

## Appendix

### Data and methodology

Sustainalytics analyses and evaluates companies on ESG criteria using targeted, sector-specific ESG indicators. The sample period for Sustainalytics data starts in 2009Q3. For recent data, Sustainalytics covers roughly 4,400 companies globally.

Sustainalytics offers multiple scores for each specific E, S and G category; however, our main focus is the composite scores computed for E, S and G, as well as a total (aggregated) ESG score. Each indicator is assigned a score between 0 and 100, where 100 is a perfect score. Security-level scores for E, S, G and total ESG are calculated based on a weighted average of the underlying indicator scores.[12] To generate portfolio-level (index-level) ESG scores, we calculate a weighted average composite Sustainalytics score. Profile characteristics data for manager universes comes from Russell calculations. We generate portfolio- and index-level ESG scores from calculations of companies covered by Sustainalytics. Where the coverage is less than 100%, we gross them up. They are weighted according to the allocation in the portfolio or index, and subsequently normalised to the portfolio level.

### Analysis of European equity active manager behaviour – the detail

Our examination of indices revealed some important points for us to consider: ubiquitously high Governance scores in Europe, a clear capitalisation bias and increasing scores over time. From the broad representations of the large cap index, what securities are active managers selecting?

We know from our analysis above that ESG scores have a large cap bias. A typical way of evaluating tilts is to look at medians or averages across a universe. However, because of the influential role of capitalisation in ESG space, we want to evaluate those averages while taking the cap tilt into account. We separate out the ESG tilt from the cap tilt, using a very simple regression model:

Equation (1) $\widehat{ESG}_i = T + CE * \widehat{CAP}_i$ ,

where

$\widehat{ESG}_i$ = the ESG score of active manager *i* less the ESG score of the index (or E, S, G),

*T* = the “Modified Average Tilt” or the average active tilt which takes into account the cap

effect (a regression intercept),

*CE* = the average “Cap Effect” on the benchmark-relative ESG score (a regression coefficient), and

$\widehat{CAP}_i$ = the CAP weight of the active manager *i* less the CAP weight of the index.

We show the results of this regression in Exhibit A for the Pan Europe universe. For each date in our sample period, we show the cross-sectional Modified Average Tilt and the Cap Effect for the universe. When a Modified Average Tilt is positive, then the average manager has a positive ESG tilt. When a Cap Effect is positive, then the active manager’s ESG score is positively affected by capitalisation. When Modified Average Tilt or Cap Effect is statistically significant, we display the regression coefficient in **orange and bold**.[13] We restrict this analysis to 2011Q3 through 2014Q3.[14]

Exhibit A illustrates very clearly the robust capitalisation bias in our ESG tilts. For all periods, Cap Effect has a positive and significant impact on ESG, E, S and G tilts. We expected this result, based on our observation of indices. What we could not have anticipated is that the Modified Average Tilts for all quarters are not significantly different from the relatively high cap-weighted benchmark scores in this region.

From this analysis, we conclude that European managers are aligned with the high European ESG scores. We note that these managers are seeking to add value above their benchmarks and, therefore, ESG tilts may very well be consistent with value creation in European equity portfolios. More specifically, we find that European active managers do not systematically tilt away from the high ESG scores in their region.

[12] Sustainalytics has a standard weighting scheme for each sector that is meant to reflect which criteria are most pertinent within each sector.

[13] We assign statistical significance at the 95% level.

[14] We use data starting in third quarter 2011 because Sustainalytics greatly expanded its coverage at that time and updated its methodology.

**Exhibit A: Modified Average ESG scores for active managers in Pan Europe Universe**[15]

| DATE | | ESG | E | S | G |
|---|---|---|---|---|---|
| **9/30/2011** | Modified Average Tilt | 0.20 | -0.01 | 0.45 | 0.08 |
| | Cap Effect | **2.59** | **2.70** | **2.31** | **2.89** |
| **12/31/2011** | Modified Average Tilt | 0.09 | -0.08 | 0.39 | -0.17 |
| | Cap Effect | **2.43** | **2.65** | **2.22** | **2.55** |
| **3/31/2012** | Modified Average Tilt | -0.01 | -0.02 | 0.15 | -0.30 |
| | Cap Effect | **2.45** | **2.68** | **2.16** | **2.57** |
| **6/30/2012** | Modified Average Tilt | -0.09 | **-0.13** | 0.12 | -0.46 |
| | Cap Effect | **2.93** | **3.10** | **2.69** | **3.01** |
| **9/30/2012** | Modified Average Tilt | -0.28 | -0.55 | 0.07 | -0.50 |
| | Cap Effect | **2.93** | **3.37** | **2.64** | **2.89** |
| **12/31/2012** | Modified Average Tilt | -0.16 | -0.34 | 0.18 | -0.53 |
| | Cap Effect | **3.09** | **3.79** | **2.77** | **2.73** |
| **3/31/2013** | Modified Average Tilt | -0.32 | -0.35 | -0.10 | **-0.71** |
| | Cap Effect | **3.04** | **3.88** | **2.76** | **2.41** |
| **6/30/2013** | Modified Average Tilt | -0.37 | -0.33 | -0.20 | **-0.75** |
| | Cap Effect | **2.81** | **3.81** | **2.53** | **2.02** |
| **9/30/2013** | Modified Average Tilt | -0.24 | -0.04 | -0.16 | **-0.66** |
| | Cap Effect | **2.80** | **4.12** | **2.50** | **1.66** |
| **12/31/2013** | Modified Average Tilt | 0.04 | 0.23 | 0.01 | -0.10 |
| | Cap Effect | **2.71** | **4.01** | **2.39** | **1.74** |
| **3/31/2014** | Modified Average Tilt | -0.36 | -0.29 | -0.31 | -0.40 |
| | Cap Effect | **2.62** | **3.62** | **2.47** | **1.79** |
| **6/30/2014** | Modified Average Tilt | -0.18 | 0.02 | -0.39 | -0.07 |
| | Cap Effect | **2.39** | **3.37** | **2.03** | **1.86** |

*Ultimately, as active equity managers in Europe seek to add long-term value their portfolios are consistent with the positive ESG tilt of the region.*

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[15] For this analysis, we use each fund’s capitalisation weight relative to the MSCI Europe Index.