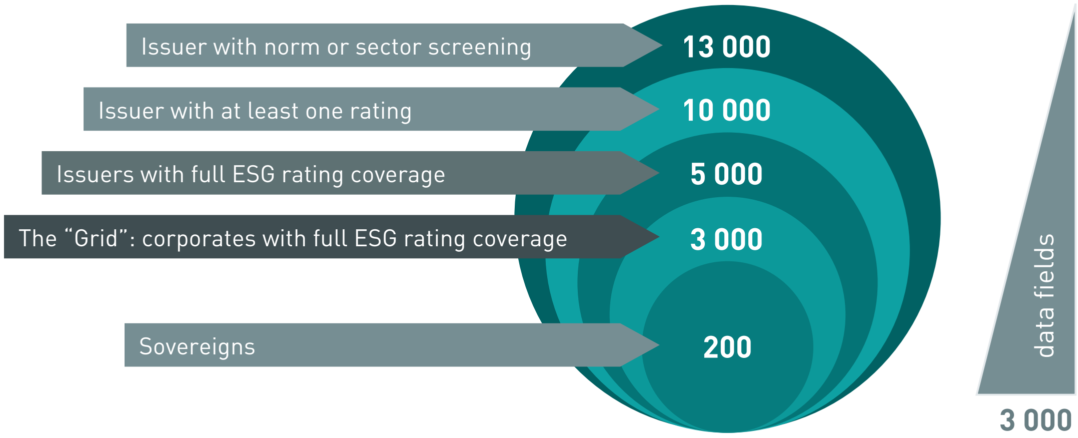
HIGHER ESG SCORES THAT DON'T COST THE EARTH

Verity Worsfold
Vice President, Portfolio Solutions, Multi-Asset & Solutions, DWS

Figure 1: Coverage of DWS ESG Engine



Source: DWS as at April 2018.

Increasing ESG with tracking error in mind

Environmental, social and governance related measures are increasingly being recognised as valuable sources of information on companies, with investors using them to supplement traditional financial metrics in constructing portfolios and risk analysis.

Incorporating ESG into investment decision-making may also reduce regulatory, reputational and operational risks, and result in a portfolio of companies that are more likely to be industry-leaders, better at anticipating and mitigating risk – and more focused on the long term.

When constructing actively managed portfolios, investors have the freedom to take a range of approaches when implementing their ESG criteria and create myriad variables that alter their strategies.

But when investing using a passive or index-tracking fund, it is less simple. Investors have usually chosen a specific index or benchmark for a specific need and must consider the trade-off between improving the ESG qualities of a portfolio and the impact this has on any variance from it.

DWS operates Europe's largest global passive business, running €113bn in client assets, and we have developed sophisticated tools to help alleviate this quandary for investors.

Instead of accepting that passive investors must accept a significant shift from their chosen benchmark when adapting ESG principles, we have found a way for them to stick to their core, specific investment agenda.

Assessing companies for ESG

Increased transparency and reporting from companies, combined with an explosion of specialised data vendors, means there has never been more data through which to assess ESG standards.

By leveraging these resources, DWS has built a market-leading ESG Engine that combines data from seven specialist ESG providers alongside that from NGOs and other publicly available sources.

Our ESG Engine covers more than 3,000 data fields, allowing sector and norms screening of over 13,000 issuers and full ESG rating coverage of more than 5,000. DWS, as a passive investment manager, tracks more than 300 global benchmarks.

Such comprehensive coverage has fuelled the development of our DWS ESG SynRating system. This leverages the multiple information sources of the ESG Engine to take a 360 degree view of companies, and looks for consensus across the different ESG agency scores in order to build a more informed rating system.

The DWS SynRating system assigns a point score to companies 'SynPoints', ranging from 0 (an ESG laggard) to 100 (a true ESG leader), with an associated letter rating from F to A.

While the opportunities to extract value from the data and portfolio construction options made possible by the ESG Engine are extensive, here we employ the SynRating system.

Our aim in this paper is to create a series of portfolios optimised for ESG scores and to investigate the impact of the changes required to achieve such higher ESG ratings on portfolio tracking-error and composition vis a vis the portfolios' benchmark.

For our investment universe, we consider developed market equities, as represented by the MSCI World Index. The first step in this process is to understand our starting point in terms of the ESG score of the benchmark portfolio overall, and the distribution of ratings across its component sectors.

Figure 2: DWS Rating System

A	**True leader in ESG** (≥ 87.5 SynPoints)
B	**ESG runner up** (75–87.5 SynPoints)
B	**ESG upper midfield** (50–75 SynPoints)
D	**ESG lower midfield** (25–50 SynPoints)
E	**ESG slow starter** (12.5–25 SynPoints)
F	**True laggard in ESG** (0–12.5 SynPoints)

Source: DWS as at June 2018.

Figure 3 shows the SynPoint score for each GICS sector of the MSCI World. The end points of the lines represent the minimum and maximum ratings (respectively) for companies within that sector, the limits of the boxes represent the 33rd and 67th percentiles, and the central bar shows the median value.

We can see that while some sectors have tighter ranges of scores (e.g. Health Care), and some tend to have more higher SynPoint scores, all sectors have companies with scores at both extremes, and all median values fall within a relatively tight range of 7 points.

The overall ESG SynPoint score of this portfolio – and similarly for those portfolios we will create - is calculated as the weighted sum of the individual company SynPoints. The score thus calculated for the MSCI World index as at date of this analysis is 58.9 SynPoints, giving it a solid C, or "ESG upper midfield" SynRating.

