

ESG EXPLAINED

THE MYTH OF ESG UNDERPERFORMANCE

A SUMMARY OF RESPONSIBLE INVESTING AND ITS PERFORMANCE OVER TIME

While the benefits of ESG factors have gained wide acceptance, the misconception that responsible investing underperforms over the long run remains for some. This belief is simply not supported by the available data.

Morningstar research shows that investors who purchase funds that incorporate ESG factors don't appear to suffer a performance penalty¹. This is apparent when the long-term performance of the MSCI World Index and MSCI World SRI Index are compared. The chart below contrasts the performance of both indices over a decade, ending December 2020.

Growth Comparison: MSCI World Index vs. MSCI World SRI Index

From January 2011 to December 2020



Source: Morningstar. March 2021.

Index	Initial Value	Ending Value
MSCI World Index	\$10,000	\$25,628
MSCI World SRI Index	\$10,000	\$26,926

Source: Morningstar

Over this 10-year period, the MSCI World SRI Index outperformed the MSCI World Index, showing that responsible investing can generate comparable returns to non-responsible investment strategies. The MSCI SRI Index also exhibited less risk (i.e. lower standard deviation) and had better downside protection (i.e. lower maximum drawdown), compared to the MSCI World Index.

Comparative Performance Metrics: MSCI SRI Index vs. MSCI World Index

From January 2011 to December 2020

Index	Return	Standard Deviation	Max Drawdown ²
MSCI World Index	9.87%	13.97%	-21.05%
MSCI World SRI Index	10.41%	13.35%	-17.94%

Source: Morningstar

Responsible investment's use of non-financial information in evaluating investments can provide an enhanced degree of risk management within the portfolio management process. This results in a material difference for portfolio returns relative to non-responsible investment portfolios.

¹ Morningstar. (2016, November). Sustainable Investing Research Suggests. Retrieved April 8, 2020, from Morningstar.com: http://video.morningstar.com/ca/170717_SustainableInvesting.pdf

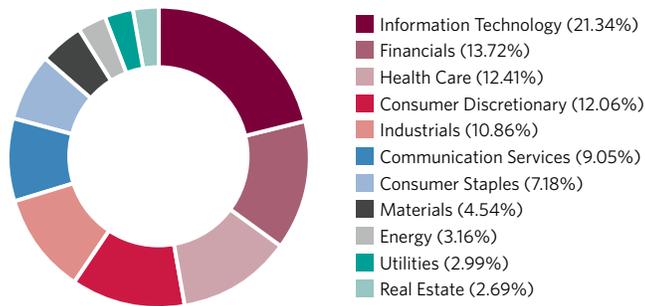
² The peak-to-trough decline during a specific record period of an investment or fund. It's usually quoted as the percentage between the peak and trough.

The Impact of ESG Considerations

The MSCI World SRI Index focuses on companies that have high ESG ratings and excludes companies who have a negative social or environmental impact. This results in a portfolio of high-conviction holdings—especially noteworthy when compared to the MSCI World Index—demonstrating the impact ESG considerations may have in shaping a portfolio. The charts below detail each index’s sector exposure as of March 2021.

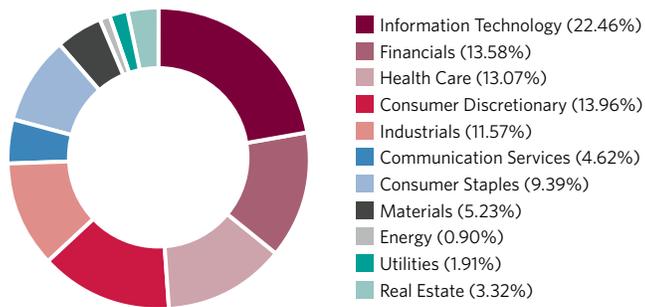
MSCI World Index

MSCI World Index Constituents: 1,586



MSCI World SRI Index

MSCI World SRI Index Constituents: 363



Source: MSCI Inc., March 2021.

A key differentiator of the MSCI World SRI Index, relative to the MSCI World Index, is its removal of companies involved in thermal coal mining and power generation. This means the index aims to minimize its carbon intensity or fossil fuel exposure. As detailed in the previous charts, the MSCI World SRI Index’s energy exposure is 0.90% percent versus 3.16% for the MSCI World Index.

ESG considerations lead to better outcomes

Growth Comparison: MSCI World Index, MSCI World SRI Index, and MSCI World Energy Index

From January 2011 to December 2020



Source: Morningstar, March 2021.

Index	Initial Value	Ending Value	Return	Standard Deviation	Max Drawdown
MSCI World Energy Index	\$10,000	\$7,025.27	-3.47%	23.64%	-61.77%

Source: Morningstar

Given the relative underperformance and added volatility of the energy sector over the last decade, it’s no surprise that investment strategies with lower exposure outperformed over the period. The MSCI World SRI Index isn’t immune to this observation. Investors should expect trade-offs associated with any values-based restrictions to broad-market investing. As illustrated in the above chart, the MSCI World SRI Index’s negligible exposure to energy, specifically oil- and gas-focused investments, boosted its overall performance. It’s also a clear indication that despite delivering a slightly different return profile, responsible investing doesn’t deserve a reputation for performance concessions.

In addition to the data, there’s also mounting evidence that points to integrating non-financial risk (ESG factors) into the investment process leads to better portfolios. As portfolio managers and analysts adopt more formal processes around ESG integration, non-financial considerations (like controversies, diversity, environmental policies, etc.) that can meaningfully impact share prices, are more widely considered as material in the valuation process. Considering these factors leads to a better understanding of what could go wrong for a company and the true risk of investing in its stock or debt.

Conclusion

While the implementation of responsible investing may differ among investment managers and practitioners, there's a clear benefit for investors. Incorporating factors in the investment management process can add value to overall portfolio performance in a consistent manner, over a long-term investment horizon.

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