INSPIRED INVESTING: PART 2

Dispelling Misconceptions About ESG Investing

Max Gokhman, CFA
Assistant Vice President, Head of Asset Allocation
Pacific Life Fund Advisors

In part one of this series, we discussed the rapid evolution of ESG investing over the last few decades and the important, yet somewhat convoluted, task of measuring what matters. In this second part, we'll debunk some myths and misconceptions around ESG investments.

Key Takeways:

- Many commonly held misconceptions about ESG are just that. For instance, rather than sapping performance, ESG strategies have generally been more resilient to economic downturns and thus supportive of stronger risk-adjusted returns. Given governments' focus on environmental regulation and consumers' desire to shop sustainably, this pattern of outperformance should persist.
- Similarly, ESG strategies do not cost more than average. Instead, most ESG funds' expense ratios are equal to or lower than their peers.

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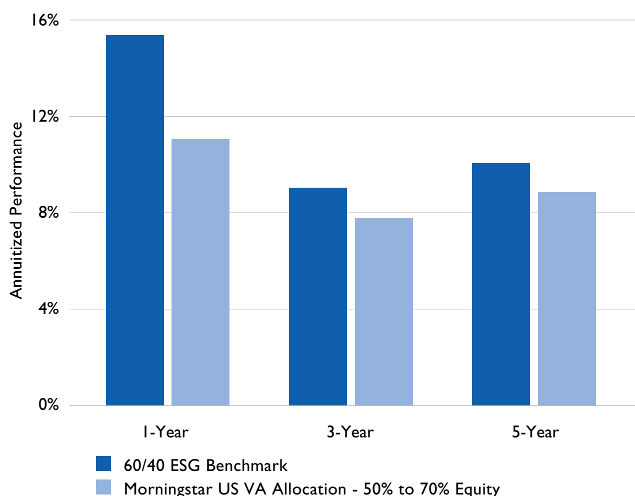
Sustainability without Sacrifices

Despite an ever-smaller contingent of naysayers, the body of evidence shows that ESG considerations at both the security and fund levels are not a hindrance to performance. Instead, they are more likely to be harbingers of superior long-term risk-adjusted returns. One example is the paper by Hang, et al., which aggregated the findings of 142 separate studies and found a positive link between companies' efforts to become more environmentally conscious and their financial outperformance in subsequent years. Moreover, as seen through the 2008 financial crisis and the unprecedented turbulence of 2020, ESG funds can provide downside protection during periods of economic upheaval and are generally less volatile than strategies that don't consider sustainability according to a Morgan Stanley analysis of more than 3,000 retail funds.

Our own analysis confirms this as well. We looked at the performance of a static 60/40 ESG benchmark against Morningstar 50%-70% VA & VUL Allocation funds. Even though these funds could, and generally did, adjust their strategic and intra-asset allocations to take advantage of the market environment, they nonetheless trailed the benchmark during all three periods.

ESG Benchmark vs. VA & VUL Asset Allocation Funds



Past performance does not guarantee future results.

Note: 60/40 ESG Benchmark represents a static composite of 60% ACWI ESG and 40% Bloomberg Barclays MSCI Global Aggregate ESG.

While viewing strong ESG metrics as potential alpha sources is still novel among retail investors, it is commonplace among professionals. A 2019 survey conducted by Pensions & Investments found that 90% of institutional investors believe ESG-integrated portfolios are likely to perform as well or better than non-ESG portfolios.

The reason companies with strong ESG metrics may outperform peers with weaker metrics likely can be traced to changing governmental policies and consumer preferences. Governments around the globe have been enacting laws to reduce pollution, increase data privacy, and foster workplace diversity. Companies that fail to keep up with these regulations are likely to lose market share if not face outright fines. Similarly, today's consumers tap and swipe their values whether they are buying a fair-trade espresso or an electric car. Firms with bonafide sustainability credentials can thus create lasting loyalty to their brands.

When it comes to fees, ESG funds have moved with the rest of the investment industry's momentum toward lower fees. Moreover, Morningstar reports that many recently launched ESG funds are among the cheapest in their respective categories, and, on average, ESG fund expense ratios are equal to or lower than their peers'.

To summarize, sustainable strategies showed resilience through a financial crisis and a pandemic, demonstrating their ability to boost investors' risk-adjusted returns. Moreover, secular consumer and governmental trends bode well for companies that look after their stakeholders as well as shareholders.

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