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Responsible investors bring eggs home in a better basket

Review of Hoepner, A. G. F. (2010) "Portfolio diversification and environmental, social or governance criteria: Must responsible investments really be poorly diversified?" (Working Paper, School of Management, University of St. Andrews),

Review by Robert Kropp.

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Summary

Andreas Hoepner challenges the oft-cited 1981 platitude of Andrew Rudd, that by limiting portfolio diversification, investment screens inevitably worsen portfolio performance. Instead, as Hoepner reports, the implementation of environmental, social or governance (ESG) into investment decision-making can reduce risk to a significant degree, and lead to portfolio outperformance. The author concludes that such findings are relevant not only for investment managers and pension fund trustees, but for policy makers as well.

- Study challenges received academic wisdom that the integration of environment, social or governance criteria in investment processes must worsen portfolio diversification.
- Argues that portfolio diversification results from three drivers: (1) number of stocks, (2) weighted average correlation of stocks, (3) weighted average specific risk of stocks.
- While ESG criteria likely worsen portfolio diversification through the first and second driver, the robust empirical finding that ESG risk management reduces a firm's specific risk suggests that ESG criteria can improve portfolio diversification via the third driver.
- Paper argues that especially ESG best-in-class screened funds can have a better portfolio diversification than otherwise identical peers.

Main review

One recent evening, I walked my dog to one of the several convenience stores that seem to proliferate in the low-income New England village in which I reside, where I purchased a bottle of the microbrew for which the Green Mountain state has gained some renown. As I neared my apartment, the paper bag which held the bottle ripped, and the bottle fell to the ground. It didn't break, although upon opening it, a significant portion sprayed out, thereby resulting in some loss of value for me.

In his paper entitled 'Portfolio diversification and environmental, social or governance criteria: Must responsible investments really be poorly diversified?', Andreas Hoepner uses eggs as his metaphor for debunking the reflexive belief among many, "that integrating environmental, social or governance (ESG) screens in investment strategies must lead to a diversification penalty compared to otherwise identical conventional investment strategies." But the spirit of the argument is the same, whether one uses eggs or beer to advance it: "investors or their asset managers are diversifying their portfolios in irresponsible stock...and believe this behaviour to reduce their risk exposure despite it effectively does the opposite in many cases."

To return to the author's metaphor, "The safety of walking eggs home does not only depend on the number of baskets and the number of people carrying them, but it also depends on the quality of the baskets." For the retail investor, who loses a few eggs or a portion of a bottle of beer, the losses can be frustrating; but when pension fund managers diversify their portfolios without regard to ESG considerations, the results can be "especially tragic". In the author's words, they have "negative effects on a pension fund's risk adjusted financial performance as well as on the pension fund's consideration of ESG criteria."

In 1981, Andrew Rudd asserted that limiting portfolio diversification through the integration of responsible investment screening criteria inevitably worsens portfolio performance. The responsible investor will note the timeframe. The 1980s marked the first major triumph of responsible investment, when shareholder activism led to widespread divestment in companies doing business in apartheid South Africa. Yet Rudd would argue that excluding large companies doing business in South Africa would lead to decreased portfolio performance.

As it turned out, however, as Zakri Bello argued in his 2005 paper entitled *Socially responsible investing and portfolio diversification*, "The small-stock bias of the South Africa-free strategy greatly increased portfolio returns", outperforming other New York Stock Exchange stocks by 0.187 per cent annually.

As if such a refutation alone was not enough to undermine Rudd's reflexive claim of responsible investment portfolio underperformance, the nature of responsible investment

has undergone a profound evolution since 1981. Then, the emphasis was on negative screening, or excluding companies on the basis of their involvement in activities that violated social norms. Since then, responsible investors have acknowledged the benefits of engaging with companies to improve their ESG performance, and accept a wider latitude of industry sectors in which they are willing to consider investment.

Hoepner raises this issue in his study, stating "negative ESG screening likely results in a diversification penalty for active mutual funds, while purely positive or especially best-in-class screening probably leads active funds to experience a diversification bonus."

One result of the evolution of responsible investment criteria is that portfolio diversification is increased. Therefore, even if the arguments of Rudd and his many supporters contained elements of fact, such elements would have had much less influence by 2010, when consideration of ESG factors have supplanted the negative screening of ethical investment. Hoepner employs the standard determination of portfolio diversification, dividing it into three drivers of portfolio diversification: (i) the number of assets, (ii) the correlation between assets, and (iii) most importantly, the standard deviation of the selected assets which asserts its influence via the covariance matrix, as any covariance equals the product of a correlation and two standard deviations. Citing recent studies that investigate the relationship between ESG criteria and risk, the author observes that stocks with good ESG ratings have been found to experience significantly under-proportional specific risk and hence lower standard deviations.

Challenging the assertions of Rudd, the author finds that "adopting a best-in-class responsible investment strategy likely allows mutual funds, pension funds, or sovereign wealth funds to improve instead of worsen their portfolio diversification."

Hoepner's conclusions have implications for not only investment managers and pension fund trustees, but for policy makers as well. By requiring sovereign wealth funds and pension funds, for instance, to integrate ESG criteria, policy makers can contribute to a "decrease (in) the ESG risk (and) also the financial risk of investment portfolios."