ESG 2023: Greenwashing or Source of Alpha?

April 2023

Private & Confidential

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When entering the world of **ESG**, we can fall into an abyss of terminology, extreme currents of thought, emerging regulation, and a lot of marketing.

However, ESG is something that every investor should at least be aware of and have on their horizon for a multitude of reasons.

Regarding portfolio management, how do we know whether ESG has a future? Let's ask **ChatGPT-3,** now that it is so fashionable. If you're not familiar with this AI Chatbot yet, many people are already calling it the new Google. Go ahead and try it!

J is ESG important when you build a portfolio

Yes, ESG (environmental, social, and governance) factors can be important when building a portfolio. These factors can impact a company's performance and can be used to identify potential risks and opportunities. Investors may choose to consider ESG factors when building a portfolio in order to align their investments with their personal values and to potentially improve the long-term sustainability and performance of their portfolio.

J Is there a consensus on which ESG scores to use?

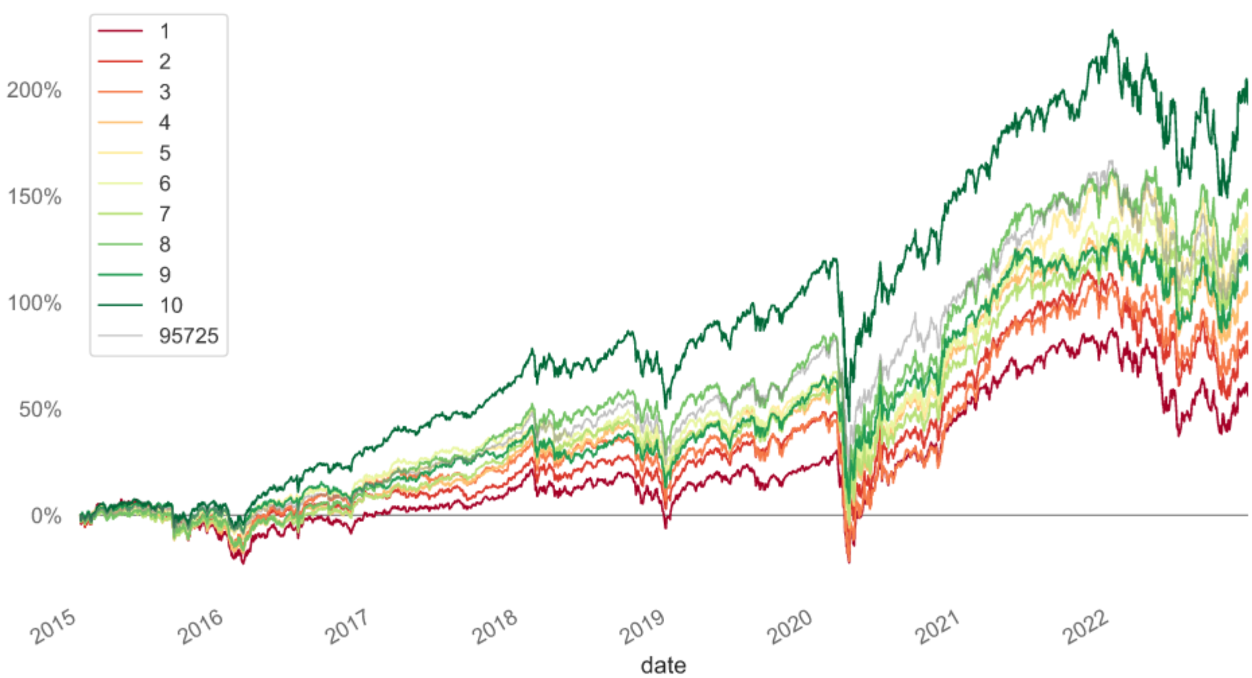
There is no consensus on which ESG scores to use when evaluating a company's performance on environmental, social, and governance factors. Different organizations may use different methodologies to assess a company's ESG performance, and these scores can vary depending on the specific metrics and weightings used in the calculation. It is important for investors to understand the methodology and criteria used by a particular scoring system in order to accurately interpret the resulting scores.

It seems clear that ChatGPT should be taken seriously, but at the same time, there is still no single reliable source of data, which makes it much more challenging for us as data analysts. In addition, this **lack of convergence** between data providers generates a lot of mistrust and leads many to label ESG scoring as “**greenwashing** “.

How Was 2022 for the ESG Factor?

Let’s dig a little deeper. It is well known that when we look at the long-term factor and use the appropriate **materiality matrices**, the ESG risk factor is exploitable and generates alpha for investors.

Cumulative Returns



Decile test on the S&P 500 universe (id=95725), where 1 is a portfolio of the companies with the worst ESG risk metrics and 10 includes companies with the best ESG risk scores. Weights are equally distributed and rebalanced monthly since 2015.

