Financial materiality, a pragmatic approach to ESG

Many ESG approaches have a priori limits which hinder the allocation of capital most efficiently. CPR Asset Management has instead developed for pension fund clients a pragmatic methodology that reflects which ESG criteria work best in different regions of the world.

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While the richness of Environmental, Social and Governance (ESG) analysis grows and grows, its integration into securities management can often be simplistic. This is the view of Caroline Le Meaux, from Caisse des Depôts, the fiduciary manager for several French public sector pension schemes. "I built my first quant model using ESG data in 2002 and I don't think that modelling technics have changed in the same magnitude as in the financial data field," she says.

For Le Meaux, averages are the real enemy because they blunt risk management and conceal many of the subtleties that ESG analysis supplies to asset managers. This was apparent after the scandal in 2016 of VW employees manipulating emissions tests. "On average, VW scored well in ESG but there were specific indicators in governance that acted as warning lights," she recalls.

The emissions scandal triggered a desire for change that Le Meaux had long harboured. She contacted several asset management houses to ask if they could build a better ESG methodology. The first to respond was CPR Asset Management, a subsidiary of Amundi in Paris, and existing mandate-holder with pension scheme IRCANTEC.

Tegwen Le Berthe, head of ESG Development at CPR AM, takes up the story: "We were already managing money on an SRI basis so the question was how to adapt pragmatically to IRCANTEC's challenge while maintaining our own successful style."

Over the best part of a year, CPR AM developed its ideas and met Le Meaux and her colleagues on a monthly basis to test their findings. Accessing prime research was relatively easy thanks to parent Amundi's 12-strong inhouse team of ESG analysts. CPR AM settled on 15 criteria generated by Amundi, including ethics, board structure and employment practices. Over 5,500 issuers were scored by each of these 15 criteria from A to G, with A the highest score. To add some finesse, there are some sector-specific questions included in the mix. For example, the automotive sector was rated by its involvement in Electric Vehicles.

At this point, the temptation for simple integration might have been to only average the scores for all the criteria. That was not enough for CPR AM. He points to spidergrams of each analysis: several exhibit single legs which score G while by all other criteria the security seems healthy. Danger signals get masked by mere averages, which was Le Meaux's original comment.

And so, in the first cut, CPR AM eliminated only those securities that scored F and G on an average basis, which in global equities accounted for roughly 4% of the universe. These are the companies which are bad at everything. Of the entire universe, however, they constitute just a slither, reflecting two tenets of the new approach. The first was that ESG screening works better to remove worst offenders; not positively to identify winners. The second tenet was that the ESG methodology was not to contribute the majority of outperformance for clients: that was to come from CPR AM's subsequent active management. Evidence for this second tenet came from comparing the risk-adjusted performance of global equities ranked A, B or C across all criteria versus the conventional index. For the period of research, from 2010 to 2017, that simple ESG portfolio offered less return for more risk than the index.

High Five

For the second, deeper cut, CPR AM then ran a series of tests on each of the 15 general criteria. The tests sort the index of stocks by each criterion in order to discover which facilitates:

- the best information ratio;
- adequate coverage of the market;
- limited turnover;
- and diversification.

There is a minimum inclusion of 60% of issuers for coverage. Diversification is measured by correlation between each universe formed by a single ESG criterion, e.g. employment practices. There are thus 15 universes to compare with each other. Criteria exhibiting lowest correlation are most attractive.

The top five ESG measures by all these tests are then combined to form the working methodology for global and regional equities (the methodology for credit is similar).

What is striking about the sorting is that it leaves different regions of the global equity market assessed by different ESG criteria. Once the weaker aspects have been discarded, there are no Environmental measures on Japanese companies while there are no Social measures applied to North American companies (although we should remember that the full set of 15 criteria was used initially to screen out the very worst companies in each region).

Le Berthe emphasises that the analysis is pragmatic but also quantitative. The goal was always to avoid the most damaging stocks while keeping a risk-return profile similar to the relevant universe; CPR AM would not have minded if risk-adjusted returns had been slightly lower. There has been little interference with the findings to introduce some "balance" between E, S and G; or between regions. Nor do the resultant portfolios resemble the benchmark index in every sense. For example, more than one-quarter of companies from MSCI ACWI are absent post sorting.

Never a bad backtest

Here is a characteristic dilemma of quantitative modelling to consider. The five chosen criteria demonstrate good results because the modelling has found what worked in the recent past – from 2010 in Developed Markets and from 2014 in Emerging Markets. Le Berthe openly admits that CPR cannot be absolutely sure the methodology will work in the future. "We are not sure that the combination of the five leading criteria will always be the best," he says. And so, the selection is retested on an annual basis, with a tailwind that the quality and quantity of ESG data are rising every month.

Regarding regional differences, Le Berthe makes the observation that they are more idiosyncratic than industrial sectors, for numerous reasons including the fact that most influential regulation still tends to be regional. Sectoral differences remain more important but have already been recognised in the rating process.

Speaking as a client, Le Meaux says that the ESG quality of the real portfolio results have been very satisfying. But the period so far is short. CPR will continue its work in the laboratory and in practice as new clients have already come on board. Le Berthe's final reminder is that as an active manager, CPR applies another layer of skills in financial analysis and management to the portfolios once they have been shaped by the ESG criteria. They are not the biggest drivers of outperformance and should not hold sway over the analysis of financial management.

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