The Profitability of Sustainable & Responsible Investing: A Structured and Systematic Approach for Optimal Portfolios

Executive summary

This paper focuses on Sustainable & Responsible Investing (SRI) – often referred to as ESG (Environmental, Social and Governance) investing. We argue that ESG investing is no longer a niche strategy. Rather it has been widely adopted by large institutional investors and demanded by society. Its share of global asset under management has grown tremendously and this growth is likely to continue.

The growth of ESG investing has been driven by the strategy's ability to enhance returns, align with the interests of key beneficiaries and stakeholders as well as strengthen risk management by capturing non-financial data into stock pricing.

To construct sustainable portfolios, we: 1) adopt negative/positive screening to our investment universe; and 2) include expected returns and ESG explicitly as the function to maximise in our optimiser. Thus, our portfolios are optimal with returns/sustainability maximised; and risks and transaction costs minimised. The second step is subtle but significant in terms of whether the portfolio maximises sustainability (without compromising returns); or is sustainability compliant only.

Our optimiser can also be combined with other factors such as value, momentum to create blended portfolio. Our approach can also cope with granular data on E, S or G pillar so that client's preference within the individual pillar can be incorporated into the strategy construction.

We adopt historical point-in-time data of global stocks and demonstrate that ESG investing is profit enhancing. We find that a pure ESG strategy constructed from an ESG compliant universe and using the ESG factor outperforms the non-ESG compliant strategy of balance value strategy by roughly 7.4% annually.

The approach would be even more profitable if ESG investing is combined with the right global theme. We show that ESG investing can be easily integrated with other factors. Regionally and across sectors, there is variation of ESG's predictive power by its separate E, S and G pillars.

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