# ESG as source of alpha

HQAM Factor of the month – November 2021

ESG investments are undoubtedly suitable for a clear conscience, after all, the abbreviation stands for environmental, social and governance. But are these selection criteria, which investors are increasingly paying attention to, also suitable for good performance?

Cumulated Outperformance of Investment Strategies
Top Portfolio vs. Benchmark
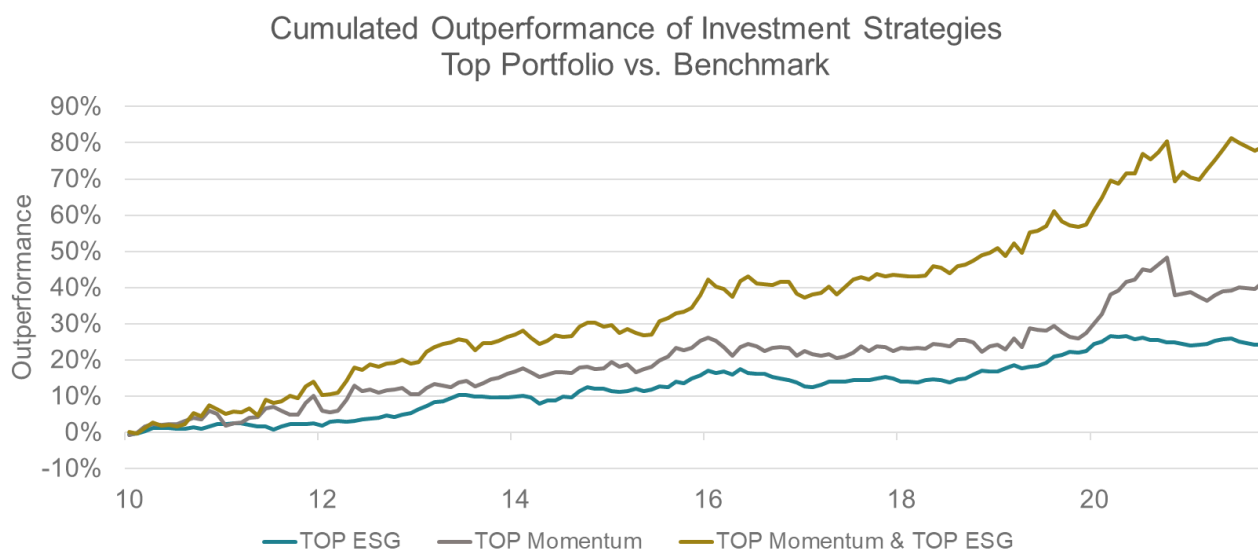
Sources: HQAM, S&P Capital IQ, MSCI

The problem

- There is no such thing as an ESG metric, not even a single path to a sustainable equity portfolio.
- When selecting stocks, product providers and investors rely on three different approaches: exclusion lists, positive lists and best-in-class.
- The ESG information is mostly viewed in isolation. This means that there is a risk that investors will choose companies with a good ESG score but poor balance sheet quality - a rather poor interaction of factors.

The solution

- In addition to the three approaches, it makes more sense to use the ESG information as part of a holistic company analysis.
- The diagram shows how something like this can look in practice with three different investment strategies. The best invests in companies that have a top ESG score and a high price momentum at the same time - a very good interaction.
- Investors who only bet on one of these two criteria would have done worse.
- However, the price momentum in the future does not have to result in the best ESG combination, after all there are over 200 factors - a case for AI.

Technical terms explained

ESG exclusion lists (blacklist): Companies are excluded based on criteria. For example, when a company is active in controversial business areas.

ESG positive lists (whitelist): Companies are selected on the basis of criteria. For example, when a company makes a positive contribution to sustainability.

ESG best-in-class: companies are sorted and selected based on criteria in descending order. For example, all companies with a top ESG rating are selected.

Factor: A factor is a key figure according to which companies are sorted. Examples:
- business indicators: performance indicators (EBIT), liquidity indicators (cash ratio), profitability indicators (return on sales), etc.
- technical metrics: price momentum, volatility, etc.
- valuation metrics: price / earnings ratio, etc.

Factor-based investing: With factor-based investing, you regularly, usually monthly, sort all companies according to a factor. The top companies are selected. The system also applies to bonds and other asset classes.

Interactions (of factors): Companies are selected based on the combination of several factors. For example, all companies that have a high momentum and a high ESG rating at the same time are selected.

AI: AI stands for artificial intelligence. AI methods can analyze a large amount of data quickly and efficiently. This makes them ideal for use in asset management, as many scientific studies have shown. The basics of computationally intensive AI methods have been researched for decades. The simple and fast availability of large computing power has greatly accelerated the use of AI over the past ten years.

Details of the empirical analysis

- The analysis refers to the European equity universe (MSCI Europe, excluding financials)
- The calculation period runs from January 31, 2010 to October 31, 2021.
- The following applies to every company: Price momentum is calculated based on the performance of the last 12 months, excluding the last month. ESG is calculated based on the MSCI ESG scores.
- The factors are calculated on a monthly basis, adjusted for sector effects.
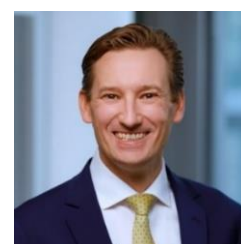- The top portfolio consists of companies that rank among the highest 30%.

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To the background:

It's no secret that favorites change on the stock exchange - sometimes stocks with a low P / E ratio are in demand, sometimes with high dividends, sometimes small and sometimes large caps. HQ Asset Management (HQAM) deals very intensively with such factors. As part of the research process, HQAM uses artificial intelligence to analyze around 200 factors every month and determine which have been able to best explain the price development of the individual stocks recently - and should continue to do so.

The research team analyzes one of these factors under the heading "HQAM factor of the month". The experts at HQ Asset Management explain the background and context and point out special features that can support investors in putting their portfolio together.

To HQAM:

HQAM is one of the financial service providers of the Harald Quandt family. The company offers a clear focus on quantitative asset management for institutional and semi-institutional investors. As the next generation asset manager, HQAM relies on the use of modern technology, alternative data and methods of artificial intelligence when making investment decisions.

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