For 2022, if we take the S&P index for example and compare it to its S&P500 ESG counterpart, we could say that this was a flat year for the ESG factor, since their respective performances were almost exactly the same. At this juncture, the reader is encouraged to read the methodology used to create the ESG index, so as not to draw conclusions based on its name alone.

Performance Evolution

Summary

NAME	ANNUALIZED RETURN	VOLATILITY	DD	MDD
S&P 500 ESG Index USD TR Available period (30 Apr 2008 - 7 Dec 2022)	-14.46 %	23.54 %	-16.40 %	-24.59 %
S&P 500 Total Return Index Available period (4 Jan 1988 - 7 Dec 2022)	-14.70 %	23.38 %	-16.72 %	-24.49 %

Comparison between the S&P 500 index and the S&P 500 ESG over the past year.

If, on the other hand, we were solely to rely on opinion articles highlighting ESG's numerous regulatory issues or the runaway success of the energy sector in 2022, which is mostly labeled as anti-ESG, we might conclude that it has been a really bad year for the ESG factor.

Remember We are Quantitative Analysts

Okay, let's cast aside the opinions and consider the evidence. **Has the ESG factor been exploitable in the last year?**

The answer is an absolute **YES**; companies with the best ESG metrics – let's not forget that governance (G) is one of its main pillars – have outperformed those with the worst metrics.

Cumulative Returns

Decile test on the S&P 500 universe (id=95725), where 1 is a portfolio of the companies with the worst ESG risk metrics and 10 are the companies with the best ESG risk scores. Weights are equally weighted and monthly rebalancing over the last 12 months.

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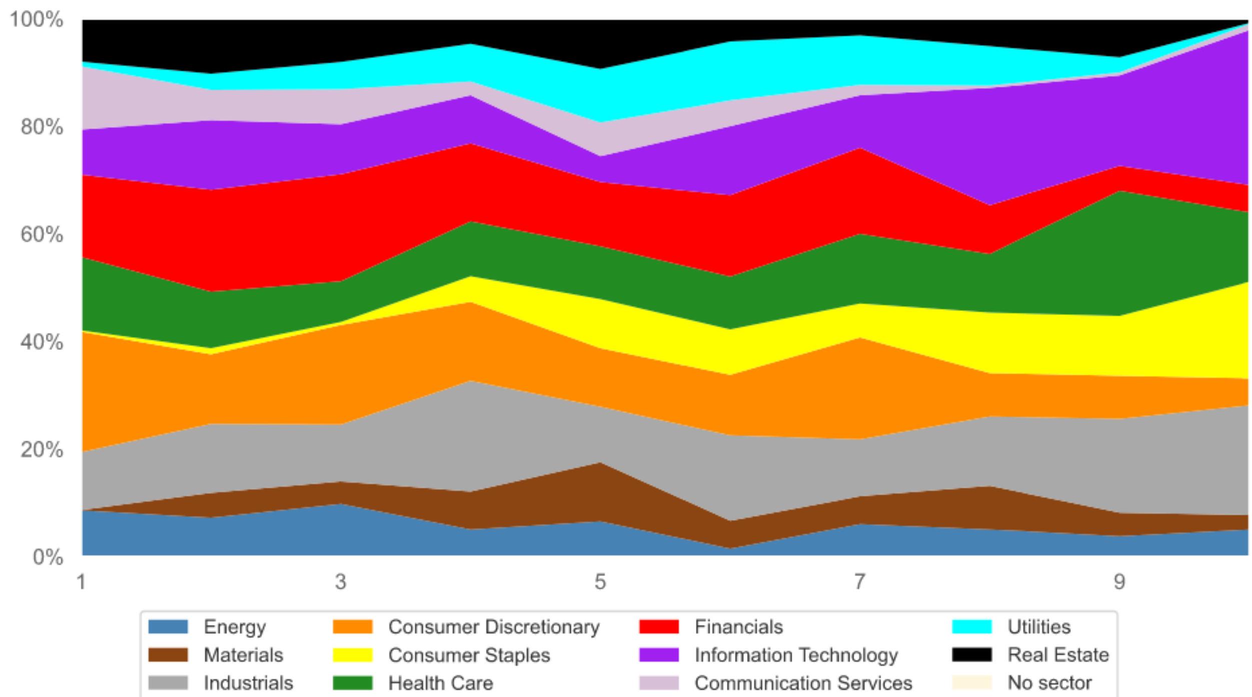
In addition, good data providers such as Clarity AI treat each sector individually by normalizing *a posteriori*, in order to have more comparable metrics between companies. This makes the distribution of sectors during testing unbiased.

Mean Sector Exposures



Current exposure to the different sectors of the GICs classification of each portfolio in the decile test.

In conclusion, 2022 has been a good year for those who have privileged high ESG metrics in their decision-making, **adding alpha in addition to investing consciously.**

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