Excluding controversial weapons

While there is generally not a huge degree of consensus on what constitutes a 'good ESG' portfolio, one aspect that is frequently agreed upon is the exclusion of controversial weapons. For this reason we excluded those companies for all the portfolios we constructed and analysed. This automatically removed 25 of the 1646 securities from MSCI World Index and provided our starting point from which to dial up the ESG criteria.

This base MSCI World ex-controversial weapons portfolio had a SynPoint score of 59.2 and a tracking error of 0.18% against the original index.

Optimising ESG scores

To illustrate how our SynPoints system works, and their impact on tracking error, we constructed five portfolios, each allowed to have higher tracking error from the benchmark and then optimised to achieve the highest ESG rating possible.

Rather than carry out a purely academic exercise, we created portfolios that were sufficiently diversified to represent investment holdings that our clients would chose and would comfortably sit within prescribed UCITS rules. We did not impose constraints around country or sector weights, nor a minimum or maximum number of securities when constructing these portfolios.

By optimising the ex-controversial weapons portfolio, the SynPoint score improves to 65.9 for a tracking error of just 0.2%.

For the second portfolio there is also a large (22%) improvement in SynPoint score. Here a further 0.7% increase in tracking error (from the 0.2% tracking error of the first optimised portfolio to 0.9%), allows an improvement in the SynPoint score of 14.5 points, from 65.9 to 80.4. This also lifts the portfolio SynRating from C to B, making it an "ESG runner up".

To gain an A rating or ESG Leader status, the portfolio incurred a tracking error of 2.30% and at this level of tracking-error, almost all of the gains from optimisation in terms of ESG scoring have been attained.

Identifying Syn stocks – Characteristics of optimised portfolios

By excluding and optimising securities within these five portfolios, we found those with the highest ESG SynPoints had large active weights towards real estate, information technology and industrials, with the strongest active underweight to be health care.

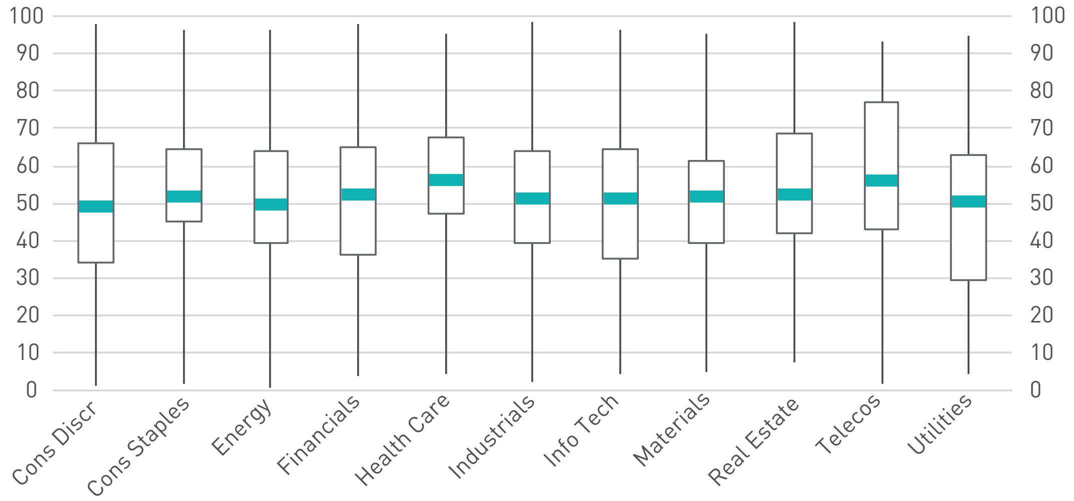
Looking geographically, the portfolios that scored the highest ESG SynPoints had active overweights to Europe and active underweights to North America.

Given that the ESG-optimised portfolios that were being tested had such a low tracking error, we had expected a relatively small difference in volatility. However, despite the number of stocks being reduced for each optimisation, the difference in volatility between these new portfolios and the main index was even lower than we had expected.

What does this mean for performance?

There is increasing evidence that investing within an ESG framework does not mean investors have to take a hit on returns.

Figure 3: Synpoint Scores of MSCI World GICS Sectors



Source: Bloomberg, DWS. Data as at 30 April 2018. Past performance is not indicative of future returns.

Figure 4: Historical Performance Of MSCI World ESG Leaders Vs. MSCI World

Source: Bloomberg, DWS. Data Aug 2007 to July 2018. Past performance is not indicative of future returns.

While we did not carry out a full back test of our SynPoint portfolios, we overlaid the MSCI World index with its partner benchmark that tracks ESG Leaders within the universe to act as a proxy. Since 2008, the annual performance fell behind only as far as 1.4 percentage points, while offered outperformance of up to 2.4 percentage points.

While one example should never be the basis for broad investment strategy, at least it shows there is no significant performance cost for ESG integration – the fear of many an investor.

Make your own ESG solution

For investors seeking to improve the overall ESG score of their passively managed portfolios, our SynPoints show it is possible to achieve clear improvements while remaining within a tracking error limit commonly cited by institutional clients.

Our composite DWS SynRating ESG scoring system, which leverages multiple highly regarded specialist sources to build consensus-driven scoring, is a valuable tool to apply a measurement metric around something as multi-faceted as ESG.

The flexibility of the DWS ESG Engine allows investors to create bespoke scoring systems as well as their own optimisation constraints and exclusion criteria.

With the advent of these tools, the possibilities for both standardisation and customisation are extensive. It is now time for passive investors to navigate the best solution for individual portfolio requirements that sit within their ESG framework.